

INTERNATIONAL MICROCOMPUTER SOFTWARE INC /CA/  
Form 10QSB  
February 14, 2005

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

**FORM 10-QSB**

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

For the quarterly period ended **December 31, 2004**

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 0-15949

**INTERNATIONAL MICROCOMPUTER SOFTWARE, INC.**

(Exact name of Small business issuer in its charter)

**CALIFORNIA**

(State or other jurisdiction of incorporation or  
organization)

**94-2862863**

(I.R.S. Employer Identification No.)

**100 ROWLAND WAY, NOVATO, CALIFORNIA**

(Address of principal executive offices)

**94945**

(Zip code)

**(415) 878-4000**

Issuer's telephone number

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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 **February 8, 2005**, **28,253,507** Shares of Issuer's common stock, no par value, were outstanding.

Transitional Small Business Disclosure Format: YES  NO

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**INTERNATIONAL MICROCOMPUTER SOFTWARE, INC.  
AND SUBSIDIARIES**

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**PART I - FINANCIAL INFORMATION****Item 1- Condensed Consolidated Financial Statements****INTERNATIONAL MICROCOMPUTER SOFTWARE, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS**

(In thousands, except share amounts)

|  | <b>December 31,<br/>2004</b> | <b>June 30, 2004</b> |
|--|------------------------------|----------------------|
|  | <b>Unaudited</b>             |                      |
| <b>ASSETS</b>  |                              |                      |
| <b>Current assets:</b>   |                              |                      |
| Cash and cash equivalents  | \$ 2,804                     | \$ 3,212             |
| Investment in marketable securities  | 2,548                        | 2,151                |
| Receivables, less allowances for doubtful accounts, discounts and returns of \$908 and \$958 | 2,646                        | 2,522                |
| Inventories, net of reserves for obsolescence of \$123 and \$123                             | 1,088                        | 1,122                |
| Receivables, other (related to discontinued operations)                                      | --                           | 1,000                |
| Note receivable from related party   | 325                          | 350                  |
| Other current assets   | 691                          | 552                  |
| Assets related to discontinued operations  | 499                          | 828                  |
| <b>Total current assets</b>  | <b>10,601</b>                | <b>11,737</b>        |
| <b>Fixed assets, net</b>   | <b>613</b>                   | <b>637</b>           |
| <b>Intangible Assets</b>   |                              |                      |
| Capitalized software, net  | 2,815                        | 2,748                |
| Domain names, net  | 1,964                        | 1,566                |
| Trademarks   | 710                          | 709                  |
| Distribution rights, net   | 543                          | 594                  |
| Capitalized customer lists   | 940                          | 843                  |
| Goodwill   | 8,829                        | 7,559                |
| <b>Total intangible assets</b>   | <b>15,801</b>                | <b>14,019</b>        |
| <b>Other assets:</b>   |                              |                      |
| Prepaid expenses   | 73                           | 99                   |
| Investment in securities   | --                           | 1,771                |
| <b>Total other assets</b>  | <b>73</b>                    | <b>1,870</b>         |
| <b>TOTAL ASSETS</b>  | <b>\$ 27,088</b>             | <b>\$ 28,263</b>     |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                              |                      |
| <b>Current liabilities:</b>  |                              |                      |
| Short term debt  | \$ 2,360                     | \$ 3,557             |
| Trade accounts payable   | 2,137                        | 2,375                |
| Accrued and other liabilities  | 1,199                        | 1,751                |
| Liabilities related to discontinued operations   | 42                           | 397                  |
| <b>Total current liabilities</b>   | <b>5,738</b>                 | <b>8,080</b>         |
| Long-term debt and other obligations   | 1,842                        | 2,318                |
| <b>Total liabilities</b>   | <b>7,580</b>                 | <b>10,398</b>        |

**Shareholders' Equity**

Common stock, no par value; 300,000,000 authorized; 28,248,507 issued and outstanding on December 31, 2004 and 26,261,829 issued and outstanding on June 30, 2004

|   |                  |                  |
|---|------------------|------------------|
|   | 43,335           | 41,512           |
| Accumulated deficit                               | (23,723)         | (23,577)         |
| Accumulated other comprehensive loss              | (104)            | (70)             |
| <b>Total shareholders' equity</b>                 | <b>19,508</b>    | <b>17,865</b>    |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b> | <b>\$ 27,088</b> | <b>\$ 28,263</b> |

See Notes to Condensed Consolidated Financial Statements

**INTERNATIONAL MICROCOMPUTER SOFTWARE, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS and COMPREHENSIVE**  
**INCOME/(LOSS)**

(In thousands, except per share amounts)  
(Unaudited)

|  | Three Months Ended December |               | Six Months Ended December 31, |                |
|--|-----------------------------|---------------|-------------------------------|----------------|
|  | 2004                        | 31,<br>2003   | 2004                          | 2003           |
| Net revenues   | \$ 6,019                    | \$ 2,356      | \$ 11,713                     | \$ 3,977       |
| Product costs  | 1,604                       | 789           | 3,119                         | 1,363          |
| <b>Gross margin</b>  | <b>4,415</b>                | <b>1,567</b>  | <b>8,594</b>                  | <b>2,614</b>   |
| <b>Costs and expenses</b>  |                             |               |                               |                |
| Sales and marketing  | 2,536                       | 887           | 4,829                         | 1,485          |
| General and administrative                                       | 1,257                       | 964           | 2,391                         | 1,621          |
| Research and development   | 994                         | 452           | 2,033                         | 860            |
| <b>Total operating expenses</b>                                  | <b>4,787</b>                | <b>2,303</b>  | <b>9,253</b>                  | <b>3,966</b>   |
| <b>Operating loss</b>  | <b>(372)</b>                | <b>(736)</b>  | <b>(659)</b>                  | <b>(1,352)</b> |
| <b>Other income and (expense)</b>                                |                             |               |                               |                |
| Interest and other, net  | --                          | 60            | 18                            | 142            |
| Realized / unrealized gain on marketable securities              | 471                         | 47            | 422                           | 177            |
| Gain on sale of product line                                     | 33                          | --            | 33                            | --             |
| Gain (loss) on extinguishment of debt                            | --                          | (5)           | --                            | 76             |
| <b>Income (loss) before income tax</b>                           | <b>132</b>                  | <b>(634)</b>  | <b>(186)</b>                  | <b>(957)</b>   |
| Income tax (expense) benefit                                     | (3)                         | 6             | (8)                           | 10             |
| <b>Income (loss) from Continuing Operations</b>                  | <b>129</b>                  | <b>(628)</b>  | <b>(194)</b>                  | <b>(947)</b>   |
| Income (loss) from discontinued operations, net of income tax    | --                          | 30            | (5)                           | (51)           |
| Gain from the sale of discontinued operations, net of income tax | --                          | 1,000         | 53                            | 1,000          |
| <b>Net income (loss)</b>   | <b>\$ 129</b>               | <b>\$ 402</b> | <b>(\$146)</b>                | <b>\$ 2</b>    |
| <b>Other comprehensive loss</b>                                  |                             |               |                               |                |
| Foreign currency translation adjustments                         | (24)                        | (28)          | (34)                          | (32)           |
| <b>Comprehensive income (loss)</b>                               | <b>\$ 105</b>               | <b>\$ 374</b> | <b>(\$180)</b>                | <b>(\$30)</b>  |
| <b>Basic income (loss) per share</b>                             |                             |               |                               |                |
| Income (loss) from continuing operations                         | \$0.00                      | (\$0.02)      | (\$0.01)                      | (\$0.03)       |
| Income (loss) from discontinued operations, net of income tax    | --                          | \$0.00        | (\$0.00)                      | (\$0.01)       |
|  | --                          | \$0.04        | \$0.00                        | \$0.04         |

Gain from the sale of discontinued operations, net of income tax

|                   |        |      |          |        |
|-------------------|--------|------|----------|--------|
| Net income (loss) | \$0.00 | 0.02 | (\$0.01) | \$0.00 |
|-------------------|--------|------|----------|--------|

**Diluted income (loss) per share**

|  |        |          |          |          |
|--|--------|----------|----------|----------|
| Income (loss) from continuing operations | \$0.00 | (\$0.02) | (\$0.01) | (\$0.03) |
|--|--------|----------|----------|----------|

|   |    |        |          |          |
|---|----|--------|----------|----------|
| Income (loss) from discontinued operations, net of income tax | -- | \$0.00 | (\$0.00) | (\$0.01) |
|---|----|--------|----------|----------|

|  |    |        |        |        |
|--|----|--------|--------|--------|
| Gain from the sale of discontinued operations, net of income tax | -- | \$0.04 | \$0.00 | \$0.04 |
|--|----|--------|--------|--------|

|                   |        |        |          |        |
|-------------------|--------|--------|----------|--------|
| Net income (loss) | \$0.00 | \$0.02 | (\$0.01) | \$0.00 |
|-------------------|--------|--------|----------|--------|

|  |        |        |        |        |
|--|--------|--------|--------|--------|
| Shares used in computing basic earnings (loss) per share information | 27,916 | 23,268 | 27,605 | 23,223 |
|--|--------|--------|--------|--------|

|  |        |        |        |        |
|--|--------|--------|--------|--------|
| Shares used in computing diluted earnings (loss) per share information | 29,885 | 23,268 | 27,605 | 23,223 |
|--|--------|--------|--------|--------|

See Notes to Condensed Consolidated Financial Statements

**INTERNATIONAL MICROCOMPUTER SOFTWARE, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**

Six Months ended December 31, 2004

(In thousands)

(Unaudited)

|   | Common Stock  |                  | Accumulated       | Accumulated<br>Other<br>Comprehensive | Total            |
|---|---------------|------------------|-------------------|---------------------------------------|------------------|
|   | Shares        | Amount           | Deficit           | Loss                                  |                  |
| <b>Balance at June 30, 2004</b>   | <b>26,262</b> | <b>\$ 41,512</b> | <b>(\$23,577)</b> | <b>(\$70)</b>                         | <b>\$ 17,865</b> |
| Issuance of common stock related to:  |               |                  |                   |                                       |                  |
| Warrants exercised  | 125           | 26               |                   |                                       | 26               |
| Stock options exercised   | 222           | 111              |                   |                                       | 111              |
| Acquisitions  | 1,640         | 1,602            |                   |                                       | 1,602            |
| Issuance of warrants related to:  |               |                  |                   |                                       |                  |
| Consulting services rendered  |               | 13               |                   |                                       | 13               |
| Acquisitions  |               | 8                |                   |                                       | 8                |
| Issuance of stock options related to:   |               |                  |                   |                                       |                  |
| Consulting services rendered  |               | 2                |                   |                                       | 2                |
| Acquisitions  |               | 66               |                   |                                       | 66               |
| Variable accounting adjustment<br>related to stock options previously<br>issued |               | (5)              |                   |                                       | (5)              |
| Net loss  |               |                  | (146)             |                                       | (146)            |
| Foreign currency translation<br>adjustment                                      |               |                  |                   | (34)                                  | (34)             |
| <b>Balance at December 31, 2004</b>   | <b>28,249</b> | <b>\$ 43,335</b> | <b>(\$23,723)</b> | <b>(\$104)</b>                        | <b>\$ 19,508</b> |

See Notes to Condensed Consolidated Financial Statements

**INTERNATIONAL MICROCOMPUTER SOFTWARE, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)  
(Unaudited)

|  | Six months ended December 31, |                  |
|--|-------------------------------|------------------|
|  | 2004                          | 2003             |
| <b>Cash flows from operating activities:</b>                 |                               |                  |
| <b>Net cash generated (used) by operating activities</b>     | <b>\$ 248</b>                 | <b>(\$2,507)</b> |
| <b>Cash flows from investing activities:</b>                 |                               |                  |
| Proceeds from sale of marketable securities                  | 1,780                         | --               |
| Cash released from escrow                                    | 650                           | --               |
| Proceeds from sale of product line                           | 258                           | --               |
| Related party note receivable (DCDC)                         | 25                            | (350)            |
| Acquisition of business, net of cash acquired                | (1,357)                       | (257)            |
| Cash transferred to escrow                                   | (499)                         | --               |
| Purchase of trade names, software and domain names           | (172)                         | (13)             |
| Purchase of equipment and furniture                          | (126)                         | (167)            |
| Acquisition of product line                                  | --                            | (1,525)          |
| Investment in marketable securities                          | --                            | (160)            |
| Cash used by discontinued operations in investing activities | --                            | (7)              |
| <b>Net cash generated (used) by investing activities</b>     | <b>559</b>                    | <b>(2,479)</b>   |
| <b>Cash flows from financing activities:</b>                 |                               |                  |
| Settlement of note payable (Imageline)                       | --                            | (160)            |
| Proceeds from short-term borrowings                          | 400                           | --               |
| Repayments of Contractual Liabilities                        | (1,718)                       | (109)            |
| Warrants exercised   | 26                            | 65               |
| Options exercised  | 111                           | 71               |
| Cash used by discontinued operations in financing activities | --                            | --               |
| <b>Net cash used by financing activities</b>                 | <b>(1,181)</b>                | <b>(133)</b>     |
| Effect of exchange rate change on cash and cash equivalents  | (34)                          | (31)             |
| <b>Net increase (decrease) in cash and cash equivalents</b>  | <b>(408)</b>                  | <b>(5,150)</b>   |
| Cash and cash equivalents at beginning of period             | 3,212                         | 10,399           |
| <b>Cash and cash equivalents at end of the period</b>        | <b>\$ 2,804</b>               | <b>\$ 5,249</b>  |

See Notes to Condensed Consolidated Financial Statements

| (In thousands)  | Six months ended December 31, |      |
|---|-------------------------------|------|
|   | 2004                          | 2003 |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b> |                               |      |
| Interest paid   | \$125                         | \$0  |

**SUPPLEMENTAL DISCLOSURE OF NON-CASH FINANCING ACTIVITIES**



|   |         |       |
|---|---------|-------|
| Notes payable incurred in conjunction with acquisitions | \$505   | \$833 |
| Capital stock issued in conjunction with acquisitions   | \$1,602 | \$77  |

See Notes to Condensed Consolidated Financial Statements

**INTERNATIONAL MICROCOMPUTER SOFTWARE, INC. AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Basis of Presentation**

The interim condensed consolidated financial statements have been prepared from the records of International Microcomputer Software, Inc. and Subsidiaries ("IMSI") without audit. All significant inter-company balances and transactions have been eliminated in consolidation. In the opinion of management, all adjustments, which consist of only normal recurring adjustments, to present fairly the financial position at December 31, 2004 and the results of operations and cash flows for the three and six months ended December 31, 2004 and 2003, have been made. The interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in our Annual Report on Form 10-KSB as amended for the fiscal year ended June 30, 2004. The results of operations for the three and six months ended December 31, 2004 are not necessarily indicative of the results to be expected for any other interim period or for the full year.

**2. Use of Estimates**

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States ( GAAP ). These accounting principles require us to make certain estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions upon which we rely are reasonable based upon information available to us at the time that these estimates, judgments and assumptions are made. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities as of the date of the financial statements as well as the reported amounts of revenues and expenses during the periods presented. Our financial statements would be affected to the extent there are material differences between these estimates and actual results. In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP and does not require management's judgment in its application. There are also areas in which management's judgment in selecting any available alternative would not produce a materially different result.

**3. Discontinued Operations**

**Gain from the sale of discontinued operations, net of income tax**

As previously disclosed in our annual report on Form 10-KSB, as amended, for the fiscal year ended June 30, 2004, we sold the assets and customer related liabilities of our wholly owned subsidiary Keynomics, Inc. in July 2004. We evaluated the Keynomics business segment and its long term prospects during the fourth quarter of fiscal 2004 and with our focus on direct marketing and the on-line distribution of utilities and precision design content, we determined that Keynomics no longer represented a strategic fit for our company. The \$53,000 gain from the sale of discontinued operations for the six months ended December 31, 2004 relate to the sale of Keynomics during the quarter ended September 30, 2004 and represent the excess of the total consideration received over its net carrying value.

During the quarter ended December 31, 2003, we recorded a gain of \$1.0 Million from the sale of discontinued operations representing the successful achievement of the first earn-out from the sale of ArtToday to Jupitermedia Corporation in June 2003.

**Income (loss) from discontinued operations, net of income tax**

The amounts reported for the three and six months ended December 31, 2004 and 2003 as discontinued operations represent the pre-tax results of operations for Keynomics. This segment had pre-tax net gain of \$30,000 for the quarter ended December 31, 2003 and pre-tax losses of \$5,000 and \$51,000 for the six months ended December 31, 2004 and

2003 respectively. These losses were derived from net revenues of \$319,000 for the quarter ended December 31, 2003 and \$68,000 and \$478,000 for the six months ended December 31, 2004 and 2003 respectively.

#### **4. Acquisitions**

The table below details the consideration paid for acquisitions and amendments to prior acquisitions, completed during the six month period ended December 31, 2004 and the allocation of that consideration to the tangible and intangible assets acquired.

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Table I-1-4

|                                    | <b>Precision Design<br/>Solutions<br/>Segment<br/>Aggregated Non<br/>Material<br/>Transactions</b> | <b>Consumer and<br/>Business<br/>Software<br/>Solutions<br/>Segment<br/>Aggregated<br/>Non Material<br/>Transactions</b> |                                  |
|------------------------------------|--|--|----------------------------------|
| <b>Consideration</b>               |  |  |                                  |
| Cash                               | \$ 1,318   | \$ 50  |                                  |
| Escrowed cash                      | 75   | 0  |                                  |
| Notes                              | 300  | 205  |                                  |
| Common stock                       | 503  | 65   |                                  |
| Derivative securities              | 0  | 65   |                                  |
| Less: Cash on hand                 | (104)  | 0  |                                  |
| Legal & escrow fees                | 33   | 0  |                                  |
| Broker fees (cash & warrants)      | 43   | 0  |                                  |
| <b>Total Consideration</b>         | <b>2,168</b>   | <b>385</b>   |                                  |
|                                    |  |  | <b>Estimated<br/>Useful Life</b> |
| <b>Purchase Price Allocation</b>   |  |  |                                  |
| <b>Assumed liabilities</b>         | <b>(125)</b>   | <b>0</b>   |                                  |
| <b>Tangible Assets</b>             |  |  |                                  |
| Inventory                          | 1  | 0  |                                  |
| Prepaid expenses                   | 12   | 0  |                                  |
| Accounts receivable                | 8  | 0  |                                  |
| <b>Total Tangible Assets</b>       | <b>21</b>  | <b>0</b>   |                                  |
| <b>Intangible Assets</b>           |  |  |                                  |
| <b>Identifiable Assets</b>         |  |  |                                  |
| Customer list                      | 220  | 0  | 3 years                          |
| Domain names                       | 603  | 0  | 5 years                          |
| Software development costs         | 0  | 0  | 5 years                          |
| <b>Total Identifiable Assets</b>   | <b>823</b>   | <b>385</b>   |                                  |
| <b>Unidentifiable Assets</b>       |  |  |                                  |
| Goodwill                           | 1,449  | 0  | Indefinite                       |
| <b>Total Unidentifiable Assets</b> | <b>1,449</b>   | <b>0</b>   |                                  |
| <b>Total Intangible Assets</b>     | <b>2,229</b>   | <b>385</b>   |                                  |
| <b>Total</b>                       | <b>\$ 2,168</b>  | <b>\$ 385</b>  |                                  |

**Acquisition of Abbissoft House Plans, Inc.**

As previously disclosed in our quarterly report on Form 10-QSB for the quarter ended September 30, 2004, we completed a stock purchase agreement on September 28, 2004 whereby we acquired all the outstanding stock of Abbisoft House Plans, Inc. ( Abbisoft ), an on-line provider of stock house plans which operates the www.Homeplanfinder.com website. The consideration for the acquisition was paid in a combination of cash, notes payable (secured by the acquired business) and 500,000 unregistered IMSI common shares valued at \$1.0067 per share.

This transaction was not deemed to be a material business combination, therefore, no pro forma results are required under the Statement of Financial Accounting Standards No. 141. We do not expect the goodwill associated with this acquisition to be deductible for tax purposes.

### **Amendment to the Allume Acquisition**

In September 2004, IMSI and Aladdin Systems Holdings, Inc ( Aladdin Holdings ) amended the portion of the purchase agreement which called for earn-outs to be paid based on the achievement of certain revenue targets (under the terms of the original purchase agreement between us and Aladdin Holdings signed on April 18, 2004, cash earn-out payments could have been earned, up to an aggregate of \$2,000,000, based on net revenues derived from Aladdin for the three consecutive twelve-month periods following the Closing Date). With the amendment, the earn-out payments were converted from contingent obligations to fixed obligations as follows:

- The first earn out payment of \$666,667 which could have been due on April 19, 2005 became fully earned as of the amendment date and will be payable on June 2, 2005.
- The second and third earn-out payments were terminated in consideration of the issuance of shares of the common stock of IMSI priced as of the closing bid price on the date of the amendment. As a result, during the first quarter of Fiscal Year 2005, we issued to Aladdin Holdings an additional 1,065,807 shares of our common stock, with a value of \$1,033,867, pursuant to a transaction exempt from registration under Section 4(2) of the Securities Act.

Consequently, as of June 30, 2004, we amended the purchase price of the Allume acquisition to include the \$1.7 million value of the fixed obligations described above. This additional amount was allocated to goodwill. We do not expect the goodwill associated with this acquisition to be deductible for tax purposes.

As part of the same agreement, Aladdin Holdings agreed to modify the date by which we were required to file the registration statement on Form SB- 2 to register the common stock that Aladdin Holdings received from us as part of the original agreement from ninety (90) days from the Closing Date to September 30, 2004. Additionally, Aladdin Holdings agreed to modify the date by which the registration statement was required to be declared effective by the SEC from one hundred and eighty (180) days from the Closing Date to March 31, 2005. We filed the registration statement with the SEC on September 29, 2004 and it was declared effective on November 4, 2004, fulfilling our obligations under this agreement.

### **5. Note Receivable from Related Party - DCDC 15% Note**

On September 18, 2003, we received a 15% one-year note from Digital Creative Development Corporation ( DCDC ) upon extending a loan to DCDC in the amount of \$350,000 secured by 400,000 shares of IMSI s stock held by DCDC and due on September 18, 2004. Concurrent with this note, DCDC repaid the entire principal portion of a \$50,000 note, made in favor of IMSI on February 25, 2003. That note, due on February 25, 2004, was unsecured and carried a 4% interest rate. The note had been previously recorded as a fully reserved receivable as it was unsecured. The reversal of the reserve upon the repayment of this note was consequently accounted for as other income during the first quarter of fiscal 2004.

On September 18, 2004, we amended the terms of the \$350,000 promissory note with DCDC extending the maturity of the note to May 31, 2005. The accrued interest which was earned through September 18, 2004 was paid in full on October 1, 2004 in addition to a principal payment in the amount of \$25,000. Additionally, DCDC agreed to increase the collateral attached to the note by assigning to IMSI its interest in a private equity investment.

On January 31, 2005, we sold the above referenced promissory note to Mag Multi Corp ( Mag Multi ), a New York corporation for \$343,000, representing the principal balance and all accrued interest as of the date of the transfer.



## 6. Debt

The following table details our outstanding debt as of December 31, 2004:

**Table I-1-6**

|  | <b>As of<br/>December<br/>31, 2004</b> |
|--|--|
| <b>Short-Term</b>  |  |
| Acquisition related notes                                      |  |
| Aladdin Systems Holdings, Inc                                  | \$ 1,666                               |
| All other acquisition related obligations                      | 423                                    |
| <b>Subtotal</b>  | <b>2,089</b>                           |
| Short term financing (secured by selected accounts receivable) | 261                                    |
| Other Short term obligation                                    | 10                                     |
| <b>Subtotal Short Term</b>                                     | <b>2,360</b>                           |
| <b>Long-Term</b>   |  |
| Acquisition related notes                                      |  |
| Aladdin Systems Holdings, Inc                                  | 1,500                                  |
| All other acquisition related obligations                      | 342                                    |
| <b>Subtotal Long Term</b>                                      | <b>1,842</b>                           |
| <b>Grand Total</b>   | <b>\$ 4,202</b>                        |

## 7. Fair Value of Financial Instruments

The fair value of cash and cash equivalents, trade receivables, trade payables and debt approximates carrying value due to the short maturity of such instruments.

As of December 31, 2004 we had \$2.5 million classified under investments in marketable securities on our balance sheet representing the market value of our investment portfolio.

The total consideration related the sale of ArtToday to Jupitermedia in June 2003 included 250,000 shares of Jupitermedia common stock. The ArtToday purchase agreement originally called for these shares to be held in escrow until December 30, 2005. However, at our discretion, we had the ability to replace all, or a portion of, the common stock held in escrow with cash in an amount equal to the closing market value, at June 30, 2003, of the common stock to be replaced.

In February 2004, pursuant to an amended escrow agreement, Jupitermedia agreed to release from the escrow account, without additional cash consideration, 125,000 of the original 250,000 shares that were tendered as part of the consideration in the sale of ArtToday.

During the quarter ended September 30, 2004, we substituted approximately \$500,000 (recorded as Assets from Discontinued Operations) in cash for the remaining 125,000 shares of Jupitermedia. This amount will be released to us, net of any claims, on December 30, 2005.

After their release from the escrow account the Jupitermedia shares stock were deposited into our marketable securities account and were sold as market conditions allowed. We did not hold any shares of Jupitermedia common stock as of December 31, 2004.



In addition to the shares referenced above, the escrow account also included \$1.3 million in cash to be released in two equal installments in June 2004 and December 2004. On December 30, 2004, we received the second payment of \$650,000 that was held in escrow in connection to the ArtToday sale to Jupitermedia.

The first payment of \$650,000 was released to us on June 30, 2004 of which approximately \$42,000 was paid to the former minority shareholders of ArtToday.

The remaining \$650,000 escrow balance was released to us on December 30, 2004 in addition to accrued interest. Approximately \$42,000 of the remaining cash in escrow was due to the former minority shareholders of ArtToday and was paid to them in January 2005.

**8. Gain / (loss) on marketable securities**

The following table details the net gain on marketable securities that we recognized during the three and six months ended December 31, 2004:

**Table I-1-8**

| Description                         | Gain (loss) on marketable securities for the three months ended December 31, 2004 |  |  |                                    |               |
|-------------------------------------|---|--|--|------------------------------------|---------------|
|                                     | Realized  |  | Unrealized   |                                    | Total         |
|                                     |   | Reversal of unrealized gain / (loss) recognized in prior periods | Unrealized gain / (loss) for the quarter ended December 31, 2004 | Sub total Unrealized gain / (loss) |               |
| Jupitermedia common stock           | \$ 1,050  | (\$1,050)  | \$ 0   | (\$1,050)                          | \$ 0          |
| Other Stock in investment portfolio | 111   | 9  | 351  | 360                                | 471           |
| <b>Total</b>                        | <b>\$ 1,161</b>   | <b>(\$1,041)</b>   | <b>\$ 351</b>  | <b>(\$690)</b>                     | <b>\$ 471</b> |

| Description                         | Gain (loss) on marketable securities for the six months ended December 31, 2004 |  |   |                                    |               |
|-------------------------------------|---|--|---|------------------------------------|---------------|
|                                     | Realized  |  | Unrealized  |                                    | Total         |
|                                     |   | Reversal of unrealized gain / (loss) recognized in prior periods | Unrealized gain / (loss) for the six months ended December 31, 2004 | Sub total Unrealized gain / (loss) |               |
| Jupitermedia common stock           | \$ 2,094  | (\$2,097)  | \$ 163  | (\$1,934)                          | \$ 160        |
| Other Stock in investment portfolio | 64  | 92   | 106   | 198                                | 262           |
| <b>Total</b>                        | <b>\$ 2,158</b>   | <b>(\$2,005)</b>   | <b>\$ 269</b>   | <b>(\$1,736)</b>                   | <b>\$ 422</b> |

**9. Segment Information**

We have two reportable operating segments which serve businesses and individuals in the design and consumer markets. The segments are classified in accordance to our product families and generate revenues and incur expenses related to the sale of our software and services. All inter-company amounts are eliminated through consolidation. Certain general and administrative expenses are allocated among our different segments based on each segment contribution to total revenue.

**Table I-1-9**

|  | Three months ended December 31, 2004 |                     |       | Three months ended December 31, 2003 |                     |       |
|--|--------------------------------------|---------------------|-------|--------------------------------------|---------------------|-------|
|  | Precision Design                     | Consumer & Business | Total | Precision Design                     | Consumer & Business | Total |
|  |                                      |                     |       |                                      |                     |       |

|                | Solutions |         | Software Solutions |         | Solutions |                | Software Solutions |         |    |         |    |                |
|----------------|-----------|---------|--------------------|---------|-----------|----------------|--------------------|---------|----|---------|----|----------------|
| Net revenues   | \$        | 2,682   | \$                 | 3,337   | \$        | <b>6,019</b>   | \$                 | 1,375   | \$ | 981     | \$ | <b>2,356</b>   |
| Gross margin   |           | 1,671   |                    | 2,744   |           | <b>4,415</b>   |                    | 861     |    | 706     |    | <b>1,567</b>   |
| Operating Loss |           | (\$109) |                    | (\$263) |           | <b>(\$372)</b> |                    | (\$461) |    | (\$275) |    | <b>(\$736)</b> |

|                | Six months ended December 31, 2004 |         |                             |         | Six months ended December 31, 2003 |                |                             |         |       |         |    |                  |
|----------------|------------------------------------|---------|-----------------------------|---------|------------------------------------|----------------|-----------------------------|---------|-------|---------|----|------------------|
|                | Precision Design Solutions         |         | Consumer Software Solutions |         | Precision Design Solutions         |                | Consumer Software Solutions |         | Total |         |    |                  |
| Net revenues   | \$                                 | 4,757   | \$                          | 6,956   | \$                                 | <b>11,713</b>  | \$                          | 2,032   | \$    | 1,945   | \$ | <b>3,977</b>     |
| Gross margin   |                                    | 3,087   |                             | 5,507   |                                    | <b>8,594</b>   |                             | 1,299   |       | 1,315   |    | <b>2,614</b>     |
| Operating Loss |                                    | (\$244) |                             | (\$415) |                                    | <b>(\$659)</b> |                             | (\$729) |       | (\$623) |    | <b>(\$1,352)</b> |

The following table details the geographical breakdown in our net revenues (in thousands). The International sales refer to the revenues from our German and Australian wholly owned subsidiaries, IMSI GmbH and IMSI Australia PTY Ltd, and sales derived from international distribution and republishing agreement we have in Europe (France, England), Asia (Japan and China) and Australia.

**Table I-2-4**

|                        | <b>Three months ended December 31,</b> |             |                 |             |                  |                 |
|------------------------|--|-------------|-----------------|-------------|------------------|-----------------|
|                        | <b>2004</b>                            |             | <b>2003</b>     |             | <b>\$ Change</b> | <b>% change</b> |
|                        | \$                                     | % of total  | \$              | % of total  |                  |                 |
| Domestic sales         | \$ 5,059                               | 84%         | \$ 2,046        | 87%         | \$ 3,013         | 147%            |
| International sales    | 960                                    | 16%         | 310             | 13%         | 650              | 210%            |
| <b>Total Net Sales</b> | <b>\$ 6,019</b>                        | <b>100%</b> | <b>\$ 2,356</b> | <b>100%</b> | <b>\$ 3,663</b>  | <b>155%</b>     |

  

|                        | <b>Six months ended December 31,</b> |             |                 |             |                  |                 |
|------------------------|--------------------------------------|-------------|-----------------|-------------|------------------|-----------------|
|                        | <b>2004</b>                          |             | <b>2003</b>     |             | <b>\$ Change</b> | <b>% change</b> |
|                        | \$                                   | % of total  | \$              | % of total  |                  |                 |
| Domestic sales         | \$ 10,051                            | 86%         | \$ 3,274        | 82%         | \$ 6,777         | 207%            |
| International sales    | 1,662                                | 14%         | 703             | 18%         | 959              | 136%            |
| <b>Total Net Sales</b> | <b>\$ 11,713</b>                     | <b>100%</b> | <b>\$ 3,977</b> | <b>100%</b> | <b>\$ 7,736</b>  | <b>195%</b>     |

### 10. Earnings/ (Loss) per Share

Basic earnings/ (loss) per share is computed using the weighted average number of common shares outstanding during the period. Diluted earnings per share are computed using the weighted average number of common and potentially dilutive securities outstanding during the period. Potentially dilutive securities consist of the incremental common shares issuable upon exercise of stock options and warrants (using the treasury stock method). Potentially dilutive securities are excluded from the computation if their effect is anti-dilutive.

The following table sets forth the computation of basic and diluted earnings/(loss) per share:

**Table I-1-10**

|  | <b>Three months ended</b>          |                                    | <b>Six months ended</b>            |                                    |
|--|------------------------------------|------------------------------------|------------------------------------|------------------------------------|
|  | <b>December 31,</b><br><b>2004</b> | <b>December 31,</b><br><b>2003</b> | <b>December 31,</b><br><b>2004</b> | <b>December 31,</b><br><b>2003</b> |
| <b>Numerator:</b>  |                                    |                                    |                                    |                                    |
| Net income (loss)  | \$ 129                             | \$ 402                             | (\$146)                            | \$ 2                               |
| Numerator for basic earnings (loss) per share - income (loss) available to common stockholders                             | 129                                | \$ 402                             | (\$146)                            | \$ 2                               |
| Numerator for diluted earnings (loss) per share - income (loss) available to common stockholders after assumed conversions | \$ 129                             | \$ 402                             | (\$146)                            | \$ 2                               |
| <b>Denominator:</b>  |                                    |                                    |                                    |                                    |
|  | 27,916,479                         | 23,268,099                         | 27,605,356                         | 23,223,488                         |

Denominator for basic loss per share -  
weighted average shares outstanding

Effect of dilutive securities using the  
treasury stock method as at December  
31, 2004:

|  |           |    |    |    |
|--|-----------|----|----|----|
| Total Warrants Outstanding -<br>6,633,244      | 1,486,527 | -- | -- | -- |
| Total Stock Options Outstanding -<br>3,247,777 | 481,741   | -- | -- | -- |

Effect of dilutive securities using the  
treasury stock method as at December  
31, 2003:

|  |    |    |    |    |
|--|----|----|----|----|
| Total Warrants Outstanding -<br>7,363,244      | -- | -- | -- | -- |
| Total Stock Options Outstanding -<br>2,058,664 | -- | -- | -- | -- |

|                                  |    |    |    |    |
|----------------------------------|----|----|----|----|
| Dilutive potential common shares | -- | -- | -- | -- |
|----------------------------------|----|----|----|----|

Denominator for diluted loss per  
share - adjusted weighted average  
shares and assumed conversion

|  |            |            |            |            |
|--|------------|------------|------------|------------|
|  | 29,884,747 | 23,268,099 | 27,605,356 | 23,223,488 |
|--|------------|------------|------------|------------|

|                                   |    |      |    |      |          |    |      |
|-----------------------------------|----|------|----|------|----------|----|------|
| Basic earnings/(loss) per share   | \$ | 0.00 | \$ | 0.02 | (\$0.01) | \$ | 0.00 |
| Diluted earnings/(loss) per share | \$ | 0.00 | \$ | 0.02 | (\$0.01) | \$ | 0.00 |

### 11. Stock Based Awards

Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure, an Amendment of FASB Statement No. 123, amends the disclosure requirements of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation ( SFAS 123 ), to require more prominent disclosures in both annual and interim financial statements regarding the method of accounting for stock-based employee compensation and the effect of the method used on reported results.

We account for stock-based compensation plans in accordance with Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees, under which no compensation cost is recognized in the financial statements for employee stock arrangements when grants are made at fair market value. The Company has adopted the disclosure only provisions of SFAS No. 123, Accounting for Stock Based Compensation .

Beginning on January 1, 2006, the Company will adopt the accounting treatment required by FASB Statement No. 123 (revised 2004) which will require the Company to measure all employee stock-based compensation awards using a fair value method and record such expense in the Company's consolidated financial statements.

Under variable plan accounting, we recognize a charge equal to the per share change in the share value until the underlying options expire or are exercised. During the three months ended December 31, 2004 and 2003, we recognized an expense of \$1,737 and a benefit of (\$2,069) respectively related to variable awards. During the six months ended December 31, 2004 and 2003, we recognized a benefit of (\$4,963) and an expense of \$12,735 respectively related to variable awards.

Had compensation cost for the stock-based compensation plans been determined based upon the fair value at grant dates for awards under those plans consistent with the method prescribed by SFAS 123, net income would have been reduced to the pro forma amounts indicated below:

**Table I-1-11**

| <i>(in thousands, except per share amounts)</i>     | <b>Three months Ended December 31,</b> |              | <b>Six months Ended December 31,</b> |                |
|---|--|--------------|--------------------------------------|----------------|
|   | <b>2004</b>                            | <b>2003</b>  | <b>2004</b>                          | <b>2003</b>    |
| <b>Net income (loss), as reported</b>               | \$ 129                                 | \$ 402       | (\$146)                              | \$ 2           |
| Intrinsic compensation charge recorded under APB 25 | 7                                      | 247          | 15                                   | 254            |
| Pro Forma compensation charge under SFAS 123        | (205)                                  | (614)        | (417)                                | (866)          |
| <b>Pro Forma net income (loss)</b>                  | <b>(\$69)</b>                          | <b>\$ 35</b> | <b>(\$548)</b>                       | <b>(\$610)</b> |
| <b>Pro Forma net income (loss) per share:</b>       |  |              |                                      |                |
| Basic as reported                                   | \$ 0.00                                | \$ 0.02      | (\$0.01)                             | \$ 0.00        |
| Basic pro forma                                     | (\$0.00)                               | \$ 0.00      | (\$0.02)                             | (\$0.03)       |
| Diluted as reported                                 | \$ 0.00                                | \$ 0.02      | (\$0.01)                             | \$ 0.00        |
| Diluted pro forma                                   | (\$0.00)                               | \$ 0.00      | (\$0.02)                             | (\$0.03)       |

The weighted average fair values per option as of the grant date for grants made for both the three and six months ended December 31, 2004 were \$0.68 and \$0.74. This compares to \$0.85 and \$0.85, respectively for the three and six months ended December 31, 2003.



## **12. Goodwill**

Total goodwill at December 31, 2004 was \$8.8 million and relates to the acquisitions we consummated during fiscal 2004 and 2005. During the quarter ended September 30, 2004, we eliminated \$179,000 of goodwill related to Keynomics against the gain on the sale of discontinued operations.

In accordance with SFAS No. 142, *Goodwill and Intangible Assets* goodwill is being assessed for impairment annually or more frequently if circumstances indicate impairment. We have not recognized any impairment charges related to goodwill during the six months ended December 31, 2004.

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

#### **Overview**

IMSI is a developer and publisher of software in the precision design, utilities and business applications categories. We offer a wide variety of application software that we market through an array of distribution methods including:

- Direct marketing to consumers and businesses,
- Retail/ Distribution agreements.
- Republishing & OEM agreements.

We are committed to being a leading provider of these applications and services to businesses and consumers.

We believe that consistent growth of both the revenues and operating earnings can be achieved through internally developed products and services and through acquisition. Management believes that good value target companies are present in the marketplace and that business combinations with these entities would help us achieve our growth potential in addition to providing synergies that would improve profitability.

#### **How We Generate Revenue**

We develop, publish, market and sell a variety of software titles and services that are targeted to for a wide array of uses primarily for individuals and small businesses. To efficiently serve our customers and maximize our revenue opportunities, we have aligned our business along two segments as described below:

**Table I-2-1**

| <b>Business Segment</b>           | <b>Product Family</b>     | <b>Product Group</b>       | <b>Selected Product Brand</b>   |
|-----------------------------------|---------------------------|----------------------------|---|
| <b>Precision Design Solutions</b> | Precision Design Software | Professional CAD Solutions | <i>TurboCAD Professional</i><br><i>TurboCADCAM</i><br><i>CADsymbol CD</i><br><i>TurboCAD Deluxe</i> |
|                                   |                           | Consumer CAD Solutions     | <i>DesignCAD</i><br><i>Instant Series</i><br><i>FloorPlan</i><br><i>Houseplans.com</i>              |
|                                   | Precision Design Services | Content                    | <i>Houseplanguys.com</i><br><i>Homeplanfinder.com</i>   |



*CADsymbols.com*

|   |                                       |   |  |
|---|---------------------------------------|---|--|
|   |                                       | Compression, Access and<br>Transmission (CAT) | <i>StuffIt Deluxe &amp; Standard</i>   |
|   | Utilities                             | Security and Internet                         | <i>iClean</i><br><i>Internet Cleanup</i><br><i>SpamCatcher</i><br><i>Spring Cleaning</i><br><i>DragStrip</i><br><i>Ten for X</i> |
| <b>Consumer and<br/>Business Software<br/>Solutions</b> |                                       | Software Compilations                         | <i>Creative Essentials</i><br><i>The Big Mix</i><br><i>FlowCharts &amp; More</i><br><i>FormTool</i>                              |
|   |                                       | Business Solutions                            | <i>OrgChart Professional</i><br><i>QuickStart</i><br><i>TurboProject</i><br><i>Animations &amp; More</i>                         |
|   | Business<br>Applications and<br>Other | Graphics Solutions                            | <i>ClipArt &amp; More</i><br><i>HiJaak</i><br><i>Easy Language</i>   |
|   |                                       | Consumer Solutions                            | <i>Legacy Family Tree</i><br><i>TurboTyping</i>  |

Depending on the product and the customer, we deliver our products either through Electronic Software Downloads (ESD) or as physical products. Our distribution methods are comprised of the following three major channels:

· **Direct Marketing:**

- o ***Direct to Consumer-*** We maintain e-commerce websites and employ a sales force internally and through strategic partnerships to directly sell products to our customers. We conduct direct mail campaigns, both postal and email, for our existing and new products in addition to upgrades of existing products, as well as third-party offers. These mailings generally offer a specially priced product, as well as complementary or enhanced products for a further charge.
- o ***Direct to Businesses-*** We sell certain products and site licenses to businesses including large Fortune 100 companies. We market to these corporations through a combination of telemarketing, direct mail, and e-mailing. We believe that certain of our products and services, particularly TurboCAD, StuffIt, TurboProject, OrgChart Professional and HiJaak, are well suited for use within large corporations.
- **Retail / Distribution-** We are increasing our presence in the retail software market utilizing selected distributors and partners for a number of our products in order to reach a wider range of end users. However, intense price competition along with the intermittent unfavorable retail conditions, including erosion of margins from competitive marketing and high rates of product returns, make this distribution channel increasingly challenging.
- **Republishing / OEM-** We have republishing agreements domestically and internationally which typically include minimum guaranteed royalty payments.

Our ability to develop and distribute products and services and determine the optimum distribution channel for their maximum exposure is a competitive advantage that differentiates us from other players in the industry.

**Forward Looking Statement**

The following information should be read in conjunction with the consolidated financial statements and the notes thereto and in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations in our Fiscal 2004 Form 10-KSB, as amended. This quarterly report on Form 10-QSB, and in particular this Management's Discussion and Analysis of Financial Condition and Results of Operations, may contain forward-looking statements regarding future events or our future performance. These future events and future performance involve certain risks and uncertainties including those discussed in the Other Factors That May Affect Future Operating Results section of this Form 10-QSB, as well as in our Fiscal 2004 Form 10-KSB, as amended, as filed with SEC. Actual events or our actual future results may differ materially from any forward-looking statements due to such risks and uncertainties. We assume no obligation to update these forward-looking statements to reflect actual results or changes in factors or assumptions affecting such forward-looking statements. This analysis is not intended to serve as a basis for projection of future events.

Our consolidated financial statements are prepared in accordance with GAAP. These accounting principles require us to make certain estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions upon which we rely are reasonable based upon information available to us at the time that these estimates, judgments and assumptions are made. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities as of the date of the financial statements as well as the reported amounts of revenues and expenses during the periods presented. Our financial statements would be affected to the extent there are material differences between these estimates and actual results. In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP and does not require management's judgment in its application. There are also areas in which management's judgment in selecting any available alternative would not produce a materially different result.

**Results of Operations**

The following table sets forth our results of operations for the three and six months ended December 31, 2004 and 2003 in absolute dollars and as a percentage of net revenues. It also details the changes from the prior fiscal year in absolute dollars and in percentages.

Table I-2-2

|   | Three months ended December 31, |               |               |                              |              | Six months ended December 31, |               |               |                              |             |              |             |
|---|---------------------------------|---------------|---------------|------------------------------|--------------|-------------------------------|---------------|---------------|------------------------------|-------------|--------------|-------------|
|   | 2004                            | 2003          |               | \$ Change from previous year |              | 2004                          | 2003          |               | \$ Change from previous year |             |              |             |
|   | As % of sales                   | As % of sales | As % of sales | Increase / (Decrease) %      |              | As % of sales                 | As % of sales | As % of sales | Increase / (Decrease) %      |             |              |             |
|   | \$                              | \$            | \$            | \$                           | \$           | \$                            | \$            | \$            | \$                           | \$          |              |             |
| Net revenues  | \$ 6,019                        | 100%          | \$ 2,356      | 100%                         | \$ 3,663     | 155%                          | \$ 11,713     | 100%          | \$ 3,977                     | 100%        | \$ 7,736     | 195%        |
| Product cost  | 1,604                           | 27%           | 789           | 33%                          | 815          | 103%                          | 3,119         | 27%           | 1,363                        | 34%         | 1,756        | 129%        |
| <b>Gross margin</b>                                 | <b>4,415</b>                    | <b>73%</b>    | <b>1,567</b>  | <b>67%</b>                   | <b>2,848</b> | <b>182%</b>                   | <b>8,594</b>  | <b>73%</b>    | <b>2,614</b>                 | <b>66%</b>  | <b>5,980</b> | <b>229%</b> |
| Operating expenses                                  |                                 |               |               |                              |              |                               |               |               |                              |             |              |             |
| Sales & marketing                                   | 2,536                           | 42%           | 887           | 38%                          | 1,649        | 186%                          | 4,829         | 41%           | 1,485                        | 37%         | 3,344        | 225%        |
| General & administrative                            | 1,257                           | 21%           | 964           | 41%                          | 293          | 30%                           | 2,391         | 20%           | 1,621                        | 41%         | 770          | 48%         |
| Research & development                              | 994                             | 17%           | 452           | 19%                          | 542          | 120%                          | 2,033         | 17%           | 860                          | 22%         | 1,173        | 136%        |
| <b>Total operating expenses</b>                     | <b>4,787</b>                    | <b>80%</b>    | <b>2,303</b>  | <b>98%</b>                   | <b>2,484</b> | <b>108%</b>                   | <b>9,253</b>  | <b>79%</b>    | <b>3,966</b>                 | <b>100%</b> | <b>5,287</b> | <b>133%</b> |
| <b>Operating loss</b>                               | <b>(372)</b>                    | <b>-6%</b>    | <b>(736)</b>  | <b>-31%</b>                  | <b>364</b>   | <b>-49%</b>                   | <b>(659)</b>  | <b>-6%</b>    | <b>(1,352)</b>               | <b>-34%</b> | <b>693</b>   | <b>-51%</b> |
| Other Income (expenses)                             |                                 |               |               |                              |              |                               |               |               |                              |             |              |             |
| Interest and other, net                             | --                              | 0%            | 60            | 3%                           | (60)         | -100%                         | 18            | 0%            | 142                          | 4%          | (124)        | -87%        |
| Realized / unrealized gain on marketable securities | 471                             | 8%            | 47            | 2%                           | 424          | 904%                          | 422           | 4%            | 177                          | 4%          | 245          | 138%        |
| Gain on sale of product line                        | 33                              | 1%            | --            | 0%                           | 33           | 100%                          | 33            | 0%            | --                           | 0%          | 33           | 100%        |
| Gain (loss) on extinguishment of debt               | --                              | 0%            | (5)           | 0%                           | 5            | -100%                         | --            | 0%            | 76                           | 2%          | (76)         | -100%       |
| <b>Total other income</b>                           | <b>504</b>                      | <b>8%</b>     | <b>102</b>    | <b>4%</b>                    | <b>402</b>   | <b>395%</b>                   | <b>473</b>    | <b>4%</b>     | <b>395</b>                   | <b>10%</b>  | <b>78</b>    | <b>20%</b>  |
| <b>Income (loss) before income tax</b>              | <b>132</b>                      | <b>2%</b>     | <b>(634)</b>  | <b>-27%</b>                  | <b>766</b>   | <b>-121%</b>                  | <b>(186)</b>  | <b>-2%</b>    | <b>(957)</b>                 | <b>-24%</b> | <b>771</b>   | <b>-81%</b> |
| Income tax benefit                                  | (3)                             | 0%            | 6             | 0%                           | (9)          | -150%                         | (8)           | 0%            | 10                           | 0%          | (18)         | -180%       |

(provision)

**Income loss  
from  
continuing  
operations**

|            |           |              |             |            |              |              |            |              |             |            |             |
|------------|-----------|--------------|-------------|------------|--------------|--------------|------------|--------------|-------------|------------|-------------|
| <b>129</b> | <b>2%</b> | <b>(628)</b> | <b>-27%</b> | <b>757</b> | <b>-121%</b> | <b>(194)</b> | <b>-2%</b> | <b>(947)</b> | <b>-24%</b> | <b>753</b> | <b>-80%</b> |
|------------|-----------|--------------|-------------|------------|--------------|--------------|------------|--------------|-------------|------------|-------------|

Income (loss)  
from  
discontinued  
operations, net  
of income tax

|    |    |    |    |      |       |     |    |      |     |    |      |
|----|----|----|----|------|-------|-----|----|------|-----|----|------|
| -- | 0% | 30 | 1% | (30) | -100% | (5) | 0% | (51) | -1% | 46 | -90% |
|----|----|----|----|------|-------|-----|----|------|-----|----|------|

Gain from the  
sale of  
discontinued  
operations, net  
of income tax

|    |    |       |     |         |       |    |    |       |     |       |      |
|----|----|-------|-----|---------|-------|----|----|-------|-----|-------|------|
| -- | 0% | 1,000 | 42% | (1,000) | -100% | 53 | 0% | 1,000 | 25% | (947) | -95% |
|----|----|-------|-----|---------|-------|----|----|-------|-----|-------|------|

**Net income  
(loss)**

|               |           |               |            |                |             |                |            |             |           |                |               |
|---------------|-----------|---------------|------------|----------------|-------------|----------------|------------|-------------|-----------|----------------|---------------|
| <b>\$ 129</b> | <b>2%</b> | <b>\$ 402</b> | <b>17%</b> | <b>(\$273)</b> | <b>-68%</b> | <b>(\$146)</b> | <b>-1%</b> | <b>\$ 2</b> | <b>0%</b> | <b>(\$148)</b> | <b>-7400%</b> |
|---------------|-----------|---------------|------------|----------------|-------------|----------------|------------|-------------|-----------|----------------|---------------|

**Net Revenues**

The following illustrations of our revenue distribution reflect the allocation of our products across our business segments for the quarters ended December 31, 2004 and 2003 and are indicative of our business model.

**Revenue by Business Segment**

**Graph I-2-1**

**Revenue by Product Family**

**Graph I-2-2**

**Revenue by Distribution Channel**

**Graph I-2-3**

- - -  
- - -  
**Revenues by Business Segment and Distribution Channel**

**Graph I-2-4**

- - -  
-

**Revenues by Product Family and Distribution Channel**

-  
-  
-

Net revenues substantially increased across our product segments for the three and six months ended December 31, 2004 and 2003 as compared the same periods from the previous fiscal year. The following table summarizes the breakdown of our revenues for the periods indicated (all amounts are in thousands except for percentage amounts):

**Table I-2-3**

|                     | Three months ended December 31, |             |                 |             |                 |             |
|---------------------|---------------------------------|-------------|-----------------|-------------|-----------------|-------------|
|                     | 2004                            |             | 2003            |             | Change          |             |
|                     | \$                              | %           | \$              | %           | \$              | %           |
| Consumer & Business |                                 |             |                 |             |                 |             |
| Software Solutions  | \$ 3,337                        | 55%         | \$ 981          | 42%         | \$ 2,356        | 240%        |
| Precision Design    |                                 |             |                 |             |                 |             |
| Solutions           | 2,682                           | 45%         | 1,375           | 58%         | 1,307           | 95%         |
| <b>Net Revenues</b> | <b>\$ 6,019</b>                 | <b>100%</b> | <b>\$ 2,356</b> | <b>100%</b> | <b>\$ 3,663</b> | <b>155%</b> |

|                     | Six months ended December 31, |             |                 |             |                 |             |
|---------------------|-------------------------------|-------------|-----------------|-------------|-----------------|-------------|
|                     | 2004                          |             | 2003            |             | Change          |             |
|                     | \$                            | %           | \$              | %           | \$              | %           |
| Consumer & Business |                               |             |                 |             |                 |             |
| Software Solutions  | \$ 6,956                      | 59%         | \$ 1,945        | 49%         | \$ 5,011        | 258%        |
| Precision Design    |                               |             |                 |             |                 |             |
| Solutions           | 4,757                         | 41%         | 2,032           | 51%         | 2,725           | 134%        |
| <b>Net Revenues</b> | <b>\$ 11,713</b>              | <b>100%</b> | <b>\$ 3,977</b> | <b>100%</b> | <b>\$ 7,736</b> | <b>195%</b> |



### **Consumer & Business Software Solutions Segment**

The Consumer & Business software solutions segment is comprised of the utilities and the business applications and other product families. The increase in revenues in this segment for the three and six months ended December 31, 2004 as compared to the comparable periods from the previous fiscal year was the result of the addition of the utilities product family to this segment upon the acquisition of Allume systems in the fourth quarter of fiscal 2004:

- **Utilities:** The addition of the utility product family (which is comprised mainly of the revenues derived from Allume's products) to the Consumer & Business software solutions segment in the end of the previous fiscal year was the result of our strategy to strengthen our core software development and distribution business to increase the depth and breadth of our portfolio of products. Sales of Allume amounted to \$2.5 million and \$5.1 million, respectively, during the three and six months ended December 31, 2004. We did not have similar revenues to report for the comparable periods from the previous fiscal year.
- **Business Applications and Other:** Historically, the Consumer & Business software solutions segment was comprised only of the Business Applications and Other product family. The decline in sales in this product family during the three and six months ended December 31, 2004 as compared to the same periods of the previous fiscal year was mainly the result of the decline in the sales of OrgPlus (as we are no longer licensed to sell this product) and the decline in the sales of Hijaak as the current version nears the end of its life cycle.

### **Precision Design Solutions Segment**

Sales of our precision design segment increased substantially during the three and six months ended December 31, 2004 as compared to the same periods from the previous year as we grew sales of both product families comprising this segment.

- **Precision Design Software:** The newest version (V 10.5) of our flagship product, TurboCAD, in addition to a focused direct marketing approach to promote its added features and functionalities were the primary factors that helped boost the revenues in the precision design software product family during the three and six months ended December 31, 2004.

Additionally, and as the result of the release of new versions in the beginning of fiscal 2005, revenues from the software titles that we acquired during fiscal 2004 (DesignCAD and the Instant Series) were higher during the three and six months ended December 31, 2004 and contributed to the overall increase in revenues of the precision design segment.

- **Precision Design Services:** As with the Consumer & Business software solutions segment and consistent with our strategy to acquire new products and services in order to improve and diversify our offerings, we introduced this new product family (precision design services) which began to add to the sales of the precision design segment starting in the second quarter of fiscal 2004.

This product family is primarily comprised of the products and services we introduced upon the acquisition in November 2003 of a network of websites hosting an extensive library of over 19,000 unique stock house plans and marketed under [www.houseplans.com](http://www.houseplans.com); and the acquisition of Abbisoft House Plans, Inc. ([www.homeplanfinder.com](http://www.homeplanfinder.com)) which we completed at the end of the first quarter of fiscal 2005. These websites which are targeted to general contractors, consumers and designers offer particularly strong synergies with the precision design software product family. Revenues generated by this product family should continue to grow during the future reporting periods as we continue to focus on improving the branding and marketing of these websites.

Revenues from the Houseplans network of websites was \$897,000 and \$1,499,000 during the three and six months ended December 31, 2004 respectively. This compares to sales of \$111,000 for the three and six months ended December 31, 2003. This represents a 49% sequential increase in revenues due primarily to the addition of the Abbisoft business referred to above.

Internationally, we distribute our products through our wholly owned Australian and German subsidiaries and through distribution and republishing partners in Europe and Asia. The increase in our international revenues during the three and six months ended December 31, 2004 as compared to the same periods from the previous fiscal year was due to the additional international business from Allume's operations, to the improved results of our German subsidiary as market conditions and customer acceptance of our new versions of design products in Europe improved and to the improved performance of our international distribution and republishing partners in Europe.

Revenues from our German subsidiary grew to \$256,000 and \$479,000 for the three and six months ended December 31, 2004, respectively, from \$111,000 and \$249,000, respectively, in the comparable periods from the previous fiscal year.

During fiscal 2003, we licensed the distribution rights of some of our products in Australia to a third party publisher and our revenues from our Australian subsidiary became primarily derived from royalty payments. Revenue from our Australian subsidiary amounted to approximately \$37,000 and \$95,000 for the three and six months ended December 31, 2004, respectively. This compares to revenues of \$20,000 and \$43,000 for the comparable periods from the previous fiscal year.

The following table details the revenue breakdown between the domestic and international markets for the periods indicated.

**Table I-2-4**

|                            | <b>2004</b>     |                   | <b>2003</b>     |                   | <b>\$ Change</b> | <b>% change</b> |
|----------------------------|-----------------|-------------------|-----------------|-------------------|------------------|-----------------|
|                            | <b>\$</b>       | <b>% of total</b> | <b>\$</b>       | <b>% of total</b> |                  |                 |
| <b>Domestic sales</b>      | \$ 5,059        | 84%               | \$ 2,046        | 87%               | \$ 3,013         | 147%            |
| <b>International sales</b> | 960             | 16%               | 310             | 13%               | 650              | 210%            |
| <b>Total Net Sales</b>     | <b>\$ 6,019</b> | <b>100%</b>       | <b>\$ 2,356</b> | <b>100%</b>       | <b>\$ 3,663</b>  | <b>155%</b>     |

  

|                            | <b>2004</b>      |                   | <b>2003</b>     |                   | <b>\$ Change</b> | <b>% change</b> |
|----------------------------|------------------|-------------------|-----------------|-------------------|------------------|-----------------|
|                            | <b>\$</b>        | <b>% of total</b> | <b>\$</b>       | <b>% of total</b> |                  |                 |
| <b>Domestic sales</b>      | \$ 10,051        | 86%               | \$ 3,274        | 82%               | \$ 6,777         | 207%            |
| <b>International sales</b> | 1,662            | 14%               | 703             | 18%               | 959              | 136%            |
| <b>Total Net Sales</b>     | <b>\$ 11,713</b> | <b>100%</b>       | <b>\$ 3,977</b> | <b>100%</b>       | <b>\$ 7,736</b>  | <b>195%</b>     |

We are currently serving the domestic and international retail markets using direct sales, distribution and republishing channels. Low barriers to entry, intense price competition, and business consolidations continue to characterize the consumer software industry. Any one of these factors along with the intermittent unfavorable retail conditions, including erosion of margins from competitive marketing and high rates of product returns, may adversely affect our revenues in the future.

Our international revenues may be affected by the risks customarily associated with international operations, including fluctuations of the U.S. dollar, increases in duty rates, exchange or price controls, longer collection cycles, government regulations, political instability and changes in international tax laws.

### **Product Costs and Gross Margin**

Our product costs include license fees, royalties that we pay to third parties based on sales of published software and content, amortization of capitalized software, the costs of CD-ROM duplication, printing of manuals, packaging and fulfillment, and freight. Costs associated with the return of products, such as refurbishment and the write down in value of returned goods are also included in product costs.

Our gross margin improved significantly to 73% from 67% during the second quarter of fiscal 2005 as compared to the same period from the previous fiscal year and to 73% from 66% for the six month periods ended December 31, 2004 and 2003 respectively. The introduction of our new high margin utilities product family, upon the acquisition of Allume during the fourth quarter of fiscal 2004, accounted for the majority of the improvement in our consolidated gross margin for the three and six months ended December 31, 2004 as compared to the same periods from the previous year. More than sixty (60%) percent of these products sales were fulfilled through our direct marketing channel where the more profitable ESD is the delivery method of choice.

Amortization of capitalized software (a fixed component of our overall product costs) amounted to \$223,000 and \$433,000, respectively, for the three and six months ended December 31, 2004. This compares to \$77,000 and \$116,000, respectively, for the three and six months ended December 31, 2003. This increase in amortization expense is the result of the acquisitions we completed during the past months.

As we continue to acquire businesses and product lines, we are likely to increase our basis in certain intangible assets (i.e. capitalized software development), the amortization of which may negatively affect our gross margin in the future. In addition, given the uncertain product lifecycle for some of our historically high margin products and depending on the success of the release of newer software versions, we may see our gross margin decline in future reporting periods.

## **Sales and Marketing**

The additional sales and marketing expenses related to the businesses we acquired during fiscal 2004 and 2005 (i.e. Allume, Houseplans and Abbisoft) accounted for the majority of the increase in our sales and marketing expenses during the three and six months ended December 31, 2004 as compared to the same periods from the previous fiscal year. However, we continue to successfully integrate these acquisitions and we continue to identify synergies among our business units and implement savings. We believe these actions will positively affect our sales and marketing expenses once the integration of these businesses is completed.

In addition, increased consultant expenses incurred, during the three and six months ended December 31, 2004, to improve our focus on the direct marketing distribution channel and the ESD delivery method along with increased commissions paid to outside service providers of sales forces and E-commerce systems accounted for the increase in sales and marketing expenses which consist primarily of salaries and benefits of sales and marketing personnel, commissions, advertising, printing and direct mail expenses.

Management believes that these investments in the distribution channels and the E-commerce platform will generate increased revenues going forward, and are an indication of our continuing commitment to our core products.

## **General and Administrative**

Our general and administrative expenses consist primarily of salaries and benefits for employees in the legal, finance, accounting, human resources, information systems and operations departments, amortization expenses, fees to our professional advisors, rent and other general operating costs.

The increase in our general and administrative expenses during the three and six months ended December 31, 2004 was mainly caused by the additional expenses related to the new businesses we acquired during fiscal 2004 and 2005 (i.e. Allume, Houseplans and Abbisoft).

Our general and administrative expenses also include amortization expense mainly related to domain names acquired. Amortization expense amounted to \$123,000 and \$208,000, respectively for the three and six months ended December 31, 2004. This compares to \$41,000 and \$43,000, respectively for the three and six month periods ended December 31, 2003.

## **Research and Development**

Management believes that steady investment in research and development is essential to respond to the ever-evolving customer demands and is a reflection on our commitment to investing in and developing our core products.

The increase in research and development expenses during the three and six months ended December 31, 2004 as compared to the same periods from the previous fiscal year resulted mainly from the additional development expenses related to the Allume operations. These expenses consist primarily of salaries and benefits for research and development employees and payments to independent contractors, mainly our third party contract development teams in Russia and India with whom we continue to maintain a strong partnership at competitive costs.

## **Interest and Other, Net**

Interest and other expenses, net, include interest on debt instruments, foreign currency transaction gains and losses, and other non-recurring items. The following table summarizes the components of interest and other, net for the three and six months ended December 31, 2004 and 2003:

Table I-2-5

|                                    | Three months ended December 31, |              |                              |              | Six months ended December 31, |               |                              |             |
|------------------------------------|---------------------------------|--------------|------------------------------|--------------|-------------------------------|---------------|------------------------------|-------------|
|                                    | 2004                            | 2003         | \$ Change from previous year |              | 2004                          | 2003          | \$ Change from previous year |             |
|                                    | \$                              | \$           | \$ Increase / (Decrease)     | %            | \$                            | \$            | \$ Increase / (Decrease)     | %           |
| Interest & Other, net              |                                 |              |                              |              |                               |               |                              |             |
| Interest expense                   | (\$68)                          | \$ 0         | (\$68)                       | -100%        | (\$125)                       | \$ 0          | (\$125)                      | -100%       |
| Interest income                    | 11                              | 18           | (7)                          | -39%         | 69                            | 43            | 26                           | 60%         |
| Foreign exchange gain              | 45                              | 41           | 4                            | 10%          | 62                            | 48            | 14                           | 29%         |
| Other income                       | 12                              | 1            | 11                           | 1100%        | 12                            | 51            | (39)                         | -76%        |
| <b>Total Interest &amp; Other,</b> |                                 |              |                              |              |                               |               |                              |             |
| <b>Net</b>                         | <b>\$ 0</b>                     | <b>\$ 60</b> | <b>(\$60)</b>                | <b>-100%</b> | <b>\$ 18</b>                  | <b>\$ 142</b> | <b>(\$124)</b>               | <b>-87%</b> |

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The increase in interest expense for the three and six months ended December 31, 2004 was mainly the result of the interest we incurred on the acquisitions-related notes and interest incurred on our short term financing activities.

On September 18, 2003, we received a 15% one-year note from DCDC upon extending a loan to DCDC in the amount of \$350,000 which was secured by 400,000 shares of IMSI's stock held by DCDC and due on September 18, 2004. Concurrent with this note, DCDC repaid the entire principal portion of a \$50,000 note, made in our favor on February 25, 2003. This note, which was due on February 25, 2004, was unsecured and carried a 4% interest rate. The \$50,000 note had been fully reserved as it was unsecured. The reversal of the reserve upon the repayment of this note was consequently accounted for as other income during the first quarter of fiscal 2004.

On September 18, 2004, we amended the terms of the \$350,000 promissory note with DCDC extending the maturity of the note to May 31, 2005. Interest income for the first quarter of fiscal 2005 includes \$52,500 of interest income related to the DCDC note that we earned through September 18, 2004. This amount of accrued interest, which was recognized as interest income during the first quarter of fiscal 2005, was paid in full on October 1, 2004 in addition to a principal payment in the amount of \$25,000. Additionally, DCDC agreed to increase the collateral attached to the note by assigning to IMSI its interest in a private equity investment

On January 31, 2005, we sold the above referenced promissory note to Mag Multi Corp ( Mag Multi ), a New York corporation for \$343,000, representing the principal balance and all accrued interest as of the date of the transfer.

#### Gain / (loss) on marketable securities

The following table details the net gain on marketable securities that we recognized during the three and six months ended December 31, 2004:

**Table I-1-8**

| Description                         | Gain (loss) on marketable securities for the three months ended December 31, 2004 |  |  |                                    |               |
|-------------------------------------|---|--|--|------------------------------------|---------------|
|                                     | Realized  | Reversal of unrealized gain / (loss) recognized in prior periods | Unrealized gain / (loss) for the quarter ended December 31, 2004 | Sub total Unrealized gain / (loss) | Total         |
| Jupitermedia common stock           | \$ 1,050  | (\$1,050)  | \$ 0   | (\$1,050)                          | \$ 0          |
| Other Stock in investment portfolio | 111   | 9  | 351  | 360                                | 471           |
| <b>Total</b>                        | <b>\$ 1,161</b>   | <b>(\$1,041)</b>   | <b>\$ 351</b>  | <b>(\$690)</b>                     | <b>\$ 471</b> |

| Description | Gain (loss) on marketable securities for the six months ended December 31, 2004 |  |   |                                    |
|-------------|---|--|---|------------------------------------|
|             | Realized  | Reversal of unrealized gain / (loss) recognized in prior periods | Unrealized gain / (loss) for the six months ended | Sub total Unrealized gain / (loss) |

December  
31, 2004

|                                     |           |              |                  |           |            |                  |           |            |
|-------------------------------------|-----------|--------------|------------------|-----------|------------|------------------|-----------|------------|
| Jupitermedia common stock           | \$        | 2,094        | (\$2,097)        | \$        | 163        | (\$1,934)        | \$        | <b>160</b> |
| Other Stock in investment portfolio |           | 64           | 92               |           | 106        | <b>198</b>       |           | <b>262</b> |
| <b>Total</b>                        | <b>\$</b> | <b>2,158</b> | <b>(\$2,005)</b> | <b>\$</b> | <b>269</b> | <b>(\$1,736)</b> | <b>\$</b> | <b>422</b> |



### **Gain on sale of product line**

During the quarter ended December 31, 2004, we sold certain domain names and their related interest and contents (Cadalog.com and 3Dmodelsharing.com) and we recognized gains in the aggregate amount of \$33,000 which represented the excess of the consideration received over the net book value of the assets sold.

### **Gain on extinguishment of debt**

During the six months ended December 31, 2003, we recognized a gain of \$76,000 from the extinguishment of debt primarily relating to the settlement of liabilities related to assets under a capital lease.

### **Provision for State and Federal Income Taxes**

During the three and six months ended December 31, 2004, we recorded tax expense of \$3,000 and \$8,000, respectively, related to state income taxes where we have operations. This compares to an income tax benefit of \$6,000 and \$10,000, respectively, for the three and six months ended December 31, 2003.

We have not recorded a tax benefit for domestic tax losses because of the uncertainty of realization. We adhere to Statement of Financial Accounting Standards No. 109 "Accounting for Income Taxes," which requires an asset and liability approach to financial accounting and reporting for income taxes. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. Consistent with our past practice, we have recorded a full valuation allowance at December 31, 2004 as the realizeability of our net operating loss carry-forwards is not determinable.

### **Income from Discontinued Operations and Gain from Discontinued Operations**

#### **Gain from the sale of discontinued operations, net of income tax**

As previously disclosed in our annual report on Form 10-KSB, as amended, for the fiscal year ended June 30, 2004, we sold the assets and customer related liabilities of our wholly owned subsidiary Keynomics, Inc. in July 2004. We have previously evaluated the Keynomics business segment and its long term prospects during the fourth quarter of fiscal 2004 and given our focus on direct marketing and the on-line distribution of precision design content, we determined that Keynomics no longer represented a strategic fit for our company. The \$53,000 gain from the sale of discontinued operations for the six months ended December 31, 2004 relates to the sale of Keynomics during the quarter ended September 30, 2004 and represents the excess of the total consideration received over its net carrying value.

During the quarter ended December 31, 2003, we recorded a gain of \$1.0 Million from the sale of discontinued operations representing the successful achievement of the first earn-out from the sale of ArtToday to Jupitermedia Corporation in June 2003.

#### **Income (loss) from discontinued operations, net of income tax**

The amounts reported for the three and six months ended December 31, 2004 and 2003 as discontinued operations represent the pre-tax results of operations for Keynomics. This segment had pre-tax net gain of \$30,000 for the quarter ended December 31, 2003 and pre-tax losses of \$5,000 and \$51,000 for the six months ended December 31, 2004 and 2003 respectively. These losses were derived from net revenues of \$319,000 for the quarter ended December 31, 2003 and \$68,000 and \$478,000 for the six months ended December 31, 2004 and 2003 respectively.



### **Liquidity and Capital Resources**

As of December 31, 2004, we had \$2,804,000 in cash and cash equivalents. This represents a \$1,002,000 decline from the \$3,806,000 balance as of September 30, 2004 and a \$408,000 decline from the \$3,212,000 balance as of June 30, 2004. Working capital at December 31, 2004 was \$4,863,000. This represents an increase of \$59,000 and \$809,000, respectively over the working capital at September 30, 2004 and June 30, 2004.

Despite a net loss of \$146,000 for the six month period ended December 31, 2004, our operating activities provided net cash of \$248,000. This compares to net cash used from operations of \$2,507,000 in the six months ended December 31, 2003 on a net income of \$2,000 for the same period. The \$1,000,000 payment we received relating to the earn-out from the sale of ArtToday as described below accounted for the majority of the improvement in cash from operating activities. Improved DSO ratios across our business units and in aggregate explains the decrease in cash usage by our account receivables for the six months ended December 31, 2004 as compared to the same period from the previous fiscal year.

During fiscal 2004, we recorded a gain of \$2.0 Million from the sale of discontinued operations representing the successful achievement of the first and second earn-out from the sale of ArtToday. These earn-outs were contingent on ArtToday reaching certain revenue milestones. The first installment of \$1.0 Million was earned during the second quarter of fiscal 2004 and was paid per the stock purchase agreement on February 13, 2004 and the second installment of the earn-outs was earned during the fourth quarter of fiscal 2004 and was paid on August 14, 2004.

Our investing activities provided net cash of \$559,000 during the six months ended December 31, 2004, as compared to net cash used of \$2,479,000 during the comparable period from the previous fiscal year. During the six months ended December 31, 2004, we acquired a new business (AbbiSoft) and technology which will allow JPEG and image files to be compressed on average by 30% and will be incorporated into our StuffIt line (the consideration paid is disclosed in the table on page 8). Also, during the same period, we transferred approximately \$500,000 in cash to an escrow account as described below.

The ArtToday purchase agreement originally called for the 250,000 shares of Jupitermedia to be held in escrow until December 30, 2005. However, at our discretion, we had the ability to replace all or a portion of the common stock held in escrow with cash in an amount equal to the closing market value, at June 30, 2003, of the common stock to be replaced. As part of an amended escrow agreement with Jupitermedia, 125,000 of the original 250,000 shares that were tendered as part of the consideration in the sale were released from the escrow account in February 2004. During the quarter ended September 30, 2004, we substituted approximately \$500,000 (recorded as Assets from Discontinued Operations) in cash for the remaining 125,000 shares of Jupitermedia from the escrow agent. This amount will be released to us, net of any claims, on December 30, 2005.

The activities above were mainly financed by the proceeds we received from the sale of marketable securities (mainly Jupitermedia common stock we received as part of the sale of ArtToday), the release on December 30, 2004 of the second payment of \$650,000 that was held in escrow in connection to the ArtToday sale to Jupitermedia and the proceeds we received from the sale of the assets of Keynomics in July 2004.

The comparable period from the previous fiscal year was also marked by the consummation of several acquisitions that were consistent with our strategy to grow our software business with a focus on products and services that complement our direct marketing and online distribution strengths. These acquisitions included CADsymbols, CADsymbol, DesignCAD, Homeplans and other smaller product lines and businesses. During the same period of the previous fiscal year, we extended a \$350,000 loan to DCDC as disclosed in note 5 to our condensed consolidated financial statements. This note was sold to a third party subsequent to quarter end.

Our financing activities consumed net cash of \$1,181,000 for the six-month period ended December 31, 2004. This compares to \$133,000 of net cash used by financing activities during the comparable quarter from the previous fiscal year. The cash used by our financing activities for the six months ended December 31, 2004 was primarily related to payments we made relative to notes related to the acquisitions we consummated during fiscal 2004 and 2005.

During the comparable period from the previous fiscal year, we paid \$160,000 to Imageline in July 2003, which represents the final payment in connection with our mutual settlement of previous infringements claims. This payment accounted for most of the cash used in our financing activities during the six months ended December 31, 2003 and was in part offset by cash received from the exercise of warrants and options in the amounts of \$65,000 and 71,000, respectively.

Historically, we have financed our working capital and capital expenditure requirements primarily from short-term and long-term notes and bank borrowings, capitalized leases and sales of common stock. The sale of ArtToday to Jupitermedia in June 2003 provided us with additional sources of funds to support future growth.

To achieve our growth objectives, we are considering different strategies, including growth through mergers and/or acquisitions. As a result, we are evaluating and we will continue to evaluate other companies and businesses for potential synergies that would add value to our existing operations.

We may seek, in the future, additional equity and/or debt financing to sustain our growth strategy. However, we believe that we have sufficient funds to support our operations at least for the next twelve months, based on our current cash position and equity sources. We believe that we will be able to obtain any additional financing required on competitive terms particularly if we are successful in improving our financial performance. In addition, we will continue to seek opportunities and discussions with third parties concerning the sale or license of certain product lines and/or the sale or license of a portion of our assets.

The forecast period of time through which our financial resources will be adequate to support working capital and capital expenditure requirements is a forward-looking statement that involves risks and uncertainties, and actual results could vary. Furthermore, any additional equity financing may be dilutive to shareholders, and debt financing may involve restrictive covenants.

### **Critical Accounting Policies**

In accordance with recent Securities and Exchange Commission guidance, those material accounting policies that we believe are the most critical to an investor's understanding of our financial results and condition have been expanded and are discussed below. Certain of these policies are particularly important to the portrayal of our financial position and results of operations and require the application of significant judgment by our management to determine the appropriate assumptions to be used in the determination of certain estimates.

### **Revenue Recognition**

Revenue is recognized in accordance with American Institute of Certified Public Accountants Statement of Position ( SOP ) 97-2, *Software Revenue Recognition*, and SOP 98-9, *Modification of SOP 97-2, With Respect to Certain Transactions*. Revenue is recognized when persuasive evidence of an arrangement exists (generally a purchase order), product or service has been delivered, the fee is fixed and determinable, and collection of the resulting account is probable.

- Revenue from packaged product sales to resellers and end users is recorded at the time of the sale net of estimated returns.
- Revenue from sales to distributors is recognized when the product sells through to retailers and end users. Sales to distributors permit limited rights of return according to the terms of the contract.
- For software and content delivered via the Internet, revenue is recorded when the customer downloads the software, activates the subscription account or is shipped the content.

- Revenue from post contract customer support (PCS) is recognized ratably over the contract period.
  - Subscription revenue is recognized ratably over the contract period.
- We use the residual method to recognize revenue when a license agreement includes one or more elements to be delivered at a future date. If there is an undelivered element under the license arrangement, we defer revenue based on vendor-specific objective evidence (VSOE) of the fair value of the undelivered element, as determined by the price charged when the element is sold separately. If VSOE of fair value does not exist for all undelivered elements, we defer all revenue until sufficient evidence exists or all elements have been delivered.
- Non-refundable advanced payments received under license agreements with no defined terms are recognized as revenue when the customer accepts the delivered software.
- Revenue from software licensed to developers, including amounts in excess of non-refundable advanced payments, is recorded as the developers ship products containing the licensed software.
  - Revenue from minimum guaranteed royalties in republishing agreements is recognized ratably over the term of the agreement. Royalties in excess of the guaranteed minimums are recognized when collected.
- Revenue from Original Equipment Manufacturer (OEM) contracts is recognized upon completion of our contractual obligations.

### **Reserve for returns, price discounts and rebates**

Reserves for returns, price discounts and rebates are estimated using historical averages, open return requests, channel inventories, recent product sell-through activity and market conditions. Our allowances for returns, price discounts and rebates are based upon management's best judgment and estimates at the time of preparing the financial statements. Reserves are subjective estimates of future activity that are subject to risks and uncertainties, which could cause actual results to differ materially from estimates.

Our return policy generally allows our distributors to return purchased products primarily in exchange for new products or for credit towards future purchases as part of stock balancing programs. These returns are subject to certain limitations that may exist in the contract with an individual distributor, governing, for example, aggregate return amounts, and the age, condition and packaging of returned product. Under certain circumstances, such as terminations or when a product is defective, distributors could receive a cash refund if returns exceed amounts owed.

### **Inventories**

Inventories are valued at the lower of cost or market and are accounted for on the first-in, first-out basis. Management performs periodic assessments to determine the existence of obsolete, slow moving and non-salable inventories, and records necessary provisions to reduce such inventories to net realizable value. As of December 31, 2004, approximately \$111,000 of our inventory was held by certain of our distributors under consignment arrangements.

### **Impairment**

Property, equipment, intangible and certain other long-lived assets are amortized over their useful lives. Useful lives are based on management's estimates of the period that the assets will generate revenues. Long-lived assets are written down to fair value whenever events or changes indicate that the carrying amount of an asset may not be recoverable. Our policy is to review the recoverability of all long-lived assets at a minimum of once per year and record an impairment loss when the fair value of the assets does not exceed the carrying amount of the asset.

In accordance with SFAS No. 142, *Goodwill and Intangible Assets*, goodwill is being assessed for impairment annually or more frequently if circumstances indicate impairment.

### **Other Factors that May Affect Future Operating Results**

Factors that may affect operating results in the future include, but are not limited to:

- Market acceptance of our products or those of our competitors
- Timing of introductions of new products and new versions of existing products
- Expenses relating to the development and promotion of such new products and new version introductions
  - Intense price competition and numerous end-user rebates
  - Projected and actual changes in platforms and technologies
  - Accuracy of forecasts of, and fluctuations in, consumer demand
  - Extent of third party royalty payments

- Rate of growth of the consumer software and Internet markets
- Timing of orders or order cancellation from major customers
- Changes or disruptions in the consumer software distribution channels
- Economic conditions, both generally and within the software or Internet industries
- Our ability to successfully integrate the acquisitions that we have completed in the last twelve months
- The successful attainment of the final \$2.0m earn-out payment related to the sale of the ArtToday business



**Item 3- Controls and Procedures**

(a) Under the supervision and with the participation of IMSI's management, including IMSI's principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures ( Disclosure Controls ), as such term is defined under Rule 13a-14(c) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act ), as of December 31, 2004, the end of the period covered by this quarterly report. Based on their evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective.

(b) We have evaluated our accounting procedures and control processes in place as of December 31, 2004 related to material transactions to ensure they are recorded timely and accurately in the financial statements. There have been no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation referenced in paragraph (a) above.

**PART II - OTHER INFORMATION****Item 1- Legal Proceedings**

Not Applicable

**Item 2- Unregistered Sales of Equity Securities and Use of Proceeds**

On September 29, 2004 we filed with the SEC a registration statement on Form SB-2 which was declared effective on November 4, 2004. The registration statement relates to the sale by certain stockholders of IMSI of up to 4,542,440 shares of our common stock which they own, or which they may at a later date acquire upon the exercise of warrants to purchase shares of our common stock. Apart from nominal consideration to be received upon exercise of the warrants referenced above, we will not receive any proceeds from the sale of common stock by the selling security holders. The selling stockholders are offering to sell up to 4,044,654 shares of common stock which they own and up to 497,786 shares of common stock which they may acquire upon the exercise of warrants. During the quarter ended December 31, 2004, one of the selling shareholders named in the registration statement exercised warrants (the underlying securities of which were also covered by the above referenced registration statement) to purchase 25,000 shares of IMSI common stock. The proceeds from this exercise, totaling \$11,250 were used to finance general working capital needs.

During the quarter ended December 31, 2004, we issued the following securities in a transaction not registered under the Securities Act of 1933:

**Table II-2-1**

| <b>Date Securities Issued</b> | <b>Securities Title</b> | <b>Issued to</b> | <b>Number of Securities Issued</b> | <b>Stock Value</b> | <b>Footnotes</b> |
|-------------------------------|-------------------------|------------------|------------------------------------|--------------------|------------------|
| <b>Common Stock Issuances</b> |                         |                  |                                    |                    |                  |
| 11/1/2004                     | Common Stock            | Yaakov Gringeler | 73,864                             | \$ 65,000          | (1)              |

(1) Stock issued pursuant to an acquisition of technology for which no cash was received by us.



**Item 3- Defaults upon Senior Securities**

Not Applicable

**Item 4- Submission of Matters to a Vote of Security Holders**

Not Applicable

**Item 5- Other Information**

Not Applicable

**Item 6- Exhibits**

**Financial Statements**

The following consolidated financial statements of International Microcomputer Software, Inc., and Subsidiaries are incorporated by reference in Part I, Item 1:

Consolidated Balance Sheet at December 31, 2004 and June 30, 2004

Consolidated Statements of Operations for the interim periods ended December 31, 2004 and 2003

Consolidated Statements of Shareholders' Equity for the interim period ended December 31, 2004

Consolidated Statements of Cash Flows for the interim periods ended December 31, 2004 and 2003

Notes to Consolidated Financial Statements

**Exhibits**

The following exhibits are filed as part of, or incorporated by reference into this Report:

**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 Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

**32.2** Certification of Chief Financial Officer 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.

**INTERNATIONAL MICROCOMPUTER SOFTWARE, INC.**

Date: February 14, 2005

By: /s/ Martin Wade, III

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Martin Wade, III  
Director and Chief Executive Officer

By: /s/ William J. Bush

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William J. Bush  
Chief Financial Officer (Principal Accounting Officer)

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| <b>Number</b> | <b>Exhibit Title</b>   | <b>Page</b> |
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| <b>31.2</b>   | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | 33          |
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