INTELLIGENT SYSTEMS CORP
Form 10QSB
August 11, 2006

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

(Mark One)

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

For the quarterly period ended June 30, 2006

OR

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

For the transition period from __________ to __________

Commission file number 1-9330

INTELLIGENT SYSTEMS CORPORATION

(Exact name of Registrant as specified in its charter)

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

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

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

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

As of July 31, 2006, 4,478,971 shares of Common Stock were outstanding.

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

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Item 1. Financial Statements

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

	June 30, 2006 *(unaudited)*	December 31, 2005
ASSETS		
Current assets:		
Cash	$ 447	$ 378
Accounts receivable, net	3,590	1,827
Inventories	1,039	770
Other current assets	498	355
Total current assets	5,574	3,330
Long-term investments	4,173	4,571
Property and equipment, at cost less accumulated depreciation	1,150	940
Goodwill, net	2,047	2,047
Other intangibles, net	445	532
Other assets, net	28	17
Total assets	$ 13,417	$ 11,437
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Short-term borrowings	$ 2,012	$ 100
Accounts payable	1,801	847
Deferred revenue	4,531	4,779
Accrued payroll	1,036	1,092
Accrued expenses and other current liabilities	1,263	849
Total current liabilities	10,643	7,667
Other long-term liabilities	486	248
Commitments and contingencies (Note 8)		
Minority interest	1,516	1,516
Stockholders equity:		
Common stock, $0.01 par value, 20,000,000 shares authorized, 4,478,971 shares issued and outstanding at June 30, 2006 and December 31, 2005	45	45
Paid-in capital	18,410	18,410

Accumulated other comprehensive loss	(74)	(61)
Accumulated deficit	(17,609)	(16,388)
Total stockholders equity	772	2,006
Total liabilities and stockholders equity	$ 13,417	$ 11,437

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

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

	Three Months Ended June 30		Six Months Ended June 30	
	2006	**2005**	**2006**	**2005**
Revenue				
Products	$ 2,427	$ 2,820	$ 4,466	$ 4,883
Services	1,802	1,842	5,374	3,358
Total revenue	4,229	4,662	9,840	8,241
Cost of sales				
Products	1,226	869	2,227	1,732
Services	751	980	2,404	1,849
Total cost of sales	1,977	1,849	4,631	3,581
Expenses				
Marketing	595	601	1,186	1,142
General & administrative	949	800	2,143	1,759
Research & development	1,545	1,675	3,245	3,302
Loss from operations	(837)	(263)	(1,365)	(1,543)
Other income				
Interest income (expense), net	(33)	12	(61)	18
Investment income, net	2	914	7	1,956
Equity in earnings of affiliate companies	91	19	163	36
Other income, net	1	13	35	21
Income (loss) before income taxes	(776)	695	(1,221)	488
Income taxes				12
Net income (loss)	$ (776)	$ 695	$ (1,221)	$ 476
Basic net income (loss) per share	$ (0.17)	$ 0.16	$ (0.27)	$ 0.11
Diluted net income (loss) per share	$ (0.17)	$ 0.15	$ (0.27)	$ 0.10
Basic weighted average shares outstanding	4,478,971	4,478,971	4,478,971	4,478,971
Diluted weighted average shares outstanding	4,478,971	4,628,183	4,478,971	4,638,043

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

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

	Six Months Ended June 30,	
CASH PROVIDED BY (USED FOR):	**2006**	**2005**
OPERATIONS:		
Net income (loss)	$ (1,221)	$ 476
Adjustments to reconcile net income (loss) to net cash provided by (used for) operating activities:		
Depreciation and amortization	260	257
Stock based compensation expense	6	
Investment income, net	(7)	(1,956)
Equity in earnings of affiliate companies	(163)	(36)
Changes in operating assets and liabilities		
Accounts receivable	(1,763)	(661)
Inventories	(269)	(88)
Other current assets	(143)	(269)
Other non-current assets		8
Accounts payable	953	(32)
Accrued payroll	(56)	284
Deferred revenue	(248)	898
Accrued expenses and other current liabilities	398	(37)
Other liabilities	239	
Cash used for operating activities	(2,014)	(1,156)
INVESTING ACTIVITIES:		
Proceeds related to sales of investments	183	2,117
Purchases of intangible assets		(6)
Distributions from long-term investments	385	9
Purchases of property and equipment	(384)	(268)
Cash provided by investing activities	184	1,852
FINANCING ACTIVITIES:		
Borrowings under short-term borrowing arrangements	1,912	705
Repayments under short-term borrowing arrangements		(672)
Cash provided by financing activities	1,912	33
Effects of exchange rate changes on cash	(13)	32
Net increase in cash	69	761

Cash at beginning of period		378		670
Cash at end of period	$	447	$	1,431

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:				
Cash paid during the period for interest	$	41	$	7
Cash paid during the period for income taxes				

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

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Intelligent Systems Corporation
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Throughout this report, the terms we , us , ours , ISC and company refer to Intelligent Systems Corporation, including its majority-owned subsidiaries.

2. The unaudited consolidated financial statements presented in this Form 10-QSB have been prepared in accordance with accounting principles generally accepted in the United States applicable to interim financial statements. Accordingly, they do not include all of the information and notes required for complete financial statements. In the opinion of ISC management, these consolidated financial statements contain all adjustments (which comprise only normal and recurring accruals) necessary to present fairly the financial position and results of operations as of and for the three and six month periods ended June 30, 2006 and 2005. The interim results for the three and six months ended June 30, 2006 are not necessarily indicative of the results to be expected for the full year. These statements should be read in conjunction with our consolidated financial statements and notes thereto for the fiscal year ended December 31, 2005, as filed in our annual report on Form 10-KSB.

3. Comprehensive Income (Loss) In accordance with Financial Accounting Standards Board Statement No. 130, Reporting Comprehensive Income , comprehensive income (loss) is the total of net income (loss) and all other non-owner changes in equity in a period. A summary follows:

Consolidated Statements of Comprehensive Income (loss)	Three Months Ended June 30,		Six Months Ended June 30,	
(unaudited, in thousands)	2006	2005	2006	2005
Net income (loss)	$ (776)	$ 695	$ (1,221)	$ 476
Other comprehensive income (loss):				
Foreign currency translation adjustment	(15)	17	(13)	32
Unrealized loss on available-for-sale securities		24		(85)
Comprehensive income (loss)	$ (791)	$ 736	$ (1,234)	$ 423

4. Stock-Based Compensation At June 30, 2006, we had two stock-based compensation plans under which stock options have been granted. Stock options for employees generally vest over a three or four year term and stock options for directors vest over a two year term; options have a maturity of ten years from issuance date; and option exercise prices are equal to the closing price on the American Stock Exchange of the common stock on the grant date. Prior to 2006, we accounted for stock-based compensation in accordance with the Accounting Principles Board (APB) No. 25, Accounting for Stock Issued to Employees , which permitted companies to use the alternative intrinsic value method of accounting for stock based compensation and we adopted the disclosure provisions of SFAS No. 123, Accounting for Stock Issued to Employees . In December 2005, the FASB issued FASB Statement No. 123R, Share Based Payment , which replaced APB No. 25 and SFAS No. 123. The change was effective for our company for the reporting period beginning January 1, 2006. SFAS No. 123R requires companies to recognize in financial statements the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards. We have adopted SFAS 123R using the modified prospective application method of adoption which requires the company to record compensation cost related to unvested stock awards as of December 31, 2005 by recognizing the unamortized grant date fair value in accordance with provisions of SFAS 123R on a straight line basis over the service periods of each award. The company has estimated forfeiture rates based on its historical experience. Stock based compensation for the three and six month periods ended June 30, 2006 has been recognized as a component of general and administrative expenses in the accompanying Consolidated Financial Statements.

No options were granted, exercised or forfeited in the first six months of 2006. In the second quarter of 2005, 12,000 options were granted at fair market value on the date of grant pursuant to the Non-employee Directors Stock Option Plan. The estimated fair value of the options granted during prior years was calculated using the Black Scholes option pricing model with assumptions as previously disclosed.

As a result of adopting SFAS 123R, the impact to the Consolidated Financial Statements was to increase the net loss for the three and six months ended June 30, 2006 by $3,000 and $6,000, respectively, than if the company had continued to account for stock-based compensation under APB 25. The impact on both basic and diluted loss per share for the three and six months ended June 30, 2006 was $0 and $0 per share, respectively. Pro forma net loss as if the fair value based method had been applied to all awards is as follows:

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(in thousands, except per share data)	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
Net income (loss), reported	$ (776)	$ 695	$ (1,221)	$ 476
Add: stock-based compensation programs recorded as expense, net of related tax	3		6	
Deduct: total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax	(3)	(10)	(6)	(18)
Pro forma net income (loss)	$ (776)	$ 685	$ (1,221)	$ 458
Income (loss) per common share:				
Basic, as reported	$ (0.17)	$ 0.16	$ (0.27)	$ 0.11
Basic, pro forma	$ (0.17)	$ 0.15	$ (0.27)	$ 0.10
Diluted, as reported	$ (0.17)	$ 0.15	$ (0.27)	$ 0.10
Diluted, pro forma	$ (0.17)	$ 0.15	$ (0.27)	$ 0.10

All of the company s stock-based compensation expense relates to stock options. As of June 30, 2006, $6,000 of total unrecognized compensation cost related to stock options is expected to be recognized over a weighted average period of approximately 1 year. No options were granted, exercised or forfeited during the three or six month period ended June 30, 2006. The following table summarizes options as of June 30, 2006:

	# of Shares	Wgt Avg Exercise Price	Wgt Avg Remaining Life in Years	Aggregate Intrinsic Value
Outstanding at June 30, 2006	238,680	$2.56	5.7	$55,440
Vested and exercisable at June 30, 2006	232,680	2.57	5.4	55,440

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the company s closing stock price on the last trading day of the second quarter of 2006 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on June 30, 2006. The amount of aggregate intrinsic value will change based on the fair market value of the company s stock.

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5. *Industry Segments* Segment information is presented consistently with the basis described in the 2005 Form 10-KSB. The table following contains segment information for the three and six month periods ended June 30, 2006 and 2005.

(unaudited, in thousands)	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
Information Technology				
Revenue	$ 2,101	$ 3,219	$ 5,987	$ 5,095
Operating loss	(641)	(192)	(674)	(1,501)
Industrial Products				
Revenue	2,128	1,443	3,853	3,146
Operating income (loss)	78	153	(16)	442
Consolidated Segments				
Revenue	$ 4,229	$ 4,662	$ 9,840	$ 8,241
Operating loss	(563)	(39)	(689)	(1,059)

A reconciliation of consolidated segment data above to consolidated income (loss) follows:

	Three Months 2006	Three Months 2005	Six Months 2006	Six Months 2005
Consolidated segments operating loss	$ (563)	$ (39)	$ (689)	$ (1,059)
Corporate expenses	(274)	(224)	(676)	(484)
Consolidated operating loss	(837)	(263)	(1,365)	(1,543)
Interest income (expense), net	(33)	12	(61)	18
Investment income	2	914	7	1,956
Equity in income of affiliates	91	19	163	36
Other income, net	1	13	35	21
Income (loss) before income taxes	(776)	695	(1,221)	488
Income taxes				12
Net income (loss)	$ (776)	$ 695	$ (1,221)	$ 476
Depreciation and Amortization				
Information Technology	$ 69	$ 69	$ 139	$ 133
Industrial Products	65	62	125	117
Consolidated segments	134	131	264	250
Corporate	(7)	1	(3)	7
Consolidated depreciation and amortization	$ 127	$ 132	$ 261	$ 257

Capital Expenditures				
Information Technology	$ 14	$ 44	$ 22	$ 57
Industrial Products	140	173	338	181
Consolidated segments	154	217	360	238
Corporate	6	30	24	30
Consolidated capital expenditures	$ 160	$ 247	$ 384	$ 268

	June 30, 2006 *(unaudited)*	December 31, 2005
Identifiable Assets		
Information Technology	$ 4,893	$ 3,746
Industrial Products	3,967	2,913
Consolidated segments	8,860	6,659
Corporate	4,557	4,778
Consolidated assets	$ 13,417	$ 11,437

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

	Three Months Ended June 30,		Six Months Ended June 30,	
(unaudited)	2006	2005	2006	2005
VISaer Customer A			18%	
VISaer Customer B		14%		
VISaer Customer C	11%			10%

7. *Contract Settlement* In March 2006, our VISaer subsidiary reached a mutual agreement with one of its customers to terminate a Software License Agreement between them. The Settlement and Release Agreement assigns no fault to either party and provides for a refund to the customer of $512,000 of certain prepaid maintenance and other expenses, with such refund to be paid interest-free in monthly installments of $14,222 over a three year period. Accordingly, since VISaer had completed all of the requirements for revenue recognition, in the quarter ended March 31, 2006, VISaer recognized $1,779,000 in services revenue and $827,174 in cost of sales related to this contract, and recorded the refund amount as a liability of which $135,000 was recorded in other current liabilities and $311,000 in long-term liabilities at March 31, 2006, ($446,000 in total, which is equal to $512,000 discounted at 9.25%). At June 30, 2006, the amount related to this settlement that is included in current and long-term liabilities is $135,077 and $277,924, respectively. The liability, which is an obligation of VISaer, is not secured by any assets or guaranteed by the parent company.

8. *Commitments and Contingencies* Please refer to Note 8 to our Consolidated Financial Statements included in our 2005 Form 10-KSB for a description of our commitments and contingencies. There has been no material change since December 31, 2005 in the commitments described in such note, except that the Contract Settlement referenced in Note 7 above involves a commitment by our VISaer subsidiary to make monthly payments of $14,222 each beginning April 1, 2006 until the $512,000 refund due its customer is paid in full.

   Legal Matters In December 2004, ChemFree filed a patent infringement action against J. Walter Co. Ltd. and J. Walter, Inc. in the United States Court for the Northern District of Georgia. The complaint alleges that certain of the defendant s products infringe various U.S. patents held by ChemFree and seeks a ruling to compel defendant to cease its infringing activities. The defendant has asserted various defenses and a counterclaim. The case is pending and no trial date has been set. In 2005, ChemFree participated in an arbitration proceeding versus ZYMO International, Inc. (Zymo), a patent co-owner, that resulted in the issuance of a favorable arbitration ruling for ChemFree. In December 2005, ChemFree initiated a proceeding under the Federal Arbitration Act in the United States District Court for the Northern District of Georgia to obtain judicial confirmation of the arbitration ruling and to arbitrate a number of other disputes between ChemFree and Zymo that fall within the arbitration provisions of the co-ownership agreement between the parties. In July 2006, the judge issued a ruling confirming ChemFree s request to compel arbitration and the matter will now move through the arbitration process. While the resolution and timing of any legal action is not predictable, ChemFree believes it has sufficient grounds to prevail in these actions although there can be no assurance that the disputes will be resolved in its favor.

   ISC Guarantees In conjunction with a Software License Agreement entered into on June 12, 2003 between our majority owned subsidiary, CoreCard Software, Inc. and a CoreCard customer, ISC entered into a letter of guarantee with the CoreCard customer. Under the guarantee, in the event that the Software License is terminated due to CoreCard discontinuing operations, ISC has guaranteed to make available at its expense up to four employees to provide technical assistance to the customer during a transition period of up to one year. The guarantee is limited to the amount paid by the customer to CoreCard under the Software License Agreement at the

time of termination. The guarantee phases out upon the achievement of certain operational milestones by CoreCard or after five years, whichever occurs sooner. As of June 30, 2006, it does not appear probable that the guarantee will be paid; thus no amounts have been accrued with respect to this guarantee.

In connection with and to facilitate a software license contract between Ardext Technologies, Inc., a privately held company in which ISC holds a minority ownership, and a customer of Ardext s, ISC entered into agreements with Ardext and the customer to receive and hold milestone payments by the customer and to return such payments either to the customer or to Ardext depending on the outcome of Ardext s performance under the contract. At June 30, 2006, ISC has recorded payments totaling $150,000 received from the customer as Other Current Liabilities on the balance sheet and ISC expects to return such amount to the customer in August 2006 based on a recent

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decision by the customer to terminate the Ardext Technologies project. ISC has no other obligations under the agreements.

9. *Significant Equity Investee* The following condensed financial information is provided for Horizon Software, LLC, an investee company in which we own a 17% equity interest and which, at June 30, 2006, constituted more than 20% of our consolidated assets.

	Three Months Ended June 30,		Six Months Ended June 30,	
(unaudited, in thousands)	2006	2005	2006	2005
Net sales	$ 5,272	$ 4,956	$ 9,609	$ 8,554
Gross profit	3,826	3,781	7,084	6,544
Net income from continuing operations	556	924	912	1,047
Net income	556	924	912	1,047
ISC share of net income	95	158	156	179

10. *New Accounting Pronouncements* In December 2005, the FASB issued FASB Statement No. 123R, Share Based Payment , which replaces APB No. 25 and SFAS No. 123. The change is effective for small business issuers for the first interim or annual reporting period that begins after December 15, 2005. SFAS No. 123R requires companies to recognize in financial statements the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards. We adopted SFAS No. 123R effective January 1, 2006. There was no material impact on our results of operations or financial condition. Refer to Note 4.

In December 2004, the FASB issued FASB Statement No. 151, Inventory Costs An amendment of ARB No. 43 . SFAS No. 151 clarifies that certain abnormal amounts of production related expenses should be expensed as incurred and not included in overhead. Further, it requires that allocation of fixed production overheads to conversion costs should be based on normal capacity of production facilities. FASB No. 151 is effective for fiscal years beginning after June 15, 2005. We adopted SFAS No. 151 effective January 1, 2006. The adoption of this standard did not have a material impact on our financial position and results of operations.

11. Subsequent Event Effective July 31, 2006, the company completed the sale of the business and certain assets of its QS Technologies, Inc. (QS) subsidiary to Netsmart Public Health, Inc. and its parent company, Netsmart Technologies, Inc. [NASDAQ SC:NTST]. The company sold assets associated with the QS business consisting principally of intangibles, furniture and equipment, prepaid expenses and work-in-process for a combination of $1.9 million in cash, a promissory note of Netsmart in the amount of $1.435 million and the assumption by Netsmart Public Health of approximately $1.8 million in net liabilities of QS. The company retained accounts receivable and cash of QS aggregating approximately $ 2.0 million. The promissory note of Netsmart Technologies, Inc. bears interest at the rate of 8.25 percent and is payable in thirty-six monthly payments of $45,133 beginning September 1, 2006. The principal amount of the note is subject to adjustment based on revenue and earnings of the QS business for the period from August 1, 2006 through December 31, 2006. The transaction also provides for contingent payments to the company of up to $1.45 million in 2008 based on the attainment by the QS business of certain levels of revenue and bookings in 2007. The company will report a gain on the sale in the third quarter ending September 30, 2006. Further details of the transaction are included in the company s Form 8-K dated August 1, 2006 filed with the Securities and Exchange Commission.

On August 11, 2006, the renewal date for the company's $2 million bank line of credit was changed from September 1, 2006 to December 1, 2006 under essentially the same terms and conditions.

Item 2. Management s Discussion and Analysis or Plan of Operation

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

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For purposes of this discussion and analysis, we are assuming and relying upon the reader s familiarity with the information contained in Item 6. Management s Discussion and Analysis or Plan of Operation, in the Form 10-KSB for the year ended December 31, 2005 as filed with the Securities and Exchange Commission.

Overview

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

We derive our product revenue from sales of software licenses in our Information Technology sector and sales and leases of equipment and supplies in our Industrial Products sector. Our service revenue consists of fees for implementation, consulting, training, maintenance and support for software products in our Information Technology sector. Our consolidated revenue is the aggregate of the revenue generated at our four subsidiary companies. Our revenue fluctuates from period to period and our results are not necessarily indicative of the results to be expected in future periods. Period-to-period comparisons may not be meaningful and it is difficult to predict the level of consolidated revenue on a quarterly or annual basis for a number of reasons, including the following:

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

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

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

- Our subsidiaries are relatively small in revenue size and, in the Information Technology sector, license revenue at a subsidiary in a given period may consist of a relatively small number of contracts. Consequently, even small delays in a subsidiary s delivery under a software contract (which may be out of its control) could have a significant and unpredictable impact on consolidated revenue that we can recognize in a given quarterly or annual period.

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

We also frequently generate income or losses from non-operating sources and we may do so from time to time in the future. Occasionally we derive income from sales of holdings in affiliate and other minority-owned companies or we record a charge if we believe the value of a non-consolidated company is impaired. We also recognize on a quarterly basis our pro rata share of the income or losses of affiliate companies accounted for by the equity method. The timing

and amount of gain or loss recognized as a result of a sale or the amount of equity in the income or losses of affiliates generally are not under our control and are not necessarily indicative of future results, either on a quarterly or annual basis.

In recent years, the majority of our cash has been generated on an irregular basis from sales of our investments in early stage technology companies. We have used a significant amount of the cash received from these sales to support the operations of our CoreCard Software and VISaer subsidiaries.

As disclosed in Note 11 to these financial statements, we sold certain assets and the business operations of our QS subsidiary on July 31, 2006. Accordingly, we will not include the results of operations of the QS subsidiary in our consolidated financial statements after that date. In prior periods, on an annual basis the QS operations have contributed positive earnings and cash flow that is reflected in the ISC consolidated financial statements. We expect to report a significant non-recurring gain on the sale of the QS assets in the quarter ended September 30, 2006 but revenue, profits and cash flow from operations after the sale date will not include a contribution from the QS operations which could have a negative impact on near-term results. As explained earlier in this discussion, for a variety of reasons, our operating results vary significantly from quarter-to-quarter and are not generally predictable with any degree of certainty.

We filed a Form 8-K dated April 27, 2006 in which we disclosed that we received a letter from The American Stock Exchange (AMEX) notifying us that AMEX had determined that we do not meet certain of the AMEX continued listing standards. Specifically, AMEX noted we were not in compliance with Section 1003(a)(ii) of the AMEX Company Guide because our shareholders equity is less than $4,000,000 and we have sustained losses in three out of four of our most recent fiscal years. In May 2006, we submitted a plan to AMEX to achieve compliance with the continued listing standards within an 18 month period. On July 21, 2006, AMEX notified us that it has determined we have made a reasonable demonstration in the plan of our ability to regain compliance with the continued listing standards by October 27, 2007. During this extension period, we will be subject to periodic review to determine if we are making progress consistent with the plan.

Results of Operations

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

Revenue Total consolidated revenue in the three month period ended June 30, 3006 was $4,229,000, a nine percent decline compared to the second quarter of 2005. Revenue from products, which includes sales of equipment in our Industrial Products segment as well as software license fees related to the Information Technology segment, was $2,427,000 in the three month period ended June 30, 2006 compared to $2,820,000 in the three months ended June 30, 2005. Product revenue contributed by the Industrial Products segment was 88 percent of total product revenue in the second quarter of 2006 compared to 51 percent of total product revenue in the same quarter last year. The change in product mix is due to a 47 percent increase in revenue at the ChemFree subsidiary and a decline in the number of new software licenses recorded by our Information Technology segment, principally at the VISaer subsidiary. ChemFree increased the unit volume sold of Smartwashers, fluid and filter in both domestic and international markets. Revenue from products in the first six months of 2006 was $4,466,000, down nine percent as compared to the same six month period of 2005. The Industrial Products segment grew by 22 percent in the year-to-date period in 2006 compared to the year-to-date period in 2005, mainly due to increased volume of products sold in the domestic U.S. market in both the distributor channel and large corporate account channel. The Information Technology segment recorded a decline in the number of new software licenses recognized in the first six months of 2006 as compared to the first six months of last year, principally at the VISaer subsidiary.

Service revenue associated with the Information Technology segment was essentially flat in the three month periods ended June 30, 2006 and 2005. For the year-to-date period in 2006, service revenue increased sixty percent to $5,374,000 compared to $3,358,000 in the six month period ended June 30, 2005. Most of the increase is attributed to a single multi-year contract at the VISaer subsidiary that was completed and recognized in the first quarter of 2006, contributing $1,779,000 in services revenue.

Cost of Sales Total cost of sales was 47 percent of total revenue in three and six month periods ended June 30, 2006 compared to total cost of sales of 40 percent and 43 percent in the three and six month periods, respectively, ended June 30, 2005. Cost of product revenue was 51 percent and 50 percent of product revenue in the three and six month periods, respectively, of 2006 compared to 31 percent and 35 percent, respectively, of product revenue in the corresponding periods in 2005. The principal reason for the difference is due in part to the change in product mix

between periods. The product cost associated with Industrial Products is significantly higher than for software products and with a higher percentage of revenue associated with Industrial Products in 2006, there was a corresponding increase in cost of sales and lower gross margin. Furthermore, ChemFree experienced higher costs for transportation and certain plastic components due to increased gas and petroleum products prices, as well as more temporary facility and labor expenses

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required to support higher production output to meet current and anticipated order levels. Cost of service revenue (which relates to the Information Technology segment only) was 42 percent and 45 percent of service revenue in the three and six month periods, respectively, ending June 30, 2006 compared to 53 percent and 55 percent, respectively, of service revenue in the comparable periods in 2005. The change between periods is due in large part to fewer employees and increased productivity of the professional services personnel at VISaer.

Operating Expenses Consolidated marketing expenses were not materially different in the second quarter and six month period ended June 30, 2006 compared to the same periods in 2005. Consolidated general and administrative expenses increased by 19 percent ($149,000) and 22 percent ($384,000), respectively, in the three and six month periods ended June 30, 2006 as compared to the corresponding periods in 2005. Most of the G&A increase relates to higher legal expenses at the ChemFree subsidiary. Consolidated research and development expenses were lower by eight percent ($130,000) and two percent ($57,000), respectively, in the three and six month periods in 2006 as compared to the same periods in 2005. Although the company increased the number of development and quality assurance employees at our subsidiaries in Romania and India, the increased cost was offset by fewer domestic personnel and less use of contract personnel. In addition, at the VISaer subsidiary, more of the R&D personnel costs were allocated to cost of sales and work-in-process for specific contracts in the year-to-date period of 2006 as compared to the same period in 2005.

Interest Income (Expense) In the three and six months ended June 30, 2006, we recorded $33,000 and $61,000, respectively, in net interest expense compared to $12,000 and $18,000 in net interest income in the corresponding periods in 2005. The net interest expense in 2006 reflects greater utilization of our line of credit at a higher interest rate that in the corresponding periods of 2005 whereas the net interest income in 2005 includes interest income recorded at a subsidiary reflecting a finance charge on a customer contract, offset in part by interest expense related to the company s borrowings under its bank line of credit.

Investment Income We recorded $2,000 and $7,000 in investment income in the three and six month periods ended June 30, 2006 compared to investment income of $914,000 and $1,956,000, respectively, in the corresponding periods in 2005. The investment income in 2005 reflects cash distributions received in the first and second quarters of 2005 related to the ISC Guernsey asset sale completed in June 2004, as explained in more detail in Note 2 to the Consolidated Financial Statements in our Form 10-KSB for the year ended December 31, 2005.

Equity Earnings (Losses) of Affiliate Companies On a quarterly basis, we recognize our pro rata share of the earnings or losses of affiliate companies that we record on the equity method. We recorded $91,000 and $163,000, respectively, in net equity income of affiliate companies in the three and six months ended June 30, 2006 compared to $19,000 and $36,000, respectively in net equity in income of affiliate companies in the comparable periods in 2005. The difference between periods reflects changes in profitability at each of the affiliate companies.

Other Income, Net We recognized other income of $1,000 in the three months ended June 30, 2006 compared to other income of $13,000 in the three months ended June 30, 2005. In the six month period ended June 30, 2006, we recognized $35,000 in other income compared to $21,000 in other income in the corresponding period in 2005. The amount in each year reflects foreign currency exchange gains.

Income Taxes We did not accrue for any income tax liability year-to-date in 2006 and we believe our deferred tax assets should be fully reserved given their character and our historical losses. In the six month ended March 31, 2005, the tax liability recorded reflects $4,000 in state tax liability at a subsidiary and $8,000 in estimated alternative minimum tax.

Liquidity and Capital Resources

Our cash balance at June 30, 2006 was $447,000 compared to our cash balance of $378,000 at December 31, 2005. Our principal source of cash during the six month period ended June 30, 2006 was $1,912,000 in borrowings under our bank line of credit and to a lesser extent, $167,000 received from the sale of our holdings in Aderis Pharmaceuticals and an aggregate of $385,000 from cash distributions from two affiliate companies. Principal uses of cash during the six months ended June 30, 2006 included a $1,763,000 increase in accounts receivable due in large part to higher billings at QS Technologies for annual maintenance billings which typically occur each June, $269,000 related to higher levels of raw material and finished goods inventory at ChemFree, and $384,000 in purchases of property and equipment, most of which relates to ChemFree products which are leased to customers under long-term

leases. The increase in inventory levels at ChemFree reflects a number of factors including an increase in the price of certain plastics materials due to general market increases in prices of petroleum-based products, an increase in the minimum order quantity of certain

parts requiring ChemFree to inventory larger quantities than in the past, the addition of a new product line, and a higher level of sales. We used an aggregate of approximately $1.7 million cash in the first six months of 2006 to support the CoreCard domestic and overseas software development operations and the VISaer operations. Based on recent trends and current projections, we presently believe that scheduled customer payments on existing and pending software contracts will be sufficient to fund a significant portion of CoreCard s and VISaer s operations, although their monthly cash flows are expected to be irregular.

In the first half of 2006, negative cash flows from operations required significant borrowings under our bank line of credit. In the second quarter of 2006, we increased our line of credit to permit borrowings of up to $2.5 million. With the sale of the QS business, as disclosed in Note 11 to this report, we received $1.9 million in cash and retained accounts receivable and cash of QS aggregating approximately $2.0 million. We used proceeds from the sale and accounts receivable to pay down the $2.0 outstanding balance on our line of credit and, as of this filing, have no borrowings under the line. We have historically sold assets or acquired new ones from time to time, as exemplified by the QS transaction, and expect to do so in the future from time to time, but the timing and consideration related to such transactions are not predictable in advance.

We presently project that we will have sufficient cash on hand and expected cash flow to meet our operating needs in the foreseeable future. We also expect that accounts receivable and inventory balances will provide the required borrowing base for draws under our bank line of credit if necessary. However, if the bank elects not to renew our line of credit at the end of the current term (December 1, 2006), we may not be able to find a replacement line of credit on acceptable terms, if at all. Certain software customer contracts tie cash payments to delivery dates of various software deliverables. Delays in meeting project milestones or software delivery commitments could cause customers to postpone payments and increase our need for cash during 2006. Presently, we do not believe there is a material risk to successfully performing under these contracts but if customer payments are delayed for any reason, if we do not control costs or if we encounter unforeseen technical or quality problems, then we could require more cash than planned and we would need to increase the use of our bank line of credit.

As explained in Note 8 to our Consolidated Financial Statements in our Form 10-KSB for the year ended December 31, 2005, we are carrying an amount of $150,000 in the category Other Current Liabilities that represents funds being held by us related to a deposit by a customer of Ardext Technologies, a privately owned company in which we were a minority owner. The $150,000 is being held by us as a condition of the contract between the customer and Ardext and is expected to be refunded in August 2006 to the customer, based on a recent decision to terminate the contract between the two parties. We have no other obligations to either party with respect to this arrangement.

Beyond 2006, we currently expect that liquidity will continue to improve and consolidated operations will generate sufficient cash to fund their requirements with use of our credit facility to accommodate short-term needs. Other long-term sources of liquidity include potential sales of investments, subsidiaries or other assets although the timing and amount of any such transactions are uncertain and, to the extent they involve non-consolidated companies, generally not within our control.

We do not currently have any off balance sheet arrangements that are reasonably likely to have a current or future material effect on our financial condition, liquidity or results of operations.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets, liabilities, revenues and expenses. We consider certain accounting policies related to revenue recognition, valuation of acquired intangibles and impairment of long-lived assets, and valuation of investments to be critical policies due to the estimation processes involved in each. Management discusses its estimates and judgments with the Audit Committee of the Board of Directors. For a detailed description on the application of these and other accounting policies, see Note 1 to the Consolidated Financial Statements contained in our annual report on Form 10-KSB for the fiscal year ended December 31, 2005. Reference is also made to the discussion of the application of these critical accounting policies and estimates contained in Management s Discussion

and Analysis in our annual report on Form 10-KSB for 2005. During the three and six month periods ended June 30, 2006, there were no significant or material changes in the application of critical accounting policies that would require an update to the information provided in the Form 10-KSB for 2005.

Factors That May Affect Future Operations

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

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

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

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

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

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

- The inability of our software subsidiaries to retain key software developers who have accumulated years of know-how in our target markets and company products, or failure to attract and train a sufficient number of new software developers and testers to support our product development plans and customer requirements at projected cost levels.

- Continued increases in the price of oil, which could increase ChemFree s product costs and which could affect VISaer s results if potential aviation customers delay or cancel purchases of software or services in the face of declining industry trends or poor financial condition.

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

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

- Increased operating expenses and diversion of resources related to compliance with the internal control over financial reporting requirements of Section 404 of the Sarbanes-Oxley Act of 2002.

- Negative trends affecting the commercial aviation industry worldwide which could impact VISaer s short-term customer purchases, thus increasing its losses and need for cash.

In the Industrial Products market, failure by ChemFree to protect its intellectual property assets or to prevail in legal matters described in Item 3 of our Form 10-KSB for the year ended December 31, 2005, which could increase competition in the market place and result in greater price pressure and lower margins, thus impacting sales, profits and projected cash flow.

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

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

We have certain lease commitments, legal matters and contingent liabilities described in detail in Note 8 to the Consolidated Financial Statements in our Form 10-KSB for the year ended December 31, 2005. We are not aware presently of any facts or circumstances related to these that are likely to have a material negative impact on our results of operations or financial condition.

Item 3. Controls and Procedures

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

Part II. OTHER INFORMATION

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

At our Annual Meeting of Shareholders held on May 25, 2006, the shareholders reelected James V. Napier and J. Leland Strange to serve as directors until the Annual Meeting of Shareholders in 2009. Mr. Napier was elected by a vote of 4,117,890 For and 72,449 Withheld. Mr. Strange was elected by a vote of 4,115,371 For and 74,968 Withheld. Other directors whose terms continue after the Annual Meeting of Shareholders are Parker H. Petit and John B. Peatman.

Item 6. Exhibits

The following exhibits are filed or furnished with this report:

3(i) Amended and Restated Articles of Incorporation of the Registrant dated November 14, 1991, as amended November 25, 1997. (Incorporated by reference to Exhibit 3.1 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 1991 and to Exhibit 3.1 to the Registrant s Report on Form 8-K dated November 25, 1997.)

3(ii) Bylaws of the Registrant dated June 6, 1997. (Incorporated by reference to Exhibit 3(ii) of the Registrant s Form 10-K/A for the year ended December 31, 1997.)

4.1 Rights Agreement dated as of November 25, 1997 between the Registrant and American Stock Transfer & Trust Company as Rights Agent. (Incorporated by reference to Exhibit 4.1 of the Registrant s Report on Form 8-K dated November 25, 1997 and filed on December 16, 1997.)

4.2 Form of Rights Certificate. (Incorporated by reference to Exhibit 4.2 of the Registrant s Report on Form 8-K dated November 25, 1997 and filed on December 16, 1997.)

31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer and Chief Financial Officer furnished as required by Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, hereunto duly authorized.

INTELLIGENT SYSTEMS CORPORATION
Registrant

Date: August 11, 2006

By*: /s/ J. Leland Strange*

J. Leland Strange
Chief Executive Officer, President

Date: August 11, 2006

By*: /s/ Bonnie L. Herron*

Bonnie L. Herron
Chief Financial Officer

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