

INTELLISYNC CORP  
Form 10-Q  
March 15, 2004  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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

For the quarterly period ended January 31, 2004

OR

**.. 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 0-21709

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**INTELLISYNC CORPORATION**

(Exact name of Registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**77-0349154**  
(I.R.S. Employer

**Identification Number)**

**2550 North First Street, San Jose, California 95131**

(Address of principal executive office and zip code)

**(408) 321-7650**

(Registrant's telephone number, including area code)

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of February 12, 2004: 65,192,124

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**INTELLISYNC CORPORATION**

**10-Q REPORT**

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**Table of Contents****INTELLISYNC CORPORATION****PART I - FINANCIAL INFORMATION****Item 1. Unaudited Condensed Consolidated Financial Statements****CONDENSED CONSOLIDATED BALANCE SHEETS**

(In thousands, except per share data)

(Unaudited)

	<b>January 31, 2004</b>	<b>July 31, 2003</b>
	<u>          </u>	<u>          </u>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 6,016	\$ 7,842
Short-term investments	16,098	19,317
Accounts receivable, net of allowance for doubtful accounts of \$514 and \$340	9,140	5,469
Inventories, net	208	113
Other current assets	1,139	882
	<u>          </u>	<u>          </u>
Total current assets	32,601	33,623
Property and equipment, net	1,275	1,153
Goodwill	56,725	2,731
Other intangible assets, net	18,732	2,734
Restricted cash	296	296
Other assets	575	630
	<u>          </u>	<u>          </u>
Total assets	\$ 110,204	\$ 41,167
	<u>          </u>	<u>          </u>
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 2,022	\$ 2,619
Accrued liabilities	5,353	3,816
Current portion of obligations under capital lease	52	
Deferred revenue	3,233	2,015
	<u>          </u>	<u>          </u>
Total current liabilities	10,660	8,450
Obligations under capital lease	161	
Other liabilities	647	921
	<u>          </u>	<u>          </u>
Total liabilities	11,468	9,371
	<u>          </u>	<u>          </u>

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### Commitments and contingencies (Note 8)

#### Stockholders' equity:

Preferred stock, \$0.001 par value; 2,000 shares authorized; none issued and outstanding at January 31, 2004 and July 31, 2003		
Common stock, \$0.001 par value; 160,000 and 80,000 shares authorized; 65,079 and 47,753 shares issued and outstanding at January 31, 2004 and July 31, 2003	65	48
Additional paid-in capital	225,836	153,986
Receivable from stockholders		(112)
Deferred stock compensation	(6)	(459)
Accumulated deficit	(127,174)	(121,661)
Accumulated other comprehensive income (loss)	15	(6)
	<u>          </u>	<u>          </u>
Total stockholders' equity	98,736	31,796
	<u>          </u>	<u>          </u>
Total liabilities and stockholders' equity	\$ 110,204	\$ 41,167
	<u>          </u>	<u>          </u>

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

**Table of Contents****INTELLISYNC CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except per share data)

(Unaudited)

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>January 31,</b>		<b>January 31,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
<b>Revenue</b>				
License	\$ 7,555	\$ 4,951	\$ 12,824	\$ 9,014
Services	2,448	870	5,195	1,817
<b>Total revenue</b>	<b>10,003</b>	<b>5,821</b>	<b>18,019</b>	<b>10,831</b>
<b>Cost and operating expenses:</b>				
Cost of revenue (includes non-cash stock compensation of \$(18), \$0, \$103 and \$0)	1,797	822	3,431	1,646
Amortization of developed technology	400	146	553	295
Research and development (includes non-cash stock compensation of \$21, \$22, \$67 and \$51)	2,410	1,709	4,603	3,490
Sales and marketing (includes non-cash stock compensation of \$(75), \$0, \$216 and \$0)	3,570	2,704	6,850	5,338
General and administrative (includes non-cash stock compensation of \$80, \$146, \$878 and \$179)	1,927	1,278	4,312	2,399
Amortization of other intangibles	218		324	
In-process research and development	2,423		2,892	
Facilities exit costs and other charges	600		676	
<b>Total cost and operating expenses</b>	<b>13,345</b>	<b>6,659</b>	<b>23,641</b>	<b>13,168</b>
<b>Operating loss</b>	<b>(3,342)</b>	<b>(838)</b>	<b>(5,622)</b>	<b>(2,337)</b>
Other income, net	126	185	252	396
<b>Loss before income taxes</b>	<b>(3,216)</b>	<b>(653)</b>	<b>(5,370)</b>	<b>(1,941)</b>
Provision for income taxes	(36)	(94)	(143)	(182)
<b>Net loss</b>	<b>\$ (3,252)</b>	<b>\$ (747)</b>	<b>\$ (5,513)</b>	<b>\$ (2,123)</b>
<b>Basic and diluted net loss per common share</b>	<b>\$ (0.06)</b>	<b>\$ (0.02)</b>	<b>\$ (0.11)</b>	<b>\$ (0.05)</b>
<b>Shares used in computing basic and diluted net loss per common share</b>	<b>54,475</b>	<b>45,764</b>	<b>51,480</b>	<b>45,573</b>

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

**Table of Contents****INTELLISYNC CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

(Unaudited)

	<b>Six Months Ended January 31,</b>	
	<b>2004</b>	<b>2003</b>
<b>Cash flows from operating activities:</b>		
Net loss	\$ (5,513)	\$ (2,123)
Adjustments to reconcile net loss to net cash used in operating activities:		
In-process research and development	2,892	
Allowance for (recovery of) doubtful accounts	175	(156)
Inventory reserves	42	(21)
Depreciation	514	730
Amortization	877	295
Non-cash stock compensation	1,264	230
Realized gain on sale of investments		(10)
Changes in operating assets and liabilities, net of business acquisitions:		
Accounts receivable	(2,706)	(1,322)
Inventories	(137)	33
Other current assets	(114)	7
Other assets	(119)	20
Accounts payable	(1,720)	297
Accrued liabilities	(2,910)	(1,003)
Deferred revenue	57	(83)
Net cash used in operating activities	<u>(7,398)</u>	<u>(3,106)</u>
<b>Cash flows from investing activities:</b>		
Purchase of property and equipment	(196)	(74)
Purchase of short term investments	(4,785)	(7,772)
Proceeds from the sales of short-term investments	3,100	8,151
Proceeds from the maturities of short-term investments	4,900	5,700
Decrease in restricted cash	56	
Cash acquired from business acquisition	2,296	
Net cash provided by investing activities	<u>5,371</u>	<u>6,005</u>
<b>Cash flows from financing activities:</b>		
Principal payments on borrowings	(1,764)	(2,000)
Note repayments from stockholders	310	330
Proceeds upon exercise of stock options	1,508	406
Proceeds from ESPP shares issued	147	92



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Net cash provided by (used in) financing activities	201	(1,172)
Net increase (decrease) in cash and cash equivalents	(1,826)	1,727
Cash and cash equivalents at beginning of period	7,842	4,331
Cash and cash equivalents at end of period	\$ 6,016	\$ 6,058

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

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**INTELLISYNC CORPORATION**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1 The Company and a Summary of its Significant Accounting Policies**

*The Company*

Intellisync Corporation (Intellisync or the Company) was incorporated in California on August 27, 1993 as Puma Technology, Inc. and was subsequently reincorporated in Delaware on November 27, 1996. The Company changed its corporate name from Pumatech, Inc. to Intellisync Corporation effective February 17, 2004. The Company develops, markets and supports synchronization, mobile-application development, remote access and mobile-application management/device management software that enables consumers, business professionals and information technology (IT) officers to extend the capabilities of enterprise groupware and vertical applications, handheld organizers/computers, Web-enabled cellular phones, pagers and other wireless or wireline personal communications platforms.

*Liquidity and Capital Resources*

The Company has incurred losses and negative cash flows since inception. The Company incurred a net loss of approximately \$3,252,000 and \$5,513,000 for the three and six months ended January 31, 2004 and negative cash flows from operations of approximately \$7,398,000 for the six months ended January 31, 2004. The Company's cash balances may decline further, although the Company believes that the effects of its strategic actions implemented to improve revenue as well as control costs along with existing cash resources will be adequate to fund its operations for at least the next 12 months. Failure to generate sufficient revenues or control spending could adversely affect the Company's ability to achieve its business objectives.

Refer to Note 12 - Subsequent Events regarding \$57,100,000 net proceeds from the Company's recent issuance of convertible senior notes.

*Basis of Presentation and Consolidation*

The accompanying condensed consolidated financial statements of Intellisync as of January 31, 2004 and for the three and six months ended January 31, 2004 and 2003 are unaudited and reflect all normal recurring adjustments which are, in the opinion of management, necessary for their fair presentation. These condensed consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended July 31, 2003. The condensed consolidated balance sheet as of July 31, 2003 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The results of operations for the interim period ended January 31, 2004 are not necessarily indicative of results to be expected for the full year.

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The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. The condensed consolidated financial statements include the results of operations of all companies or assets recently acquired, including Synchrologic, Inc. and the assets purchased from Spontaneous Technology, Inc. since the date of the acquisitions. All significant inter-company balances and transactions have been eliminated in consolidation.

Certain amounts in prior periods have been reclassified to conform to the current presentation.

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### *Use of Estimates and Assumptions*

The preparation of the condensed consolidated financial statements in conformity with generally accepted accounting principles requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. On an on-going basis, the Company evaluates its estimates, including those related to provision for doubtful accounts, channel inventory and product returns, valuation of intangibles, investments and other long-lived assets, restructuring accruals, license and service revenue recognition and contingencies. The Company bases its estimates on various factors and information which may include, but are not limited to, history and prior experience, experience of other enterprises in the same industry, new related events, current economic conditions and information from third party professionals that are believed to be reasonable under the circumstances, the results of which form the basis for taking judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

### *Revenue Recognition*

Revenue is derived from software licenses and related services, which include implementation and integration of software solutions, post contract support, training and consulting.

Transactions involving the sale of software products are accounted for under the American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) No. 97-2, Software Revenue Recognition, as amended by SOP No. 98-9, Modification of 97-2, Software Revenue Recognition with Respect to Certain Transactions. For contracts with multiple elements, and for which vendor-specific objective evidence of fair value for the undelivered elements exists, revenue is recognized for the delivered elements based upon the residual contract value as prescribed by SOP No. 98-9. The Company has accumulated relevant information from contracts to use in determining the availability of vendor-specific objective evidence and believes that such information complies with the criteria established in SOP No. 97-2 as follows:

Customers are required to pay separately for annual maintenance. Optional stated future renewal rates are included as a term of the contracts. The Company uses the renewal rate as vendor-specific objective evidence of fair value for maintenance.

The Company charges standard hourly rates for consulting services, when such services are sold separately, based upon the nature of the services and experience of the professionals performing the services.

For training, the Company charges standard rates for each course based upon the duration of the course, and such courses are separately priced in contracts. The Company has a history of selling such courses separately.

Revenue from license fees is recognized when persuasive evidence of an arrangement exists, delivery of the product has occurred, no significant Company obligations with regard to implementation or integration exist, the fee is fixed or determinable and collectibility is probable. Arrangements for which the fees are not deemed probable for collection are recognized upon cash collection. Payments from customers received in advance of revenue recognition are recorded as deferred revenue.

Services revenue primarily comprises revenue from consulting fees, maintenance contracts and training. Services revenue from consulting and training is recognized as the service is performed. Maintenance contracts include the right to unspecified upgrades and ongoing support.

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Maintenance revenue is deferred and recognized ratably as services are provided over the maintenance period.

License and services revenue on contracts involving significant implementation, customization or services, that are essential to the functionality of the software is recognized over the period of each engagement, primarily

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using the percentage-of-completion method. Labor hours incurred is generally used as the measure of progress towards completion as prescribed by SOP No. 81-1, Accounting for Performance of Construction-Type and Certain Product-Type Contracts. Revenue for these arrangements is classified as license revenue and services revenue based upon estimates of fair value for each element, and the revenue is recognized based on the percentage-of-completion ratio for the arrangement. A provision for estimated losses on engagements is made in the period in which the loss becomes probable and can be reasonably estimated. The Company considers a project completed when all contractual obligations have been met (generally the go live date). When the Company sells additional licenses, revenue is recognized after the go-live date if the products or seats have been delivered and no remaining obligations exist.

The Company currently sells its products directly to individuals, small businesses and corporations, to original equipment manufacturers (OEMs) and to distributors and value-added resellers in North America, Europe, the Asia-Pacific region, South America and Africa. Revenue from products distributed indirectly through major distributors and resellers is recognized on a sell through basis. Agreements with the Company's major distributors and resellers contain specific product return privileges for stock rotation and obsolete products that are generally limited to contractual amounts. Reserves for estimated future returns are provided for upon revenue recognition. Product returns are recorded as a reduction of revenues. Accordingly, the Company has established a product returns reserve composed of 100% of product inventories held at the Company's distribution partners, as well as an estimated amount for returns from customers of the distributors and other resellers as a result of stock rotation and obsolete products. Such reserves are based on:

historical product returns and inventory levels on a product by product basis;

current inventory levels and sell through data on a product by product basis as reported by the Company's major distributors worldwide;

demand forecast by product in each of the principal geographic markets, which is impacted by the Company's product release schedule, seasonal trends and analyses developed by the Company's internal sales and marketing group; and

general economic conditions.

The Company license rights to use its intellectual property portfolio, whereby licensees, particularly OEMs, typically pay a non-refundable license fee in one or more installments and on-going royalties based on their sales of products incorporating the Company's intellectual property. Revenue from OEMs under minimum guaranteed royalty arrangements, which are not subject to future obligations, is recognized when such royalties are earned and become payable. Royalty revenue is recognized as earned when reasonable estimates of such amounts can be made. Royalty revenue that is subject to future obligations is recognized when such obligations are fulfilled. Royalty revenue that exceeds minimum guarantees is recognized in the period earned.

*Stock-Based Compensation*

The Company accounts for non-cash stock-based employee compensation using the intrinsic method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees and Related Interpretations, and complies with the disclosure provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation and SFAS No. 148, Accounting for Stock-Based Compensation, Transition and Disclosures. Stock and other equity instruments issued to non-employees is accounted for in accordance with SFAS No. 123 and Emerging Issues Task Force Issue (EITF) No. 96-18, Accounting for Equity Instruments Issued to Other than Employees for Acquiring, or in Conjunction with Selling Goods or Services and valued using the Black Scholes model. Expense associated with stock-based compensation is being amortized on an accelerated basis over the vesting period of the individual award consistent with the method described in Financial Accounting Standards Board (FASB) Interpretation (FIN) No. 28.



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If compensation cost for the Company's stock plans had been determined consistent with SFAS No. 123 Accounting for Stock-Based Compensation, the Company's net loss and loss per common share would have been adjusted to the pro-forma amounts indicated below (in thousands, except per common share data):

	Three Months Ended January 31,		Six Months Ended January 31,	
	2004	2003	2004	2003
Net loss as reported	\$ (3,252)	\$ (747)	\$ (5,513)	\$ (2,123)
Add: Stock-based employee compensation expense included in reported net loss	8	168	1,264	230
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards	1,167	176	1,726	342
Pro forma net loss	\$ (4,411)	\$ (755)	\$ (5,975)	\$ (2,235)
Basic and diluted net loss per common share as reported	\$ (0.06)	\$ (0.02)	\$ (0.11)	\$ (0.05)
Basic and diluted pro forma net loss per common share	\$ (0.08)	\$ (0.02)	\$ (0.12)	\$ (0.05)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	Stock Option Plans			
	Three Months Ended January 31,		Six Months Ended January 31,	
	2004	2003	2004	2003
Fair value per share	\$ 1.61	\$ 0.41	\$ 2.29	\$ 0.33
Option life (in years)	1.6	3.3	2.0	3.1
Risk-free interest rate	1.67%	2.44%	1.84%	2.27%
Stock price volatility	125%	132%	127%	132%
Dividend yield				

	Employee Stock Purchase Plan			
	Three Months Ended January 31,		Six Months Ended January 31,	
	2004	2003	2004	2003
Fair value per share	\$ 1.05	\$ 0.19	\$ 0.50	\$ 0.26
Option life (in years)	1.0	1.0	1.0	0.5



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Risk-free interest rate	1.25%	1.02%	1.12%	1.20%
Stock price volatility	131%	132%	132%	130%
Dividend yield				

Because the Black-Scholes option valuation model was developed for traded options and requires the input of subjective assumptions and the number of future shares to be issued or cancelled is not known, the resulting pro forma compensation cost may not be representative of that to be expected in future years.

**Table of Contents****Note 2 Recently Issued Accounting Pronouncement***Consolidation of Variable Interest Entities*

In January 2003, the FASB issued FIN No. 46, Consolidation of Variable Interest Entities. FIN No. 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. A variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. A variable interest entity often holds financial assets, including loans or receivables, real estate or other property. A variable interest entity may be essentially passive or it may engage in research and development or other activities on behalf of another company. In December 2003, the FASB released a revised version of FIN No. 46 (referred to as FIN 46R) clarifying certain aspects of FIN No. 46 and providing certain entities with exemptions from the requirements of FIN No. 46. FIN 46R requires the application of either FIN No. 46 or FIN 46R to all Special Purpose Entities (SPEs) created prior to February 1, 2003 at the end of the first interim or annual reporting period ending after December 15, 2003. All entities created after January 31, 2003 were already required to be analyzed under FIN No. 46, and they must continue to do so, unless FIN 46R is adopted early. FIN 46R will be applicable to all non-SPEs created prior to February 1, 2003 at the end of the first interim or annual reporting period ending after March 15, 2004. The Company will be required to adopt the accounting requirements of FIN 46R for the fiscal third quarter ended April 30, 2004. The Company does not expect the adoption of FIN 46R to have a material impact on its consolidated financial position, results of operations and cash flows.

**Note 3 Balance Sheets Components**

Inventories, net, consist of the following (in thousands):

	January 31, 2004	July 31, 2003
Raw materials	\$ 39	\$ 61
Finished goods and work-in-process	169	52
<b>Inventories</b>	<b>\$ 208</b>	<b>\$ 113</b>

Property and equipment, net, consist of the following (in thousands):

	January 31, 2004	July 31, 2003
Computer equipment and software	\$ 5,369	\$ 4,895
Furniture and office equipment	1,624	1,511

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Leasehold improvements	841	792
	<u>7,834</u>	<u>7,198</u>
Less: Accumulated depreciation and amortization	(6,559)	(6,045)
	<u>\$ 1,275</u>	<u>\$ 1,153</u>

Property and equipment, net, includes assets financed under capital lease obligations of approximately \$212,000 and zero, net of accumulated depreciation, as of January 31, 2004 and July 31, 2003, respectively. Refer to Note 8. The depreciation expense was \$276,000 and \$514,000 for the three and six months ended January 31, 2004, respectively, and \$347,000 and \$729,000 for the three and six months ended January 31, 2003, respectively.

**Table of Contents****Note 4 Acquisitions***Starfish Software, Inc.*

In March 2003, the Company signed and closed a purchase agreement with Motorola, Inc. of Schaumburg, Illinois to acquire all of capital stock of Starfish Software, Inc., a wholly owned subsidiary of Motorola headquartered in Scotts Valley, California. Starfish is a provider of end-to-end mobile infrastructure solutions based on integrated platforms composed of server, desktop and device software for mobile data synchronization, wireless connectivity and device management. Under the terms of the stock purchase agreement, the Company initially paid a total of \$1,501,000 in cash, subject to further adjustment based on actual working capital as of the closing date. The Company further paid \$178,000 based on subsequent adjustments made to Starfish's working capital.

The Starfish acquisition has been accounted for as a purchase business combination. The consolidated financial statements include the results of operations of Starfish since the date of acquisition. The purchase price of \$1,831,000 (including acquisition costs of \$152,000) was assigned to the fair value of the assets acquired, including the following (in thousands):

Tangible assets acquired	\$ 1,133
Liabilities assumed	(986)
In-process research and development	406
Developed technology	675
Patents	202
Trademarks	52
Customer base	278
Existing contracts	71
	<u>          </u>
	<u>\$ 1,831</u>

Tangible assets acquired and liabilities assumed were valued at their respective carrying amounts as the Company believes that these amounts approximated their current fair values at the acquisition date. The valuation of identifiable intangible assets acquired was based on management's estimates using valuation reports prepared by an independent appraiser, currently available information and reasonable and supportable assumptions. This allocation was generally based on the fair value of these assets determined using the income approach.

Of the total purchase price, \$1,278,000 was allocated to amortizable intangibles included in the above list. The amortizable intangible assets are being amortized using the straight-line method over the estimated useful life of the respective assets of nine months to four years.

As of the acquisition date, technological feasibility of the in-process technology had not been established and the technology had no alternative future use. Accordingly, the Company expensed the in-process research and development at the date of the acquisition.

The amount of the purchase price allocated to in process-research and technology was based on established valuation techniques used in high-technology computer software industry. The fair value assigned to the acquired in-process research and development was determined using

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the income approach, which discounts expected future cash flows to present value. The key assumptions used in the valuation include, among others, expected completion date of the in-process projects identified as of the acquisition date, estimated costs to complete the projects, revenue contributions and expense projections assuming the resulting product have entered the market, and discount rate based on the risks associated with the development life cycle of the in-process technology acquired. The discount rate used in the present value calculations are normally obtained from a weighted-average cost of capital analysis, adjusted upward to account for the inherent uncertainties surrounding the successful development of the in-process research and development, the expected profitability levels of such technology, and

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the uncertainty of technological advances that could potentially impact the estimates. The Company assumes the pricing model for the resulting product of the acquired in process research and technology to be standard within its industry. The Company, however, did not take into consideration any consequential amount of expense reductions from integrating the acquired in-process technology with other existing in-process or completed technology. Therefore, the valuation assumptions do not include significant anticipated cost savings.

The key assumptions underlying the valuation of acquired in-process research and development from Starfish are as follows (in thousands):

Project name: Mercury platform technology

Percent completed as of acquisition date: 70%

Estimated costs to complete technology at acquisition date: \$375,000

Risk-adjusted discount rate: 30%

First period expected revenue: calendar year 2004

Subsequent to the acquisition of Starfish, there have been no significant developments related to the current status of the acquired in-process research and development project that would result in material changes to the assumptions.

*Spontaneous Technology, Inc.*

On September 17, 2003, the Company consummated the acquisition of substantially all of the assets of Spontaneous Technology, Inc. of Salt Lake City, Utah, a provider of enterprise secure Virtual Private Network (sVPN) software designed to extend existing corporate applications to most wireless devices. Under the terms of the agreement, the Company issued a total of 869,259 shares of Intellisync's common stock valued at approximately \$2,999,000 using the five-trading-day average price surrounding the date the acquisition was announced of \$3.45 per share, less estimated registration costs. The number of shares were calculated using the average price of the Company's common stock for ten consecutive trading days ended three business days prior the date of acquisition. There are 224,417 additional shares held in escrow that are contingently issuable upon satisfaction of a pre-acquisition clause. Additionally, depending upon the Company's revenues associated with sales of its products including certain technology of Spontaneous Technology during the period ending September 30, 2004, the Company may be required to pay Spontaneous Technology additional consideration of up to \$7,000,000 in shares of Intellisync's common stock.

The condensed consolidated financial statements include the results of operations of Spontaneous Technology since the date of acquisition. Under the purchase method of accounting, the total preliminary purchase price was allocated to Spontaneous Technology's net tangible and intangible assets based upon their estimated fair value as of the acquisition date. The preliminary purchase price of \$3,319,000 (including estimated acquisition costs of \$320,000) was assigned to the fair value of the assets acquired, including the following (in thousands):

Tangible assets acquired	\$ 18
Liabilities assumed	(1,726)
In-process research and development	469
Developed and core technology	889

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Patents	168
Customer base	499
Goodwill	3,002
	<hr/>
	\$ 3,319
	<hr/>

Tangible assets acquired and liabilities assumed were preliminarily valued at their respective carrying amounts as the Company believes that these amounts approximated their current fair values at the acquisition date. The preliminary valuation of identifiable intangible assets acquired was based on management's estimates using valuation reports prepared by an independent appraiser, currently available information and reasonable and supportable assumptions. This allocation was generally based on the fair value of these assets determined using the income approach.

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Of the total purchase price, \$1,556,000 was allocated to amortizable intangibles included in the above list. The amortizable intangible assets are being amortized using the straight-line method over the estimated useful life of the respective assets of 4 years. Refer to Note 5.

As of the acquisition date, technological feasibility of the in-process technology had not been established and the technology had no alternative future use. Accordingly, the Company expensed the in-process research and development at the date of the acquisition.

The amount of the purchase price allocated to in-process research and technology was based on established valuation techniques used in the high-technology software industry. The fair value assigned to the acquired in-process research and development was determined using the income approach, which discounts expected future cash flows to present value. The key assumptions used in the valuation include, among others, expected completion date of the in-process projects identified as of the acquisition date, estimated costs to complete the projects, revenue contributions and expense projections assuming the resulting product has entered the market, and discount rate based on the risks associated with the development life cycle of the in-process technology acquired. The discount rate used in the present value calculations are normally obtained from a weighted-average cost of capital analysis, adjusted upward to account for the inherent uncertainties surrounding the successful development of the in-process research and development, the expected profitability levels of such technology, and the uncertainty of technological advances that could potentially impact the estimates. The Company assumes the pricing model for the resulting product of the acquired in process research and technology to be standard within its industry. The Company, however, did not take into consideration any consequential amount of expense reductions from integrating the acquired in-process technology with other existing in-process or completed technology. Therefore, the valuation assumptions do not include significant anticipated cost savings.

The key assumptions underlying the valuation of acquired in-process research and development from Spontaneous Technology are as follows (in thousands):

Project names: Version upgrade of Spontaneous Technology s secure Virtual Private Network (sVPN)

Percent completed as of acquisition date: 60%

Estimated costs to complete technology at acquisition date: \$125,000

Risk-adjusted discount rate: 22%

First period expected revenue: calendar year 2004

The development of above technology remains highly dependent on the remaining efforts to achieve technical viability, rapidly changing customer markets, uncertain standards for a new product, and significant competitive threats from several companies. The nature of the efforts to develop this technology into a commercially viable product consists primarily of planning, designing, experimenting, and testing activities necessary to determine that the technology can meet market expectations, including functionality and technical requirements. Failure to bring the product to market in a timely manner could result in a loss of market share or a lost opportunity to capitalize on emerging markets, and could have a material adverse impact on the Company s business and operating results.

Subsequent to the acquisition of Spontaneous Technology, there have been no significant developments related to the current status of the acquired in-process research and development project that would result in material changes to the assumptions.



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A preliminary estimate of \$3,002,000 has been allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill will not be amortized but will be tested for impairment (a tax deductible charge) at least annually.

**Table of Contents***Synchrologic, Inc.*

On December 29, 2003, the Company completed its acquisition of all of the issued and outstanding stock of Synchrologic, Inc. headquartered in Atlanta, Georgia pursuant to an Agreement and Plan of Merger, dated as of September 14, 2003. The Agreement and Plan of Merger also provided for the dismissal of the Company's outstanding litigation against Synchrologic with prejudice as of September 17, 2003, thereby permanently ending this specific suit. Synchrologic's product line provides mobile access to enterprise applications, email and personal information management (PIM) data, file content, intranet sites, and Web content, while giving IT groups the tools to manage mobile devices remotely.

In the merger, all outstanding shares of Synchrologic common stock and preferred stock were converted into the right to receive a total of 15,130,171 shares of the Company's common stock. In addition, all outstanding options to purchase Synchrologic common stock were converted into options to purchase a total of 1,018,952 shares of the Company's common stock. The total number of shares issued was determined by dividing \$60,000,000 by the average closing price of \$5.22 of the shares of the Company's common stock for the thirty consecutive trading days ending on the last complete trading day immediately preceding the closing date of the merger (which amount was subject to adjustment based on the transaction expenses incurred by Synchrologic in connection with the merger), provided that the number of shares did not exceed 19,800,000 or be fewer than 16,200,000 (in each case subject to adjustment based on the transaction expenses incurred by Synchrologic in connection with the merger). The shares were valued at approximately \$62,125,000 using the five-trading-day average price surrounding the date the acquisition was announced of \$4.11 per share, and the options were valued at approximately \$4,123,000 using the Black-Scholes option pricing model. The following assumptions were used to perform the calculations of the fair market value of stock options issued: fair value of Company's common stock of \$4.05, expected life of 3.9 years, risk-free interest rate of 3.4%, expected volatility of 132% and no expected dividend yield.

The condensed consolidated financial statements include the results of operations of Synchrologic since the date of acquisition. Under the purchase method of accounting, the total preliminary purchase price was allocated to Synchrologic's net tangible and intangible assets based upon their estimated fair value as of the acquisition date. The preliminary purchase price of \$67,148,000 (comprising the value of the shares and options described above and the estimated acquisition costs of \$900,000) was assigned to the fair value of the assets acquired, including the following (in thousands):

Tangible assets acquired	\$ 3,844
Liabilities assumed	(5,523)
In-process research and development	2,423
Developed and core technology	10,493
Patents	1,321
Customer base	3,487
Goodwill	51,103
	<hr/>
	\$ 67,148

Tangible assets acquired and liabilities assumed were preliminarily valued at their respective carrying amounts as the Company believes that these amounts approximated their current fair values at the acquisition date. The preliminary valuation of identifiable intangible assets acquired was based on management's estimates using valuation reports prepared by an independent appraiser, currently available information and reasonable and supportable assumptions. This allocation was generally based on the fair value of these assets determined using the income approach.

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Of the total purchase price, \$15,301,000 was allocated to amortizable intangibles included in the above list. The amortizable intangible assets are being amortized using the straight-line method over the estimated useful life of the respective assets of 4 years. Refer to Note 5.

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As of the acquisition date, technological feasibility of the in-process technology had not been established and the technology had no alternative future use. Accordingly, the Company expensed the in-process research and development at the date of the acquisition.

The amount of the purchase price allocated to in-process research and technology was based on established valuation techniques used in the high-technology software industry. The fair value assigned to the acquired in-process research and development was determined using the income approach, which discounts expected future cash flows to present value. The key assumptions used in the valuation include, among others, expected completion date of the in-process projects identified as of the acquisition date, estimated costs to complete the projects, revenue contributions and expense projections assuming the resulting product has entered the market, and discount rate based on the risks associated with the development life cycle of the in-process technology acquired. The discount rate used in the present value calculations are normally obtained from a weighted-average cost of capital analysis, adjusted upward to account for the inherent uncertainties surrounding the successful development of the in-process research and development, the expected profitability levels of such technology, and the uncertainty of technological advances that could potentially impact the estimates. The Company assumes the pricing model for the resulting product of the acquired in process research and technology to be standard within its industry. The Company, however, did not take into consideration any consequential amount of expense reductions from integrating the acquired in-process technology with other existing in-process or completed technology. Therefore, the valuation assumptions do not include significant anticipated cost savings.

The key assumptions underlying the valuation of acquired in-process research and development from Synchrologic are as follows (in thousands):

Project names: Version upgrade of Data Sync, File Sync, E-mail accelerator and Systems Management products

Percent completed as of acquisition date: 60%-70%

Estimated costs to complete technology at acquisition date: \$3,000,000

Risk-adjusted discount rate: 22%

First period expected revenue: calendar year 2004

The development of above technology remains highly dependent on the remaining efforts to achieve technical viability, rapidly changing customer markets, uncertain standards for a new product, and significant competitive threats from several companies. The nature of the efforts to develop this technology into a commercially viable product consists primarily of planning, designing, experimenting, and testing activities necessary to determine that the technology can meet market expectations, including functionality and technical requirements. Failure to bring the product to market in a timely manner could result in a loss of market share or a lost opportunity to capitalize on emerging markets, and could have a material adverse impact on the Company's business and operating results.

Subsequent to the acquisition of Synchrologic, there have been no significant developments related to the current status of the acquired in-process research and development project that would result in material changes to the assumptions.

A preliminary estimate of \$51,103,000 has been allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill associated with Synchrologic acquisition will not be amortized but will be tested for impairment (a tax deductible charge) at least annually.

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The liabilities assumed by the Company included Synchrologic's outstanding balance of approximately \$1,764,000 under a credit facility agreement with a bank. The Company fully paid the outstanding balance during the second quarter of fiscal 2004. The bank credit facility agreement was automatically terminated upon the Company's acquisition of Synchrologic.

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The following unaudited pro-forma consolidated financial information reflects the results of operations for the three and six months ended January 31, 2004 and 2003, as if the acquisition of Starfish and Synchrologic and asset acquisition of Spontaneous Technology had occurred on the beginning of each period presented and after giving effect to purchase accounting adjustments. These pro forma results have been prepared for comparative purposes only and do not purport to be indicative of what operating results would have been had the acquisitions actually taken place on the beginning of each period presented. In addition, these results are not intended to be a projection of future results and do not reflect any synergies that might be achieved from the combined operations (in thousands, except per share data):

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>January 31,</b>		<b>January 31,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Pro forma revenue	\$ 11,254	\$ 9,631	\$ 22,614	\$ 18,843
Pro forma net loss	\$ (563)	\$ (5,912)	\$ (2,360)	\$ (14,568)
Pro forma basic and diluted net loss per common share	\$ (0.01)	\$ (0.09)	\$ (0.04)	\$ (0.23)

The effect of the in-process research and development charges has been excluded in the above unaudited pro forma consolidated financial information as they represent non-recurring charges directly related to the acquisitions.

**Note 5 Goodwill, Developed Technology and Other Intangible Assets**

Goodwill represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill is not amortized but will be tested for impairment at least annually. The Company performs the annual impairment tests in the fourth quarter of each fiscal year. The Company currently only has one reporting unit, therefore all of the goodwill has been assigned to the enterprise as a whole. The following table sets forth the changes in goodwill during the first two quarters of fiscal 2004 (in thousands):

	<b>Goodwill</b>
<b>Balance at July 31, 2003</b>	\$ 2,731
Acquired from Spontaneous Technology	3,002
Acquired from Synchrologic	51,103
Adjustment	(111)
<b>Balance at January 31, 2004</b>	<b>\$ 56,725</b>

The \$111,000 adjustment to goodwill relates to the Company's elimination of royalties due to Synchrologic prior to its acquisition.



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Other intangible assets, net, consist of the following (in thousands, except weighted average useful life):

	Weighted Average Useful Life	January 31, 2004			July 31, 2003		
		Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
Developed technology	4 years	\$ 19,298	\$ (6,533)	\$ 12,765	\$ 7,900	\$ (5,980)	\$ 1,920
Patents	4 years	1,691	(85)	1,606	202	(17)	185
Trademarks	3 years	52	(15)	37	52	(6)	46
Customer base	4 years	4,418	(198)	4,220	431	(25)	406
Covenant not-to-compete	2 years	101	(26)	75	100	(1)	99
Existing contracts	9 months	310	(281)	29	310	(232)	78
		<u>\$ 25,870</u>	<u>\$ (7,138)</u>	<u>\$ 18,732</u>	<u>\$ 8,995</u>	<u>\$ (6,261)</u>	<u>\$ 2,734</u>

Other intangibles as of January 31, 2004 include a total of approximately \$15,301,000 amortizable identifiable intangibles obtained from the Company's acquisition of Synchrologic, \$1,556,000 amortizable identifiable intangibles obtained from the Company's acquisition of substantially all of the assets of Spontaneous Technology during the first two quarters of fiscal 2004 and an \$18,000 adjustment to the amortizable identifiable intangibles obtained from the Company's asset purchase of Loudfire, Inc. during fiscal 2003.

The amortization of developed technology amounted to \$400,000 and \$553,000 for the three and six months ended January 31, 2004, respectively, and \$146,000 and \$295,000 for the corresponding periods in fiscal 2003. The amortization of other intangible assets amounted to \$218,000 and \$324,000 for the three and six months ended January 31, 2004, respectively, and zero for the corresponding periods in fiscal 2003. The Company continues to amortize other intangible assets and is required to review such assets for impairment under SFAS No. 144,

Accounting for the Impairment or Disposal of Long-Lived Assets, reassess their useful lives and make any necessary adjustments. Based on acquisitions completed as of January 31, 2004, the estimated future amortization expense of other intangible assets is as follows (in thousands):

	Developed Technology	Other Intangibles
Six months ending July 31, 2004	\$ 1,673	\$ 807
Fiscal year ending July 31,		
2005	3,345	1,614
2006	3,345	1,539
2007	3,280	1,486
2008	1,122	521
	<u>\$ 12,765</u>	<u>\$ 5,967</u>

**Note 6 Related Party Transactions**



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On September 30, 2003, the Company's board of directors approved change of control agreements with three of the Company's officers that provides for 12 months acceleration of vesting of each individual's options held at the time of a change of control. In addition, the Company granted these individuals options to purchase an aggregate of an additional 425,000 shares of the Company's common stock. As of the date of grant, the option shares will vest over four years, with 25% vesting after one year and then 1/48th vesting monthly thereafter. The Company accounts for these options using the guidance prescribed by APB Opinion No. 25, Accounting for Stock Issued to Employees and Related Interpretations, and EITF No. 00-23, Issues Relating to Accounting for Stock Compensation Under APB Opinion No. 25 and FASB Interpretation No. 44 (FIN No. 44).

As a result, the Company determined that the approval of the change of control agreement would result in a new measurement date for the calculation of stock-based compensation expense under FIN No. 44 because the modification may allow the officers to vest in an option or award that would otherwise been forfeited pursuant to

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the award's original terms. As of January 31, 2004, no change of control had occurred and the Company is unable to determine the number of options that the officers will ultimately retain that would otherwise have been forfeited, absent the modification. As a result, no compensation expense has been recognized in relation to those awards during the three months ended January 31, 2004.

The Company had a full-recourse promissory note used by its chief executive officer to purchase shares of the Company's common stock with a principal amount of approximately \$310,000. The loan carried an interest rate of 4.75% per annum and was payable on June 14, 2008. During the second quarter of fiscal 2004, the promissory note was fully paid, together with the accrued interest. Due to the non-substantive nature of the exercise of the related stock option, the Company recorded a long-term liability in the consolidated balance sheets as of January 31, 2004 and July 31, 2003 of approximately \$43,000 and \$198,000, respectively, for the unvested portion of the shares purchased. These unvested shares are subject to repurchase by the Company.

**Note 7 Restructuring Accrual**

The Company implemented a number of cost-reduction plans aimed at reducing costs that were not integral to its overall strategy, better aligning its expense levels with current revenue levels and ensuring conservative spending during periods of economic uncertainty. These initiatives included a reduction in workforce and facilities consolidation.

During the second quarter of fiscal 2004, the Company recorded facilities exit costs of \$600,000 for vacating its remaining office space in Santa Cruz, California and a floor of its office facility in San Jose, California. Inherent in the estimation of the costs related to the Company's restructuring efforts are assessments related to the most likely expected outcome of the significant actions to accomplish the restructuring. In determining the excess facilities exit costs, the Company was required to estimate future sublease income, negotiated lease settlement costs, future net operating expenses of the facilities, and brokerage commissions, among other expenses. These estimates, along with other estimates made by management in connection with restructuring, may vary significantly depending, in part, on factors that may be beyond the Company's control. Specifically, these estimates will depend on the Company's success in negotiating with lessors, the time periods required to locate and contract suitable subleases and the market rates at the time of such subleases. Adjustments to the reserve for the consolidation of excess facilities will be required if actual lease exit costs or sublease income differ from amounts currently expected.

The following table sets forth the activities in the restructuring accrual account during the first two quarters of fiscal 2004 (in thousands):

	<b>Consolidation of Excess Facilities</b>
	<b>_____</b>
<b>Balance at July 31, 2003</b>	\$ 1,766
Restructuring provision	600
Cash payments	(712)
	<b>_____</b>
<b>Balance at January 31, 2004</b>	<b>\$ 1,654</b>
	<b>_____</b>

The remaining unpaid amount as of January 31, 2004 of \$1,654,000, related to the net lease expense due to the consolidation of excess facilities, will be paid over the respective lease terms through June 2006 using cash from operations. The current and long-term portions of the underlying

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accrual of \$1,122,000 and \$532,000 are classified as Accrued Liabilities and Other Liabilities, respectively, in the condensed consolidated balance sheet as of January 31, 2004.

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The Company continually evaluates the balance of the restructuring reserve it records in prior periods based on the remaining estimated amounts to be paid. Differences, if any, between the estimated amounts accrued and the actual amounts paid will be reflected in operating expenses in future periods.

**Note 8 Commitments and Contingencies***Leases*

During the first quarter of fiscal 2004, the Company entered into a capital lease agreement for a phone system, which expires in February 2008. Assets and future obligations related to the capital lease are included in the accompanying condensed consolidated balance sheet as of January 31, 2004 in property and equipment and liabilities, respectively. Current and long-term portions of the capital lease amounted to \$52,000 and \$161,000, respectively, at January 31, 2004. Depreciation of assets held under the capital lease is included in depreciation and amortization expense.

The Company leases its facilities under operating leases that expire at various dates through June 2006. The leases provide for escalating lease payments.

Future minimum lease payments, for which the Company anticipates using cash from operations, for all non-cancelable capital and operating lease agreements at January 31, 2004, were as follows (in thousands):

	Total	Six months ending July 31, 2004	Fiscal year ending July 31,			
			2005	2006	2007	2008
Capital lease obligation	\$ 222	\$ 28	\$ 55	\$ 55	\$ 55	\$ 29
Operating leases:						
Operating leases	6,365	1,766	2,882	1,717		
Proceeds from subleases	(823)	(303)	(501)	(18)		
Net operating leases	5,543	1,463	2,381	1,699		
Future minimum lease payments	\$ 5,765	\$ 1,491	\$ 2,436	\$ 1,754	\$ 55	\$ 29

Refer to Note 12 - Subsequent Events regarding the Company's new commitments as a result of the recent issuance of convertible senior notes, as well as the definitive agreement to acquire Search Software America.

*Guarantees*

The Company has three letters of credit that collateralize certain operating lease obligations and total approximately \$397,000 and \$408,000 at January 31, 2004 and July 31, 2003, respectively. The Company collateralizes these letters of credit with cash deposits made with three of its financial institutions and has classified the short-term and the long-term portions of approximately \$101,000 and \$296,000 at January 31, 2004, and \$112,000 and \$296,000 at July 31, 2003 as Other Current Assets and Restricted Cash, respectively, in the consolidated balance sheets. The long-term portion expires through June 2006. The holders of the letters of credit are able to draw on each respective letter of credit in the event that the Company is found to be in default of its obligations under each of its operating leases.

*Warranties*

The Company generally provides a warranty for its software products and services to its customers for a period of 90 days. The Company's software products' media are generally warranted to be free of defects in materials and workmanship under normal use and the products are also generally warranted to perform substantially as described in certain Company documentation. The Company's services are generally warranted to be performed in

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a professional manner and to conform materially to the specifications set forth in a customer's signed contract. In the event there is a failure of such warranties, the Company generally corrects or provides a reasonable work around or replacement product. The Company believes such obligations do not significantly affect the Company's financial position or results of operations.

The Company accrues for warranty expenses at the time revenue is recognized and maintains a warranty accrual for the estimated future warranty obligation based upon the relationship between historical and anticipated costs. In other instances, additional amounts are recorded when such costs are probable and can be reasonably estimated. The warranty accrual is reviewed at least quarterly. As of January 31, 2004, the warranty accrual was \$200,000, which approximates the balance as of July 31, 2003.

### *Indemnification Obligations*

On certain occasions, the Company provides to its customers intellectual property indemnification, subject to certain limitations, in its arrangements for the Company's software products or services. Typically these obligations provide that the Company will indemnify, defend and hold the customers harmless against claims by third parties that its software products or services infringe upon the copyrights, trademarks, patents or trade secret rights of such third parties. As of January 31, 2004, there has been no significant claim made by any third party with regard to the Company's software products or services. The liability reserve for indemnification obligations is not significant.

Section 145 of the Delaware General Corporation Law ( Delaware Law ) permits the indemnification of officers, directors, and other corporate agents under certain circumstances and subject to certain limitations. The Company's Certificate of Incorporation and Bylaws provide that the Company shall indemnify its directors, officers, employees, and agents to the full extent permitted by Delaware Law, including in circumstances in which indemnification is otherwise discretionary under Delaware law. In addition, the Company has entered into separate indemnification agreements with its directors and officers which would require the Company, among other things, to indemnify them against certain liabilities which may arise by reason of their status or service (other than liabilities arising from willful misconduct of a culpable nature). These indemnification provisions may be sufficiently broad to permit indemnification of the Company's officers and directors for liabilities (including reimbursement of expenses incurred) arising under the Securities Act of 1933, as amended. At present, there is no pending litigation or proceeding involving a director, officer, employee or other agent of the Company in which indemnification is being sought nor is the Company aware of any threatened litigation that may result in a claim for indemnification by any director, officer, employee or other agent of the Company.

### *Litigation*

On December 5, 2002, the Company filed a patent infringement suit against Synchrologic, Inc. in the United States District Court for the Northern District of California, alleging that Synchrologic's server and desktop products infringe on six of Intellisync's synchronization-related patents. As a result of the Company's definitive agreement dated September 14, 2003 to purchase all of the issued and outstanding stock of Synchrologic, the Company and Synchrologic agreed to dismiss the Company's outstanding litigation against Synchrologic with prejudice as of September 17, 2003, thereby permanently ending this specific suit.

On April 19, 2002, the Company filed a patent infringement suit against Extended Systems, Inc. in the United States District Court for the Northern District of California (the Court ). The Company alleged that Extended Systems' server and desktop products infringe on seven of its synchronization-related patents. The Company sought an injunction against future sales of Extended Systems' infringing server and desktop products, as well as monetary damages for past sales of the infringing products. The Company further alleged that Extended Systems' infringement of the eight synchronization patents was willful and deliberate, entitling the Company to an award of treble damages, costs and

reasonable attorneys' fees.

Refer to Note 12 - Subsequent Events regarding an update on the litigation against Extended Systems.

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The Company is also involved in various litigation and claims arising in the normal course of business. In management's opinion, these matters are not expected to have a material impact on the Company's consolidated results of operations or financial condition.

**Note 9 Net Loss Per Common Share**

Basic net loss per common share is computed by dividing net loss available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted net loss per common share is computed by dividing net loss by the weighted average number of dilutive potential common shares that were outstanding during the period. Diluted weighted average shares reflect the dilutive effect, if any, of potential common shares based on the treasury stock method.

Basic and diluted net loss per common share were calculated as follows (in thousands, except per common share amounts):

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>January 31,</b>		<b>January 31,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
<i>Numerator:</i>				
Net loss	\$ (3,252)	\$ (747)	\$ (5,513)	\$ (2,123)
<i>Denominator:</i>				
Weighted average shares outstanding used to compute basic and diluted net loss per common share	54,475	45,764	51,480	45,573
Basic and diluted net loss per common share	\$ (0.06)	\$ (0.02)	\$ (0.11)	\$ (0.05)

All common shares that were held in escrow and that were subject to repurchase by the Company, totaling approximately 1,433,000 and 653,000 as of January 31, 2004 and 2003, respectively, were excluded from basic and diluted net loss per common share calculations.

Potential common shares attributable to stock options, warrants, shares held in escrow and shares subject to repurchase by the Company, of 10,097,423 and 7,143,596 were outstanding at January 31, 2004 and 2003, respectively. However, as a result of the net loss incurred by the Company in the three and six months ended January 31, 2004 and 2003, none of the shares were included in the weighted average outstanding shares (using the treasury stock method) used to calculate net loss per common share because the effect would have been antidilutive.



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Accumulated other comprehensive loss consists of net unrealized gain/loss on available for sale investments and foreign currency translation adjustments. Total comprehensive loss for the three months ended January 31, 2004 and 2003, respectively, is presented in the following table (in thousands):

	Three Months Ended		Six Months Ended	
	January 31,		January 31,	
	2004	2003	2004	2003
Net loss	\$ (3,252)	\$ (747)	\$ (5,513)	\$ (2,123)
Other comprehensive gain (loss):				
Change in net unrealized loss on investments	(5)	(22)	(34)	(52)
Realized gain on investments				10
Change in currency translation adjustments	1	(2)	55	(4)
Total other comprehensive gain (loss)	(4)	(24)	21	(46)
Total comprehensive loss	\$ (3,256)	\$ (771)	\$ (5,492)	\$ (2,169)

**Note 11 Business Segments**

Operating segments are identified as components of an enterprise about which separate, discrete financial information is available that is evaluated by the chief operating decision maker or decision-making group to make decisions about how to allocate resources and assess performance. The Company's chief operating decision maker is the chief executive officer. To date, the Company has reviewed its operations principally in a single segment. The chief operating decision maker assesses performance based on the gross profit generated by this segment.

The Company operates in a single industry segment encompassing the development, marketing and support of synchronization software and services. The Company's customer base consists primarily of corporate organizations, business development organizations, industry associations, resellers, international system integrators, large OEMs in the personal computer (PC) market and selected distributors, which primarily market to the retail channel, in North America, Europe, the Asia-Pacific region, South America, and Africa.

Revenue is attributed to regions based on the location of customers. Revenue information by geographic region is as follows (in thousands):

Three Months Ended January 31,		Six Months Ended January 31,	
2004	2003	2004	2003

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North America	\$ 7,672	\$ 3,887	\$ 13,116	\$ 7,433
Japan	1,454	962	3,374	1,834
Other International	877	972	1,529	1,564
Total revenue	\$ 10,003	\$ 5,821	\$ 18,019	\$ 10,831

Substantially all of the Company's long-lived assets are in the United States.

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Revenue information by product group is as follows (in thousands):

	Three Months Ended January 31,		Six Months Ended January 31,	
	2004	2003	2004	2003
Enterprise and retail products	\$ 4,483	\$ 3,363	\$ 7,360	\$ 6,356
Technology licensing components	5,520	2,458	10,659	4,475
<b>Total revenue</b>	<b>\$ 10,003</b>	<b>\$ 5,821</b>	<b>\$ 18,019</b>	<b>\$ 10,831</b>

The Company's enterprise and retail products include Intellisync<sup>®</sup> Handheld Edition, Intellisync Handheld Edition for Enterprise (formerly Enterprise Intellisync), Intellisync Phone Edition, Intellisync goAnywhere, Intellisync Mobile Suite (formerly Synchrologic Mobile Suite), Intellisync MobileApp Designer (formerly Satellite Forms) and Intellisync for Oracle, as well as related support and maintenance. Technology licensing components include various licensed technology platforms, including Intellisync Software Development Platform, Intellisync for the Web, Intellisync SyncML Server (formerly TrueSync<sup>®</sup>), Intellisync VPN, Intellisync Server-to-Server, professional services, non-recurring engineering services and related maintenance contract programs.

No customers accounted for more than 10% of the Company's total revenue for the three and six months ended January 31, 2004. Products sold through Ingram Micro US, a distributor, accounted for 16% and 14% of the total revenue in the three and six months ended January 31, 2003, respectively. No other customers accounted for more than 10% of total revenue during those periods in fiscal 2003.

**Note 12 Subsequent Events***Convertible Senior Notes*

In February 2004, the Company announced its offering of \$50,000,000 aggregate principal amount of convertible senior notes due March 2009, through an offering to qualified institutional buyers under Rule 144A of the Securities Act of 1933, as amended. These notes will be convertible into shares of Intellisync common stock at a conversion rate of 250.0000 shares per \$1,000 principal amount of notes, which is equivalent to a conversion price of \$4.00 per share and represents a 22.7% premium to the closing price of \$3.26 per share of Intellisync common stock on February 26, 2004. The notes bear interest at an annual rate of 3%, payable semi-annually in arrears. The notes mature on March 1, 2009, and may not be redeemed by the Company prior to maturity. Holders of the notes may require the Company to redeem the notes upon the occurrence of certain events. The Company has granted the initial purchasers of the notes an option to acquire up to an additional \$10,000,000 aggregate principal amount of notes which was exercised on March 8, 2004. Proceeds of \$57,100,000, net of the initial purchasers' discounts and commissions and estimated offering costs, were received in March 2004.

The Company expects to use approximately \$20,000,000, which may include a portion of the net proceeds of the offering, to complete the acquisition of Search Software America, as described below. The Company intends to use the balance of the net proceeds to fund possible investments in, or acquisitions of, complementary businesses, products or technologies or establishing joint ventures and for general corporate

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purposes and working capital requirements. The Company intends to invest the net proceeds from this offering, pending their ultimate use, in short-term, interest-bearing, investment grade securities.

In order to manage interest costs and risk, the Company will use a derivative contract which swaps the fixed interest payments on the senior notes to a floating interest rate.

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*Search Software America Acquisition*

On February 24, 2004, the Company announced that it has entered into a definitive agreement, subject to customary closing conditions, to acquire Search Software America, a privately held division of SPL WorldGroup, for approximately \$20,000,000 in cash. Search Software America, with operations in the United States, United Kingdom, Australia and South America and whose products enhance the ability to find, match and group (synchronize) identity data within computer systems and network databases, will operate as a wholly owned subsidiary of the Company. The acquisition is expected to close within 30 days from the announcement date of the acquisition.

*Litigation Settlement*

On March 4, 2004, the Company announced its mutual agreement with Extended Systems, Inc. to settle the patent infringement lawsuit initiated by the Company in April 2002. In an agreement signed by both companies, the Company and Extended Systems agreed to settle all claims and terminate litigation proceedings immediately.

In the settlement agreement, Extended Systems will make a one-time payment of \$2,000,000 to the Company and receive a license to certain Intellisync patents, which Extended Systems acknowledges are valid. The payment covers estimated past and future royalties on revenue related to Extended Systems' products shipped and covered under Intellisync's licensed patents. Both companies have agreed there will be no further patent litigation actions for a period of five years and that the Company will release all Extended Systems customers from any claims of infringement relating to their purchase and future use of Extended Systems products.

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

*The following information should be read in conjunction with the condensed consolidated financial statements and the notes thereto contained elsewhere in this Form 10-Q and in conjunction with the consolidated financial statements and management's discussion and analysis of financial condition and results of operations in our Form 10-K. This quarterly report on Form 10-Q, and in particular management's discussion and analysis of financial condition and results of operations, contains forward-looking statements regarding future events or our future performance that involve certain risks and uncertainties including those discussed in Factors That May Affect Future Operating Results below. In this Form 10-Q, the words anticipates, believes, expects, intends, future and similar expressions identify forward-looking statements. All statements that address operating performance, our stock price, events or developments that we expect or anticipate will occur in the future, including statements relating to planned product releases and composition of revenue, both in terms of segment and geographical source, are forward-looking statements. Such forward-looking statements are based on management's current views and assumptions regarding future events and operating performance, and speak only as of the date hereof. We undertake no obligation to publicly update or revise any forward-looking statements whether as a result of new information, future events or otherwise. Actual events or our actual future results may differ materially from any forward-looking statements due to the risks and uncertainties outlined below.*

Management's discussion and analysis includes:

Business overview.

A comparison of our results of operations in the three and six months ended January 31, 2004 with the results in the corresponding periods in fiscal 2003.

Recently issued accounting pronouncements.

A discussion of our operating liquidity and capital resources.

A discussion of factors that may affect our future operating results.

**Business Overview**

Intellisync Corporation was incorporated in California on August 27, 1993 as Puma Technology, Inc. and was subsequently reincorporated in Delaware on November 27, 1996. We changed our corporate name from Pumatech, Inc. to Intellisync Corporation effective February 17, 2004. We develop, market and support synchronization, mobile-application development, remote access and mobile-application management/device management software that enables consumers, business professionals and information technology (IT) officers to extend the capabilities of enterprise groupware and vertical applications, handheld organizers/computers, Web-enabled cellular phones, pagers and other wireless or wireline personal communications platforms. Designed to connect people with essential information, anytime and anywhere, our product family includes the following offerings:

Intellisync® Handheld Edition, Intellisync Handheld Edition for Enterprise (formerly Enterprise Intellisync) and Intellisync Phone Edition software;

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Intellisync for Oracle software;

Intellisync goAnywhere software acquired from Loudfire, Inc.;

Intellisync Mobile Suite (formerly Synchrologic Mobile Suite);

Intellisync MobileApp Designer (formerly Satellite Forms);

Intellisync Software Development Platform;

Intellisync for the Web;

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Intellisync SyncML Server (formerly TrueSync®) software developed by our wholly owned subsidiary, Starfish Software, Inc.;

Intellisync VPN software acquired from Spontaneous Technology; and

Intellisync Server-to-Server

We have organized our operations into a single operating segment encompassing the development, marketing and support of software and services that provide synchronization, mobile application development, application/device management, real-time remote information access, and secure VPN capabilities.

We license our software products directly to corporations, original equipment manufacturers (OEMs) and business development organizations worldwide. In addition, we sell our retail products through several distribution channels both in the United States and internationally, including major distributors, resellers, computer dealers, retailers and mail-order companies. Internationally, we are represented by over 100 distributors and resellers in North America, Europe, the Asia-Pacific region, South America and Africa.

Part of our business strategy is to enhance shareholder value through acquisitions that target companies where our management, shareholders and corporate structure can be leveraged to improve strategic market position and growth potential in both emerging and established technologies. Our recent acquisitions, together with our internal development efforts, have been aimed at expanding our focus from cabled synchronization to synchronization for wireless handhelds, smartphones, laptops and tablets, where a number of industry analysts, such as International Data Corporation (IDC), predict important growth in the near future. With the asset purchase of Spontaneous Technology, Inc., the acquisition of Synchronologic, Inc. and planned acquisition of Search Software America, we believe our management and employee efforts should continue to aid in our growth and development.

### ***Acquisitions***

On September 17, 2003, we consummated the acquisition of substantially all of the assets of Spontaneous Technology, Inc. of Salt Lake City, Utah, a provider of enterprise secure Virtual Private Network (sVPN) software designed to extend existing corporate applications to most wireless devices. Under the terms of the agreement, we issued a total of 869,259 shares of our common stock valued at approximately \$2,999,000. There are 224,417 additional shares held in escrow that are contingently issuable upon satisfaction of a pre-acquisition clause. Additionally, depending upon our revenues associated with sales of our products including certain technology of Spontaneous Technology during the period ending September 30, 2004, we may be required to pay Spontaneous Technology additional consideration of up to \$7,000,000 in shares of our common stock.

On December 29, 2003, we completed our acquisition of all of the issued and outstanding stock of Synchronologic, Inc. headquartered in Atlanta, Georgia pursuant to an Agreement and Plan of Merger, dated as of September 14, 2003. The Agreement and Plan of Merger also provided for the dismissal of the outstanding litigation against Synchronologic with prejudice as of September 17, 2003, thereby permanently ending this specific suit. In the merger, we issued a total of 15,130,171 shares of our common stock valued at approximately \$62,125,000 and options to purchase a total of 1,018,952 shares of our common stock valued at approximately \$4,123,000. Synchronologic's product line provides mobile access to enterprise applications, email and personal information management (PIM) data, file content, intranet sites, and Web content, while giving IT groups the tools to manage mobile devices remotely.



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On February 24, 2004, we announced a definitive agreement, subject to customary closing conditions, to acquire Search Software America, a privately held division of SPL WorldGroup, for approximately \$20,000,000 in cash. Search Software America, with operations in the United States, United Kingdom, Australia and South America and whose products enhance the ability to find, match and group (synchronize) identity data within computer systems and network databases, will operate as a wholly owned subsidiary of Intellisync. The acquisition is expected to close within 30 days from the announcement date of the acquisition.

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We believe that the acquisitions of Spontaneous Technology's assets, Synchrologic and Search Software America will enhance our enterprise offerings, while also serving to bolster our position, patent portfolio and technology leadership in the synchronization and mobile infrastructure software arenas.

### ***Convertible Senior Notes***

In February 2004, we announced our offering of \$50,000,000 aggregate principal amount of convertible senior notes due March 2009, through an offering to qualified institutional buyers under Rule 144A of the Securities Act of 1933, as amended. These notes will be convertible into shares of our common stock at a conversion rate of 250.0000 shares per \$1,000 principal amount of notes, which is equivalent to a conversion price of \$4.00 per share and represents a 22.7% premium to the closing price of \$3.26 per share of our common stock on February 26, 2004. The notes will bear interest at an annual rate of 3%, payable semi-annually in arrears. The notes mature on March 1, 2009, and may not be redeemed by us prior to maturity. Holders of the notes may require us to redeem the notes upon the occurrence of certain events. We have granted the initial purchasers of the notes an option to acquire up to an additional \$10,000,000 aggregate principal amount of notes which was exercised on March 8, 2004. Proceeds of \$57,100,000, net of the initial purchasers' discounts and commissions and estimated offering costs, were received in March 2004.

We expect to use approximately \$20,000,000, which may include a portion of the net proceeds of the offering, to complete the acquisition of Search Software America, as described above. We intend to use the balance of the net proceeds to fund possible investments in, or acquisitions of, complementary businesses, products or technologies or establishing joint ventures and for general corporate purposes and working capital requirements. We intend to invest the net proceeds from this offering, pending their ultimate use, in short-term, interest-bearing, investment grade securities.

In order to manage interest costs and risk, we will use a derivative contract which swaps the fixed interest payments on our senior notes to a floating interest rate.

### ***Litigation Settlement***

On March 4, 2004, we announced our mutual agreement with Extended Systems, Inc. to settle our patent infringement lawsuit we initiated in April 2002. In the agreement, we agreed with Extended Systems to settle all claims and terminate litigation proceedings immediately.

In the settlement agreement, Extended Systems will make a one-time payment of \$2,000,000 and receive a license to certain Intellisync patents, which Extended Systems acknowledges are valid. The payment covers estimated past and future royalties on revenue related to Extended Systems' products shipped and covered under Intellisync's licensed patents. We have agreed there will be no further patent litigation actions for a period of five years and that we will release all Extended Systems customers from any claims of infringement relating to their purchase and future use of Extended Systems products.

**Table of Contents****Results of Operations**

The following table sets forth items included in the condensed consolidated statements of operations as a percentage of revenue for the periods indicated. Certain prior period amounts were reclassified to conform to the current period's presentation.

	Three Months		Six Months	
	Ended		Ended	
	January 31,		January 31,	
	2004	2003	2004	2003
Revenue				
License	75.5%	85.0%	71.2%	83.2%
Services	24.5	15.0	28.8	16.8
<b>Total revenue</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>
Cost and operating expenses:				
Cost of revenue	18.0	14.1	19.0	15.2
Amortization of developed technology	4.0	2.5	3.1	2.7
Research and development	24.1	29.4	25.6	32.2
Sales and marketing	35.7	46.4	38.0	49.3
General and administrative	19.2	22.0	23.9	22.2
Amortization of intangibles	2.2		1.8	
In-process research and development	24.2		16.0	
Facilities exit costs and other charges	6.0		3.8	
<b>Total cost and operating expenses</b>	<b>133.4</b>	<b>114.4</b>	<b>131.2</b>	<b>121.6</b>
Operating loss	(33.4)	(14.4)	(31.2)	(21.6)
Other income, net	1.3	3.2	1.4	3.7
Loss before income taxes	(32.1)	(11.2)	(29.8)	(17.9)
Provision for income taxes	(0.4)	(1.6)	(0.8)	(1.7)
<b>Net loss</b>	<b>(32.5)%</b>	<b>(12.8)%</b>	<b>(30.6)%</b>	<b>(19.6)%</b>

*Revenue.* We derive revenue from two primary sources: software licenses and fees for services. Revenue for the three and six months ended January 31, 2004 was \$10,003,000 and \$18,019,000, respectively, compared with \$5,821,000 and \$10,831,000, respectively, for the corresponding periods in fiscal 2003. The 72% increase in revenue for the three months ended January 31, 2004, compared with the corresponding period in fiscal 2003, was led by approximately \$1,727,000 increase in revenue from Intellisync Software Development Platform, \$1,273,000 increase in revenue from our server products and \$1,271,000 increase in revenue from professional services. The 66% increase in revenue for the six months ended January 31, 2004, compared with the corresponding period in fiscal 2003, was led by a approximately \$3,158,000 increase in revenue from Intellisync Software Development Platform, \$3,005,000 increase in revenue from professional services and \$1,057,000 increase in revenue from servers. The increase in revenue in each of the first two quarters of fiscal 2004 was attributable to new customer contracts, in particular professional service agreements, associated with our recent acquisitions and to a combination of revenue from new major customers and increased royalty revenue from existing OEM customers.

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Our acquisition of Starfish Software, Inc. and asset purchase of Loudfire in fiscal 2003, as well as our recent asset purchase of Spontaneous Technology and acquisition of Synchrologic, are expected to provide us with access to new technology capabilities, potential access to new markets and customers and other revenue-generation opportunities. We expect revenue benefits over time through synergies in technology, product development and operations. Our recent acquisitions already have made positive contributions to revenue for the three and six months ended January 31, 2004. We believe that new and existing products based upon the technologies from Starfish, Loudfire, Spontaneous Technology, and Synchrologic could continue to have a positive impact on revenues, provide operational benefits and improve our bottom line in the remainder of fiscal 2004.

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*License Revenue.* License revenue is earned from the sale and use of software products (including our technology licensing components) and royalty agreements with OEMs. License revenue for the three and six months ended January 31, 2004 increased by 53% to \$7,555,000 and 42% to 12,824,000, respectively, compared with \$4,951,000 and \$9,014,000 for the corresponding periods in fiscal 2003. As a percentage of total revenue, license revenue was 76% and 71% for the three and six months ended January 31, 2004, respectively, compared with 85% and 83% for the corresponding periods in fiscal 2003. The increase in absolute license revenue for the three months ended January 31, 2004 reflected an increase of \$1,820,000 in revenue from technology licensing components and an increase of \$800,000 in revenue from enterprise, partially offset by a decrease of \$16,000 in revenue from our legacy personal computers or notebooks business (Intellisync for Notebooks royalty revenue) that we are now phasing out. The increase in absolute license revenue for the six months ended January 31, 2004 reflected an increase of \$3,241,000 in revenue from technology licensing components and an increase of \$621,000 in revenue from enterprise, partially offset by a decrease of \$52,000 in revenue from the phasing-out Intellisync for Notebooks royalty revenue. A significant portion of the increase in our license revenue for the three and six months ended January 31, 2004, respectively, was contributed by Synchrologic. As a percentage of total revenue, license revenue decreased due to significant increase in our revenue from professional services as described below.

*Service Revenue.* Service revenue is derived from fees for services, including fixed-price and time-and-materials professional services arrangements and amortization of maintenance contract programs. Service revenue for the three and six months ended January 31, 2004 increased by 181% to \$2,448,000 and 186% to \$5,195,000, respectively, compared with \$870,000 and \$1,817,000 for the corresponding periods in fiscal 2003. As a percentage of total revenue, service revenue was 24% and 29% for the three and six months ended January 31, 2004, respectively, compared with 15% and 17% for the corresponding periods in fiscal 2003. The increase in service revenue for the three months ended January 31, 2004 resulted from an increase of approximately \$1,271,000 in professional service revenue associated with our technology licensing partners and \$307,000 in amortization of our maintenance contract programs triggered by our increased effort to renew maintenance agreements within the existing customer base. The increase in service revenue for the six months ended January 31, 2004 resulted from an increase of approximately \$3,005,000 in professional service revenue associated with our technology licensing partners and \$373,000 in amortization of our maintenance contract programs. The increase in professional service revenue was attributable to new customer contracts primarily associated with our recent acquisitions.

Our enterprise and retail products revenue includes sales to retail distribution channels, as well as direct sales of our personal and server products licensed to corporations for internal use. Enterprise and retail products include Intellisync Handheld Edition, Intellisync Handheld Edition for Enterprise (formerly Enterprise Intellisync), Intellisync Phone Edition, Intellisync goAnywhere, Intellisync Mobile Suite (formerly Synchrologic Mobile Suite), Intellisync MobileApp Designer (formerly Satellite Forms) and Intellisync for Oracle, as well as related support and maintenance. Total enterprise and retail products revenue increased by 33% to \$4,483,000 and 16% to \$7,360,000 for the three and six months ended January 31, 2004, respectively, compared with \$3,363,000 and \$6,356,000 for the corresponding periods in fiscal 2003. The increase in enterprise and retail products revenue for the three months ended January 31, 2004 resulted from an increase of \$1,273,000 in revenue from our enterprise server products, an increase of \$319,000 in revenue from amortization of support and maintenance, and an increase of \$212,000 in retail sales of our Intellisync software. This increase for the three months ended January 31, 2004 was slightly offset by a \$684,000 decrease in revenue from Intellisync Handheld Edition for Enterprise and Intellisync MobileApp Designer. The increase in enterprise and retail products revenue for the six months ended January 31, 2004 resulted from an increase of \$1,244,000 in revenue from our enterprise server products, an increase of \$772,000 in retail sales of our Intellisync software and an increase of \$381,000 in revenue from amortization of support and maintenance, which was slightly offset by the decline of \$1,393,000 in revenue from our Intellisync Handheld Edition for Enterprise and Intellisync MobileApp Designer. The transition in our enterprise server offering from Enterprise Intellisync Server to the Intellisync Mobile Suite in the first quarter of fiscal 2004 had a negative short-term impact on enterprise revenues in both the United States and Europe. We expect revenue from enterprise and retail products to further improve in the following quarter, which will be driven by contributions from Intellisync Mobile Suite acquired from Synchrologic.

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Technology licensing components include various licensed technology platforms, including Intellisync Software Development Platform, Intellisync for the Web, Intellisync SyncML Server (formerly TrueSync), Intellisync VPN, Intellisync Server-to-Server, professional services, non-recurring engineering services and related maintenance contract programs. Total technology licensing revenue increased by 125% to \$5,520,000 and 138% to \$10,659,000 for the three and six months ended January 31, 2004, respectively, compared with \$2,458,000 and \$4,475,000 for the corresponding periods in fiscal 2003. The increase in technology licensing revenue for the three months ended January 31, 2004 resulted from an increase in Intellisync Software Development Platform revenue of approximately \$1,819,000 and in professional services of approximately \$1,271,000, offset by a decrease of \$28,000 in revenue from Intellisync for Notebooks. The increase in technology licensing revenue for the six months ended January 31, 2004 resulted from an increase in Intellisync Software Development Platform revenue of approximately \$3,240,000 and in professional services of approximately \$3,005,000, offset by a decrease of \$61,000 in revenue from Intellisync for Notebooks.

International revenue continues to represent a significant portion of our revenue. International revenue for the three and six months ended January 31, 2004 was \$3,009,000, or 30% of revenue, and \$6,385,000, or 35% of revenue, respectively, compared with \$2,135,000, or 37% of revenue, and \$3,755,000, or 35% of revenue, respectively, in the corresponding periods in fiscal 2003. The year-over-year increase in our international revenues accounted for 21% and 37% of our total revenue increase for the three and six months ended January 31, 2004, respectively. The increase in our professional services revenue and the number of our international technology licensing partners, particularly in Japan, resulted in an increase in our international revenue during this period. We believe our international revenue will fluctuate on a quarter to quarter basis as we periodically enter into new agreements for professional services and new international partner contracts for technology licensing. International revenue may be subject to certain risks not normally encountered in operations in the United States, including exposure to tariffs, various trade regulations, fluctuations in currency exchange rates, as well as international software piracy. We believe that continued growth could require further expansion in international markets. We have utilized, and may continue to utilize, substantial resources both to expand and establish international operations in the future.

No customers accounted for more than 10% of our total revenue for the three and six months ended January 31, 2004. Products sold through Ingram Micro US, a distributor, accounted for 16% and 14% of the total revenue for the three and six months ended January 31, 2003, respectively. No other customers accounted for more than 10% of total revenue during those periods in fiscal 2003.

Deferred revenue results from the billing of fees from our customers for the purchase of license agreements and maintenance services for which we have not yet recognized revenue. We recognize the respective revenue after meeting the terms and conditions detailed in our revenue recognition policy. Deferred revenue increased to \$3,233,000 at January 31, 2004 compared with \$2,015,000 at July 31, 2003, due to the addition of a number of agreements with future performance obligations as a result of our recent acquisition of Synchrologic. We expect that this deferred revenue may contribute to an increase in our total revenue recognized during the next few quarters.

*Cost of Revenue.* Cost of revenue consists of license costs and service costs. License costs comprise product-packaging expenses such as product media and duplication, manuals, packing supplies, and shipping costs. Service costs comprise personnel-related expenses such as salaries and other related costs associated with work performed under professional service contracts, non-recurring engineering agreements, and post-sales customer support costs. Service costs can be expected to vary significantly from period to period depending on the mix of services we provide. In general, license revenue costs represent a smaller percentage of license revenue when compared with service revenue costs as a percentage of service revenue; this is due to the high cost structure of service revenue. Additionally, license costs tend to be variable based on license revenue volumes, whereas service costs tend to be fixed within certain service revenue volume ranges.

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Cost of revenue for the three and six months ended January 31, 2004, was \$1,797,000, or 18% of revenue, and \$3,431,000, or 19% of revenue, respectively, compared with \$822,000, or 14% of revenue, and \$1,646,000, or 15% of revenue, respectively, in the corresponding periods in fiscal 2003. The increase in cost of revenue in absolute dollars and as a percentage of revenue reflected the increase in professional services costs as a result of the Starfish acquisition in the second half of fiscal 2003 and Spontaneous Technology in the first quarter of fiscal 2004. We expect cost of revenue, excluding the effects of stock compensation, in absolute dollars to increase slightly relative to that of the second quarter of fiscal 2004 as a result of the full-quarter impact of Synchrologic. However, we believe cost of revenue as a percentage of revenue could decrease slightly or remain relatively flat for the next quarter as an overall effect of an expected further increase in total revenue.

*Amortization of Developed Technology.* Amortization of developed technology for the three and six months ended January 31, 2004 amounted to \$400,000 and \$553,000, respectively, compared with \$146,000 and \$295,000, respectively, in the corresponding periods in fiscal 2003. The increase in the amortization of developed technology was primarily due to the impact of recently purchased technology from Starfish, Loudfire, Spontaneous Technology and Synchrologic. Based on acquisitions completed as of January 31, 2004, we expect the future amortization expense of developed technology is as follows (in thousands):

Six months ending July 31, 2004	\$ 1,673
Fiscal year ending July 31,	
2005	3,345
2006	3,345
2007	3,280
2008	1,122
	<hr/>
	\$ 12,765

We expect that we may acquire additional developed technology associated with any acquisitions we may complete in the future, including Search Software America. As a result, we may further increase our amortization expense of developed technology.

*Research and Development.* Research and development expenses consist primarily of salaries and other related costs for research and development personnel, quality assurance personnel, product localization, fees to outside contractors and the cost of facilities and depreciation of capital equipment. We invest in research and development both for new products and to provide continuing enhancements to existing products. Our engineering group is currently aiming their efforts at expanding focus from cabled synchronization to synchronization for wireless handhelds, smartphones, laptops and tablets, at extending our core synchronization technology to increase scalability and extensibility, and at supporting next generation wireless technology and device platforms. Research and development expenses in the three and six months ended January 31, 2004, were \$2,410,000, or 24% of revenue, and \$4,603,000, or 26% of revenue, respectively, compared \$1,709,000, or 29% of revenue, and \$3,490,000, or 32% of revenue, respectively, in the corresponding periods in fiscal 2003. The increase in research and development spending in absolute dollars was due to increase in headcount of 44 engineers since the beginning of fiscal 2004, which is mainly associated with the facility in Bulgaria established for engineering operations during fiscal 2003, and the asset purchase of Spontaneous Technology and the acquisition of Synchrologic during the first half of fiscal 2004. The decrease in research and development spending as a percentage of revenue resulted from an increase in our total revenue. Excluding the effects of stock compensation, absolute research and development expenses, and as a percentage of revenue, are expected to increase for the next quarter as a result of the full-quarter impact of various expenses associated with the workforce acquired from Synchrologic.

*Sales and Marketing.* Sales and marketing expenses consist primarily of salaries, commissions, promotional expenses and other costs relating to sales and marketing employees, as well as to technical support personnel associated with pre-sales activities such as building brand awareness, performing product and technical presentations and answering customers' product and service inquiries. Sales and marketing expenses in the three and six months ended January 31, 2004, were \$3,570,000, or 36% of revenue, and \$6,850,000, or 38% of revenue,





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respectively, compared with \$2,704,000, or 46% of revenue, and \$5,338,000, or 49% of revenue, respectively, in the corresponding periods in fiscal 2003. Sales and marketing expenses increased year-over-year in absolute dollars as a result of establishing strategic relationships with our existing and prospective enterprise customers, as well as increasing marketing program spending to support increased revenue activities driven by our recent acquisitions. We have also acquired 22 new sales and marketing employees from Synchrologic during the second quarter of fiscal 2004. The increase for the six months ended January 31, 2004 was also due to \$216,000 variable accounting charge associated with certain outstanding stock options as a result of an increase in our stock price. Sales and marketing expenses decreased as a percentage of revenue due to an increase in our total revenue. Excluding the effects of stock compensation, absolute sales and marketing expenses, and as a percentage of revenue, are expected to increase in the next quarter due to the full-quarter impact of various expenses associated with the workforce acquired from Synchrologic.

*General and Administrative.* General and administrative expenses consist primarily of salaries and other costs relating to administrative, executive and financial personnel and outside professional fees. General and administrative expenses for the three and six months ended January 31, 2004, were \$1,927,000, or 19% of revenue, and \$4,312,000, or 24% of revenue, respectively, compared with \$1,278,000, or 22% of revenue, and \$2,399,000, or 22% of revenue, respectively, in the corresponding periods in fiscal 2003. The major factors for the increase in general and administrative spending in absolute dollars for the three and six months ended January 31, 2004 include an increase of \$500,000 and \$1,056,000, respectively, in outside services brought about primarily by legal costs associated with our patent infringement lawsuits. The increase in general and administrative spending for six months ended January 31, 2004 was also due to an increase in our stock price that resulted in a significant increase of \$700,000 in noncash variable accounting charges associated with certain outstanding stock options. As a result of our settlement agreement with Extended Systems, which includes the immediate termination of all the litigation proceedings, general and administrative expenses, excluding the effects of stock compensation, are expected to remain relatively flat for the next quarter as compared with the prior quarter's general and administrative expenses.

Depending on the degree of the fluctuation of our stock price in the future, we may incur a significant variable accounting charge or a recovery of charges from prior quarters. The charge or the recovery may increase or decrease our total general and administrative costs in the next few quarters. The charge or the recovery may also further increase or offset our expected total cost of revenue, research and development and sales and marketing costs in the near future.

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*Amortization of Other Intangibles.* Amortization of other intangibles for the three and six months ended January 31, 2004 amounted to \$218,000 and zero, respectively, compared with \$324,000 and zero, respectively, in the corresponding periods in fiscal 2003. The increase in the amortization of other intangibles was primarily due to the impact of recently acquired intangibles from Starfish, Loudfire, Spontaneous Technology and Synchrologic. Based on acquisitions completed as of January 31, 2004, we expect the future amortization expense of other intangible assets is as follows (in thousands):

Six months ending July 31, 2004	\$ 807
Fiscal year ending July 31,	
2005	1,614
2006	1,539
2007	1,486
2008	521
	<hr/>
	\$ 5,967
	<hr/>

We expect that we may acquire additional intangibles associated with any acquisitions we may complete in the future, including Search Software America. As a result, we may further increase our amortization expense of other intangibles.

*In-Process Research and Development.* In the three and six months ended January 31, 2004, we recorded a charge of \$2,423,000 and \$2,892,000, respectively, for in-process research and development associated with the acquisition of Synchrologic in the second quarter of fiscal 2004 and of substantially all of the assets of Spontaneous Technology in the first quarter of fiscal 2004.

*Synchrologic.* The purchase price of Synchrologic was assigned to the fair value of the assets acquired, including the in-process research and development. As of the acquisition date, technological feasibility of the in-process technology had not been established and the technology had no alternative future use. Accordingly, we expensed the in-process research and development of \$2,423,000 at the date of the acquisition.

The amount of the purchase price allocated to in-process research and technology was based on established valuation techniques used in the high-technology software industry. The fair value assigned to the acquired in-process research and development was determined using the income approach, which discounts expected future cash flows to present value. The key assumptions used in the valuation include, among others, expected completion date of the in-process projects identified as of the acquisition date, estimated costs to complete the projects, revenue contributions and expense projections assuming the resulting product has entered the market, and discount rate based on the risks associated with the development life cycle of the in-process technology acquired. The discount rate used in the present value calculations are normally obtained from a weighted-average cost of capital analysis, adjusted upward to account for the inherent uncertainties surrounding the successful development of the in-process research and development, the expected profitability levels of such technology, and the uncertainty of technological advances that could potentially impact the estimates. We assume the pricing model for the resulting product of the acquired in process research and technology to be standard within its industry. We, however, did not take into consideration any consequential amount of expense reductions from integrating the acquired in-process technology with other existing in-process or completed technology. Therefore, the valuation assumptions do not include significant anticipated cost savings.

The key assumptions underlying the valuation of acquired in-process research and development from Synchrologic are as follows (in thousands):

Project names: Version upgrade of Data Sync, File Sync, E-mail accelerator and Systems Management products

Percent completed as of acquisition date: 60%-70%

Estimated costs to complete technology at acquisition date: \$3,000,000

Risk-adjusted discount rate: 22%

First period expected revenue: calendar year 2004

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The development of above technology remains highly dependent on the remaining efforts to achieve technical viability, rapidly changing customer markets, uncertain standards for a new product, and significant competitive threats from several companies. The nature of the efforts to develop this technology into a commercially viable product consists primarily of planning, designing, experimenting, and testing activities necessary to determine that the technology can meet market expectations, including functionality and technical requirements. Failure to bring the product to market in a timely manner could result in a loss of market share or a lost opportunity to capitalize on emerging markets, and could have a material adverse impact on our business and operating results.

*Spontaneous Technology.* The purchase price of Spontaneous Technology was assigned to the fair value of the assets acquired, including the in-process research and development. As of the acquisition date, technological feasibility of the in-process technology had not been established and the technology had no alternative future use. Accordingly, we expensed the in-process research and development of \$469,000 at the date of the acquisition.

The amount of the purchase price allocated to in-process research and technology was based on established valuation techniques used in the high-technology software industry. The fair value assigned to the acquired in-process research and development was determined using the income approach, which discounts expected future cash flows to present value. The key assumptions used in the valuation include, among others, expected completion date of the in-process projects identified as of the acquisition date, estimated costs to complete the projects, revenue contributions and expense projections assuming the resulting product has entered the market, and discount rate based on the risks associated with the development life cycle of the in-process technology acquired. The discount rate used in the present value calculations is normally obtained from a weighted-average cost of capital analysis, adjusted upward to account for the inherent uncertainties surrounding the successful development of the in-process research and development, the expected profitability levels of such technology, and the uncertainty of technological advances that could potentially impact the estimates. We assume the pricing model for the resulting product of the acquired in-process research and technology to be standard within its industry. We, however, did not take into consideration any consequential amount of expense reductions from integrating the acquired in-process technology with other existing in-process or completed technology. Therefore, the valuation assumptions do not include significant anticipated cost savings.

The key assumptions underlying the valuation of acquired in-process research and development from Spontaneous Technology are as follows (in thousands):

Project names: Version upgrade of Spontaneous Technology s secure Virtual Private Network (sVPN)

Percent completed as of acquisition date: 60%

Estimated costs to complete technology at acquisition date: \$125,000

Risk-adjusted discount rate: 22%

First period expected revenue: calendar year 2004

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The development of above technology remains highly dependent on the remaining efforts to achieve technical viability, rapidly changing customer markets, uncertain standards for a new product, and significant competitive threats from several companies. The nature of the efforts to develop this technology into a commercially viable product consists primarily of planning, designing, experimenting, and testing activities necessary to determine that the technology can meet market expectations, including functionality and technical requirements. Failure to bring the product to market in a timely manner could result in a loss of market share or a lost opportunity to capitalize on emerging markets, and could have a material adverse impact on our business and operating results.

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Subsequent to the acquisition of Synchrologic and Spontaneous Technology, there have been no significant developments related to the current status of the acquired in-process research and development projects that would result in material changes to the assumptions.

*Facilities Exit Costs and Other Charges.* In the three and six months ended January 31, 2004, we recorded a charge of \$600,000 and \$676,000, respectively, for facilities exit costs and other special charges.

*Facilities Exit Costs and Restructuring Accrual.* During the three months ended January 31, 2004, we recorded facilities exit costs of \$600,000 for vacating our remaining office space in Santa Cruz, California and a floor of our office facility in San Jose, California. Inherent in the estimation of the costs related to our restructuring efforts are assessments related to the most likely expected outcome of the significant actions to accomplish the restructuring. In determining the excess facilities exit costs, we were required to estimate future sublease income, negotiated lease settlement costs, future net operating expenses of the facilities, and brokerage commissions, among other expenses. These estimates, along with other estimates made by management in connection with restructuring, may vary significantly depending, in part, on factors that may be beyond our control. Specifically, these estimates will depend on our success in negotiating with lessors, the time periods required to locate and contract suitable subleases and the market rates at the time of such subleases. Adjustments to the reserve for the consolidation of excess facilities will be required if actual lease exit costs or sublease income differ from amounts currently expected.

The following table sets forth the activities in the restructuring accrual account for the six months ended January 31, 2004 (in thousands):

	<b>Consolidation of Excess Facilities</b>
<b>Balance at July 31, 2003</b>	\$ 1,766
Restructuring provision	600
Cash payments	(712)
<b>Balance at January 31, 2004</b>	<b>\$ 1,654</b>

The remaining unpaid amount as of January 31, 2004 of \$1,654,000, related to the net lease expense due to the consolidation of excess facilities, will be paid over the respective lease terms through June 2006 using cash from operations. The current and long-term portions of the underlying accrual of \$1,122,000 and \$532,000 are classified as *Accrued Liabilities* and *Other Liabilities*, respectively, in the condensed consolidated balance sheet as of January 31, 2004.

We continually evaluate the balance of the restructuring reserve it records in prior periods based on the remaining estimated amounts to be paid. Differences, if any, between the estimated amounts accrued and the actual amounts paid will be reflected in operating expenses in future periods.

We believe that the above restructurings have contributed towards the improvement in our gross and operating income during fiscal 2003 and the first two quarters of fiscal 2004. We expect the cost savings brought about by these restructurings to continue for the remainder of fiscal 2004.



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*Other Charges.* During the first quarter of fiscal 2004, we incurred residual costs of approximately \$76,000 for operating expenses, mainly legal and accounting, relating to an acquisition that we ceased pursuing.

*Other Income, net.* Other income, net, represents interest earned on cash and short-term investments and realized gains on miscellaneous investments, offset by interest expense on debt, miscellaneous bank fees and charges, as well as other-than-temporary impairment of investments. Other income, net, in the three and six months ended January 31, 2004 was \$126,000 and \$252,000, respectively, compared with \$185,000 and \$396,000, respectively, in the corresponding periods in fiscal 2003. Other income, net, decreased due to lower rate of interest on reduced balances of cash and investments. We expect to record \$2,000,000 in other income for the next quarter of fiscal 2004 as a result of the recent settlement of litigation against Extended Systems. This other income will be offset by interest and other expense of approximately \$190,000 as a result of amortization of debt issuance costs and interest accrued on the recently issued convertible senior notes.

*Provision for Income Taxes.* The provision for income taxes primarily represents foreign withholding taxes on royalties earned from certain foreign customers and, to a lesser extent, estimated taxes for foreign subsidiaries. The provision for income taxes in the three and six months ended January 31, 2004 was \$36,000 and \$143,000, respectively, compared with \$94,000 and \$182,000, respectively, in the corresponding periods of fiscal 2002.



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In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation (FIN) No. 46, Consolidation of Variable Interest Entities. FIN No. 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. A variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. A variable interest entity often holds financial assets, including loans or receivables, real estate or other property. A variable interest entity may be essentially passive or it may engage in research and development or other activities on behalf of another company. In December 2003, the FASB released a revised version of FIN No. 46 (referred to as FIN 46R) clarifying certain aspects of FIN No. 46 and providing certain entities with exemptions from the requirements of FIN No. 46. FIN 46R requires the application of either FIN No. 46 or FIN 46R to all Special Purpose Entities (SPEs) created prior to February 1, 2003 at the end of the first interim or annual reporting period ending after December 15, 2003. All entities created after January 31, 2003 were already required to be analyzed under FIN No. 46, and they must continue to do so, unless FIN 46R is adopted early. FIN 46R will be applicable to all non-SPEs created prior to February 1, 2003 at the end of the first interim or annual reporting period ending after March 15, 2004. We will be required to adopt the accounting requirements of FIN 46R for the fiscal third quarter ended April 30, 2004. We do not expect the adoption of FIN 46R to have a material impact on our consolidated financial position, results of operations and cash flows.

**Liquidity and Capital Resources**

In February 2004, we announced our offering of \$50,000,000 aggregate principal amount of convertible senior notes due March 2009, through an offering to qualified institutional buyers under Rule 144A of the Securities Act of 1933, as amended. We have granted the initial purchasers of the notes an option to acquire up to an additional \$10,000,000 aggregate principal amount of notes which was exercised on March 8, 2004. Proceeds of \$57,100,000, net of the initial purchasers' discounts and commissions and estimated offering costs, were received in March 2004. Refer to the discussion under the caption *Commitments* set forth below for more information on the convertible senior notes.

We invest excess cash predominantly in fixed income securities that are highly liquid, of high-quality investment grade, and predominantly have maturities of less than two years with the intent to make such funds readily available for operating purposes, if needed. We ended the second quarter of fiscal 2004 with \$22,114,000 in cash, cash equivalents and short-term investments. Cash and cash equivalents decreased by \$1,826,000 or 23% during the first half of fiscal 2004 to \$6,016,000 at January 31, 2004. Short-term investments decreased by \$3,219,000 or 17% to \$16,098,000 during the same period.

Net cash used in operating activities primarily consists of net loss as adjusted by purchased in-process research and development, provision for doubtful accounts, inventory reserves, depreciation and amortization, stock compensation and other non-cash items, and the effect of changes in working capital and other activities. Operating cash flow in the first half of fiscal 2004 comprised of \$5,513,000 of net loss, adjusted by non-cash expense items as described above of \$5,764,000, which was offset by \$7,649,000 of net change in working capital items, compared with \$2,123,000 of net loss adjusted by non-cash expense items as described above of \$1,068,000, which was offset by \$2,051,000 of net change in working capital items in the first half of fiscal 2003. Approximately \$1,200,000 was cash used for costs associated with our acquisitions during the first half of fiscal 2004.

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Net accounts receivable increased by \$3,671,000 to \$9,140,000 at January 31, 2004, from \$5,469,000 at July 31, 2003. The increase in accounts receivable resulted from an increase in revenue for the second quarter of fiscal 2004 relative to the revenue from the fourth quarter of fiscal 2003, as well as from the acquired receivables from Synchrologic amounting to approximately \$792,000 by the end of the second quarter.

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Net cash provided by investing activities of \$5,371,000 during the first half of fiscal 2004 resulted from \$8,000,000 proceeds from sales and maturities of short-term investments, \$2,296,000 cash acquired from Synchrologic and \$56,000 of decrease in restricted cash, slightly offset by \$4,785,000 cash paid for purchase of short-term investments and \$196,000 for capital expenditures. Net cash provided by investing activities of \$6,005,000 during the first half of fiscal 2003 resulted from \$13,851,000 proceeds from sales and maturities of short-term investments, partially offset by \$7,772,000 cash paid for purchase of short-term investments and \$74,000 for capital expenditures.

Net cash provided by financing activities of \$201,000 during the first half of fiscal 2004 resulted from \$1,655,000 proceeds from issuances of common stock and \$310,000 of note repayments from stockholders. The cash provided from financing activities during the first half of fiscal 2004 was partially offset by \$1,764,000 repayment on outstanding balance under a bank credit facility agreement acquired from Synchrologic. Net cash used by financing activities of \$1,172,000 during the first half of fiscal 2003 resulted from a \$2,000,000 repayment on borrowings from a line of credit that expired in September 2002, partially offset by \$498,000 proceeds from issuances of common stock and \$330,000 of note repayments from stockholders.

*Acquisitions*

On September 17, 2003, we consummated the acquisition of substantially all of the assets of Spontaneous Technology, Inc. of Salt Lake City, Utah, a provider of enterprise secure Virtual Private Network (sVPN) software designed to extend existing corporate applications to most wireless devices. Under the terms of the agreement, we issued a total of 869,259 shares of our common stock valued at approximately \$2,999,000 using the five-trading-day average price surrounding the date the acquisition was announced of \$3.45 per share, less estimated registration costs. The number of shares were calculated using the average price of our common stock for ten consecutive trading days ended three business days prior the date of acquisition. There are 224,417 additional shares held in escrow that are contingently issuable upon satisfaction of a pre-acquisition clause. Additionally, depending upon our revenues associated with sales of our products including certain technology of Spontaneous Technology during the period ending September 30, 2004, we may be required to pay Spontaneous Technology additional consideration of up to \$7,000,000 in shares of our common stock.

On December 29, 2003, we completed our acquisition of all of the issued and outstanding stock of Synchrologic, Inc. headquartered in Atlanta, Georgia pursuant to an Agreement and Plan of Merger, dated as of September 14, 2003. The Agreement and Plan of Merger also provided for the dismissal of the outstanding litigation against Synchrologic with prejudice as of September 17, 2003, thereby permanently ending this specific suit. Synchrologic's product line provides mobile access to enterprise applications, email and personal information management (PIM) data, file content, intranet sites, and Web content, while giving information technology groups the tools to manage mobile devices remotely. In the merger, all outstanding shares of Synchrologic common stock and preferred stock were converted into the right to receive a total of 15,130,171 shares of our common stock. In addition, all outstanding options to purchase Synchrologic common stock were converted into options to purchase a total of 1,018,952 shares of our common stock. The total number of shares issued was determined by dividing \$60,000,000 by the average closing price of \$5.22 of the shares of our common stock for the thirty consecutive trading days ending on the last complete trading day immediately preceding the closing date of the merger (which amount was subject to adjustment based on the transaction expenses incurred by Synchrologic in connection with the merger), provided that the number of shares did not exceed 19,800,000 or be fewer than 16,200,000 (in each case subject to adjustment based on the transaction expenses incurred by Synchrologic in connection with the merger). The shares were valued at approximately \$62,125,000 using the five-trading-day average price surrounding the date the acquisition was announced of \$4.11 per share, and the options were valued at approximately \$4,123,000 using the Black-Scholes option pricing model.

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On February 24, 2004, we announced a definitive agreement, subject to customary closing conditions, to acquire Search Software America, a privately held division of SPL WorldGroup, for approximately \$20,000,000 in cash. Search Software America, with operations in the United States, United Kingdom, Australia and South America and whose products enhance the ability to find, match and group (synchronize) identity data within computer systems and network databases, will operate as a wholly owned subsidiary of Intellisync. The acquisition is expected to close within 30 days from the announcement date of the acquisition.

For the next few quarters, we believe the asset purchase of Spontaneous Technology, the acquisition of Synchrologic, as well as the planned acquisition of Search Software America, may bring modest improvement in our cash flows from operating activities with the realization of synergistic benefits and revenue opportunities.

### *Litigation Settlement with Extended Systems*

On March 4, 2004, we announced our mutual agreement with Extended Systems, Inc. to settle our patent infringement lawsuit we initiated in April 2002 against Extended Systems. In the agreement, we agreed with Extended Systems to settle all claims and terminate litigation proceedings immediately.

In the settlement agreement, Extended Systems will make a one-time payment of \$2,000,000 and receive a license to certain Intellisync patents, which Extended Systems acknowledges are valid. The payment covers estimated past and future royalties on revenue related to Extended Systems products shipped and covered under Intellisync's licensed patents. We have agreed there will be no further patent litigation actions for a period of five years and that we will release all Extended Systems customers from any claims of infringement relating to their purchase and future use of Extended Systems products.

### *Effects of Inflation*

We believe that our financial results have not been significantly impacted by inflation and price changes during the first half of fiscal 2004. However, there can be no assurance that inflation will not have such an effect in future periods.

### *Related Party Transactions*

We had a full-recourse loan outstanding to our chief executive officer with a principal amount of approximately \$310,000, exclusive of accrued interest, as of July 31, 2003. This note used by an officer to purchase shares of our common stock was fully paid, together with the accrued interest, during the second quarter of fiscal 2004.

On September 30, 2003, our board of directors approved change of control agreements with three of our officers that provides for 12 months acceleration of vesting of each individual's options held at the time of a change of control. In addition, the board of directors granted these individuals options to purchase an aggregate of an additional 425,000 shares of our common stock. As of the date of grant, the option shares will vest over four years, with 25% vesting after one year and then 1/48<sup>th</sup> vesting monthly thereafter.

*Restricted Cash*