SMITH MICRO SOFTWARE INC
Form 10-K
March 30, 2007

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

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

**For the fiscal year ended December 31, 2006**

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

**For the transition period from __________ to __________**

**Commission File Number 0-26536**
**SMITH MICRO SOFTWARE, INC.**
**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Delaware** | **33-0029027** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification Number) |
| **51 Columbia, Suite 200, Aliso Viejo, CA** | **92656** |
| (Address of principal executive offices) | (Zip Code) |

Registrant s telephone number, including area code: **(949) 362-5800**

| | |
|---|---|
| **Common Stock, $.001 par value** | **The NASDAQ Stock Market LLC** **(NASDAQ Global Market)** |
| (Title of each class) | (Name of each exchange on which registered) |

**Securities registered pursuant to Section 12(b) of the Act: Common Stock, $.001 par value**
**Securities registered pursuant to Section 12(g) of the Act: None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as define d in Rule 405 of the Securities Act. YES o NO þ

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 YES o NO þ

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 þ NO o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K o.

Indicate by check mark if whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

As of June 30, 2006, the last business day of the registrant s most recently completed second quarter, the aggregate market value of the common stock of the registrant held by non-affiliates was $338,847,447 based upon the closing sale price of such stock as reported on the Nasdaq Global Market on that date. For purposes of such calculation, only executive officers, board members, and beneficial owners of more than 10% of the registrant s outstanding common stock are deemed to be affiliates.

As of March 6, 2007, there were 29,366,277 shares of common stock outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant s Proxy Statement for the 2007 Annual Meeting of Stockholders to be filed under the Securities Exchange Act of 1934 are incorporated by reference in Part III of this report.

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## SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS

*In this document, the terms Smith Micro, Company, we, us, and our refer to Smith Micro Software, Inc. and its subsidiaries.*

*This report contains forward-looking statements regarding Smith Micro which include, but are not limited to, statements concerning projected revenues, expenses, gross profit and income, the competitive factors affecting our business, market acceptance of products, customer concentration, the success and timing of new product introductions and the protection of our intellectual property. These forward-looking statements are based on our current expectations, estimates and projections about our industry, management s beliefs, and certain assumptions made by us. Words such as anticipates, expects, intends, plans, predicts, potential, believes, seeks, estimates, should, may, will and variations of these words or similar expressions are intended to identify forward-looking statements. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements. These statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors. Such factors include, but are not limited to the following:*

- *our ability to predict consumer needs, introduce new products, gain broad market acceptance for such products and ramp up manufacturing in a timely manner;*
- *the intensity of the competition and our ability to successfully compete;*
- *the pace at which the market for new products develop;*
- *the response of competitors, many of whom are bigger and better financed than us;*
- *our ability to successfully execute our business plan and control costs and expenses;*
- *our ability to protect our intellectual property and our ability to not infringe on the rights of others; and*
- *those additional factors which are listed under the section 1A. Risk Factors beginning on page 13 of this report.*

*All forward looking statements included in this document are based on information available to us on the date hereof. We do not undertake any obligation to revise or update publicly any forward-looking statements for any reason.*

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## PART I

### Item 1. BUSINESS

### General

Smith Micro Software, Inc. is a diversified developer and marketer of wireless communications software products and services. Our primary focus and strategy for our products and services is directed to wireless communications, including wireless wide area network (WWAN) & Wi-Fi software, personal handset information management, managing mobile content to a handset, and mobile image management, wireless compression and device management solutions. We sell our products and services to many of the world s leading companies as well as to consumers. Specific Smith Micro wireless products include QuickLink Mobile, QuickLink Mobile Enterprise and QuickLink PhoneManager, QuickLink Music, QuickLink Media and StuffIt Wireless. The proliferation of wireless technologies is providing new opportunities globally. The wireless infrastructures being implemented, such as the newer 3G technologies including EVDO, UMTS and HSDPA, offer wider bandwidth wireless data services. This infrastructure combined with mobile platforms such as the basic mobile phone, notebook computing devices ( PCs ), smart phone devices ( PDAs ), and new ultralight PCs provide opportunities for new communications software products. Our core communications technology is designed to address this emerging wireless data market.

We manufacture, market and sell value-added wireless connectivity products targeted to the original equipment manufacturers ( OEM ) market, particularly wireless service providers, mobile device manufacturers, hardware manufacturers and corporations. We offer software products for Windows, Mac, Unix, Linux and Windows Mobility operating systems. The underlying design concept is the long-standing Smith Micro purpose to enhance the out-of-box experience for the customer. Our custom engineering services bring more than 20 years of hardware and software experience, having shipped over 60 million copies of our QuickLink products to OEM s worldwide.

QuickLink Mobile provides mobile users with a laptop the ability to easily connect between wireless wide area networks ( WWAN ) and Wi-Fi hot spots. We currently maintain OEM relationships with many wireless carrier companies, including Verizon Wireless, Vodafone, Telus Mobility, Alltel and CellularOne. In addition, we have strong relationships with leading device manufactures include UTStarcom, LG Electronics, Novatell and Kyocera and hardware manufacturers such as HP and Siemens.

Sales to Verizon Wireless amounted to approximately 74.4%, 57.1% and 68.4% of the Company s net revenues for 2006, 2005 and 2004, respectively.

Our operations are organized among three business units, Wireless and OEM, Consumer and Enterprise.

In the fourth quarter of 2005, we launched a new music product, the Music Essentials Kit for Verizon Wireless V CAST music service. Following the success of this product, in 2006 Smith Micro developed the Music Essentials Manager product that allows users to dual download music from the Verizon Wireless Music Store direct to both the mobile handset and the PC. In addition, the application provides new capabilities, such as music file management and music transfer capability between the PC and the mobile handset. This product first shipped in our fourth quarter of 2006 and is expected to be a significant contributor to 2007 revenues. Verizon Wireless V CAST Music Essentials Manager is powered by the core QuickLink Music product.

A continuing initiative for our Wireless and OEM Group is StuffIt Wireless. StuffIt Wireless incorporates our patented JPEG compression technology that provides superior compression of multi-media data. This technology focuses on delivering image and resource compression for device manufacturers in order to increase storage space on the handset. By compressing phone resources we free up handset memory that can be allocated to store, more images, music or video files on the device in an economic manner. We are currently in the prototype stage of product development with potential customers and plan to fully market this product in 2007.

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Our Enterprise Solutions Group delivers wireless mobility solutions to medium and large enterprise businesses. QuickLink Mobile Enterprise has been developed for the enterprise marketplace that rely on multi-wireless carrier networks and require enhanced security when connecting wirelessly to their corporate resources or the Internet.. This product was introduced in the second quarter of 2005. In addition to addressing the need for robust security, QuickLink Mobile Enterprise is a combination wireless wide area network (WWAN) and secure Wi-Fi client application that provides the same easy to use interface and functionality regardless of carrier or device specified. The application supports over 180 carriers worldwide, hundreds of wireless devices and PDA s, many different PC Cards, and several integrated WWAN devices in notebooks.

Supporting our wireless mobility business direction is our Professional Services Group. This area of business development leverages our many years of providing custom-tooled web-based applications to support growing businesses. From basic web design to complex solutions involving complete customer management, online commerce and fulfillment services, the Professional Services Group helps businesses refine their processes and implement cost-effective, empowering web systems.

The Consumer Products Group offers products in the PC Utility, and eBusiness markets. Smith Micro s complete line of consumer products is available through direct sales on its websites, partner websites, direct through customer service order desk and through traditional retail outlets. The Consumer Group is focused on the following market segments: Compression, Access and Transmission (CAT), and Utilities, including Diagnosis, Performance, Security and Internet and Compilation and Lifestyle.

The Consumer Products Group lead product line is StuffIt, which is driven by a patented, revolutionary JPEG compression technology. StuffIt provides superior compression, encryption and archive capability. This breakthrough technology can compress JPEG photos and images up to 30% without loss of image quality.

New for 2006 is Smith Micro s pioneering product suite known as Active Images. Active Images turns any JPEG file into a self-contained multimedia messaging system. Users can send text messages, music, sound files, documents and more all in a single JPEG file. Watermarks, forms, text messages, music, links to Internet sites, voice recordings, portable digital wallet information, and even videos can all be stored in a JPEG image, and accessed on any device that has the Active Image thin client application installed. This technology plays directly into Smith Micro s strategy of broadening its wireless product offerings and provides carriers and handset manufacturers enhanced music and photo management technology products. Our Active Images patented technology is used in several of our new product offerings including our photo management products which are bundled with camera manufactures, and sold through leading retail distribution. Another new Active Images application is our Mobile Sweepstakes product, which creates a digital scratch card that can be sent to a mobile phone via MMS or to a PC via email. This new product is currently prototyped and is being used in test markets in Asia.

We currently operate in two business segments: Products and Professional Services. We do not separately allocate operating expenses to these segments, nor do we allocate specific assets to these segments. Therefore, segment information reported includes only revenues and cost of revenues. See Note 9 of Notes to Consolidated Financial Statements for financial information related to our operating segments.

Smith Micro is actively involved and maintains industry affiliations with leading groups such as Wi-Fi Alliance, OMA, GSM and CTIA to help develop industry standards and help drive the proliferation of various wireless technologies.

Research and development expenses amounted to $7.9 million, $4.0 million and $2.6 million for the years ended December 31, 2006, 2005 and 2004, respectively. Our research and development expenses consist primarily of personnel and equipment costs required to conduct our software development efforts. We remain focused on the development and expansion of our technology, particularly our wireless, diagnostic, utility and Internet software technologies.

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We were incorporated in California in November 1983, and we reincorporated in Delaware in June 1995. Our principal executive offices are located at 51 Columbia, Suite 200, Aliso Viejo, California 92656. Our telephone number is (949) 362-5800. Our website address is www.smithmicro.com. We make our filings with the SEC available on the Investor Relations page of our website. Information contained on our website is not part of this Annual Report on Form 10-K.

**Industry Background**

Smith Micro offers products in the following technology and communication-related markets:

*Wireless* To help drive revenue growth and profitability, wireless carriers have introduced new value-added products and services that coincide with a number of key enabling trends. Namely, traditional mobile devices are being replaced with multimedia-enabled devices, carriers are deploying wireless broadband network infrastructures and consumers are increasingly adopting mobile data and multimedia services. As carriers seek to enhance their competitive position, they have increasingly focused on network expansion, customer acquisition and customer service. This creates opportunities for software providers, such as Smith Micro, as carriers increase the use of third-party applications, services and custom solutions. These industry trends are the key drivers for the mobile data services market, which the Yankee Group has projected will grow from $10.5 billion in 2005 to $39.9 billion in 2010.

*Mobile Music* Digital audio players and internet-based music download services have transformed music consumption into a personal and mobile experience. As wireless carriers seek to offer premium services and mobile devices support multimedia functionality, the market for digital music distribution over wireless networks and use on wireless devices is expected to grow rapidly. The Yankee Group estimates that music-enabled mobile phone shipments worldwide will grow from 130.2 million units in 2005 to 882.7 million units in 2010, and IDC estimates that United States wireless subscribers who purchase full-track music delivered over cellular networks will grow from 9.7 million subscribers in 2006 to 54.3 million subscribers in 2010.

*Data Compression* Data compression is critical to both efficient data storage and multimedia transmission. As subscriber demand increases for mobile access to larger image, audio and video files, we believe wireless carriers and mobile device manufacturers face a pressing need to use better compression technologies to reduce the size of digital content sent over their networks and to maximize the efficient use of limited device memory. According to the Mobile Imaging Report, of the approximately 600 million digital cameras shipped in 2005, approximately 500 million were camera-enabled mobile phones. .

*Diagnostic & Utility Software* Consumers and businesses have a need for diagnostic and utility software solutions for PCs. Consumers demand products that can enhance PC performance, protect against spam, spyware and computer hacking and remove malicious code. Businesses need cross-platform solutions that can quickly identify and repair a broad range of computer-related problems.

**Products and Services**

**Products**

Our primary product lines and products consist of the following:

| Product Line | Products | Description |
| --- | --- | --- |
| OEM Wireless | QuickLink Mobile<br>V CAST Music Essentials Kit<br>QuickLink Mobile Manager<br>QuickLink Music<br>QuickLink Media<br>QuickLink Wi-Fi<br>QuickLink PhoneManager | Enable or enhance broadband wireless, multimedia services and management tools offered by wireless operators and mobile device manufacturers |

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| Product Line | Products | Description |
|---|---|---|
| Wireless Enterprise | QuickLink Mobile Enterprise | Enhanced QuickLink Mobile that provides security and support for enterprise customers |
| Wireless Compression | StuffIt Wireless<br>StuffIt Image | Enable compression of data files to facilitate storage in mobile devices and transmission over wireless networks |
| Consumer Products | StuffIt Deluxe<br>CheckIt Diagnosis<br>CheckIt System Performance Suite<br>Spring Cleaning<br>Internet Cleanup<br>FAXstf X Pro<br>HotFax MessageCenter<br>Personal Image Manager<br>Personal Photo Manager<br>Aquazone | Suite of products that includes Internet cleanup and privacy software, fax and data file transmission via modems and image |

Wireless carriers and mobile device manufacturers incorporate our products into their branded offerings, selling directly to their market segments. Our technologies are utilized in many major wireless networks to facilitate data communications via mobile devices. Our primary products include QuickLink Mobile, QuickLink Mobile Enterprise, QuickLink Music and StuffIt Wireless, as well as a variety of consumer products, which are described below.

*OEM Wireless.* QuickLink Mobile provides Windows and Macintosh users with a centralized application to control, customize and automate wireless connections, including WWAN and Wi-Fi. In the first quarter of 2006, Verizon Wireless announced the V CAST Music Essentials Kit for Verizon Wireless, which incorporates our QuickLink Music technology to allow users to purchase music from the Verizon Wireless music store, or any other compatible store, and transfer it to or from any music-capable mobile device. We also launched QuickLink Music in September 2006, a new product that expands upon the functionality in the V CAST Music Essentials Kit by adding the ability to manage a consumer s music on both a PC and a mobile device.

*Wireless Enterprise.* QuickLink Mobile Enterprise is an enhanced version of QuickLink Mobile that has expanded security functionality and web-base configuration tools tailored to an enterprise environment. Additionally, QuickLink Mobile Enterprise supports approximately 185 carriers worldwide and interoperates with many mobile devices connected via USB cable or Bluetooth.

*Wireless Compression.* StuffIt Wireless offers carriers and mobile device manufactures a suite of image and file compression solutions. StuffIt Wireless enables image compression without loss of quality, thereby lowering demand on device resources. In addition, we have added resource compression to the product allowing device manufacture to compress phone management resources thus freeing up memory on the device to allow more multimedia files to be stored. StuffIt Wireless allows wireless carriers to use available network bandwidth more efficiently and device manufacturers to reduce hardware memory costs through efficient use of limited memory resources while improving battery life through faster file transfer.

*Consumer Products.* We also offer consumer products that provide compression, utility, diagnostic, fax and eBusiness solutions. These products are designed to enhance PC performance, protect against spam, spyware and computer hacking and remove malicious code. Our line of consumer products is available through direct sales on our website, indirect sales on partner websites and through traditional retail outlets.

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## Strategy

*Provide Service-Enhancing Products for Wireless Carriers and Mobile Device Manufacturers.* We intend to continue to develop innovative, enabling technology and infrastructure products that facilitate the usage of wireless data and other premium services, thereby providing our customers with additional revenue opportunities and differentiated services that encourage customer loyalty. We launched QuickLink Mobile in 2002, which has been a key driver of our growth. In 2005, we announced StuffIt Wireless, a product that compresses data and image files. In the first quarter of 2006, Verizon Wireless announced the V CAST Music Essentials Kit for Verizon Wireless which incorporates our QuickLink Music technology.

*Leverage OEM Relationships.* We intend to continue to capitalize on our strong relationships with some of the world s leading wireless carriers and mobile device manufacturers. For example, our carrier customers serve as a valuable distribution channel, providing access to millions of end-users and also providing market feedback for future product offerings.

*Focus on Multiple High-Growth Markets.* We plan to continue to focus on the wireless communications market and believe we are well-positioned to capitalize on the favorable trends in both wireless broadband connectivity and consumer wireless data services. Among these trends are the ongoing introduction of new data services by wireless carriers, the increasing availability of multimedia-enabled mobile devices and the need for consumers and enterprises to manage their wireless access to the Internet.

*Expand our Customer Base.* We intend to grow our business domestically by offering our products to new wireless carriers and mobile device manufacturers and internationally by leveraging our products and our market expertise to build our presence with international carriers and mobile device manufacturers.

*Selectively Pursue Acquisitions of Complementary Products and Services.* We plan to continue to pursue selected acquisition opportunities in an effort to expand our product and technological abilities, enter complementary markets and extend our geographic reach. In the past, we have used acquisitions to enhance our technology features and customer base, and to extend our offerings into new markets. For example, in July 2005 we acquired Allume Systems, Inc. and launched our StuffIt Wireless compression technology product, and in April 2006 we acquired PhoTags, Inc. and integrated its multi-media management software into our product suite.

## Sales and Marketing

Smith Micro Software develops productivity and entertainment software solutions for an expanding list of customers. Our leading QuickLink® brands have long been products of choice for wireless carriers and device manufacturers around the world.

These wireless carriers and device manufacturers (OEMs) generally incorporate our products into their brands selling direct to individual consumers and in multiples to their enterprise customers. Our products are utilized in many major wireless network installations throughout the world to facilitate data communications via PC Cards, embedded network devices and mobile phones or manage user s content on the PC and send to and from a mobile device. We also sell our products and services utilizing direct sales and indirect distribution models to reach our enterprise customers. Our retail products and product upgrades are sold over the Internet through our own web store(s) at www.smithmicro.com.

Smith Micro is expanding its ability to serve OEM and enterprise customers in Europe and Asia through an international sales and support office based in Jerusalem, Israel that is now renamed Smith Micro Software, Israel.

Our OEM market continues to evolve as we continue to offer new communications, content and image management products and OEM s adopt new technologies and software bundling techniques. These manufacturers bundle our software products with their own products. We have translated selected products into as many as eighteen languages to allow our OEM customers the flexibility of offering multi-language products that meet the needs of their worldwide markets.

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Our three largest OEM customers (Verizon Wireless, Kyocera Wireless and Alltel in 2006 and 2005), and their respective affiliates, in each year, have accounted for 77.4% of our net revenue in 2006, 63.5 % of our net revenue in 2005, and 77.8% of our net revenue in 2004. Our major customers could reduce their orders of our products in favor of a competitor s product or for any other reason. The loss of any of our major OEM customers or decisions by a significant OEM customer to substantially reduce purchases could have a material adverse effect on our business.

**Customer Service and Technical Support**

We provide technical support and customer service through our knowledge base on our web site, email, voice and fax. OEM customers generally provide their own primary customer support functions and rely on us for back-up support for their own technical support personnel.

**Product Development**

The software industry, particularly the wireless market, is characterized by rapid and frequent changes in technology and user needs. We work closely with industry groups and customers, both current and potential, to help us anticipate changes in technology and determine future customer needs. Software functionality depends upon the capabilities of the hardware. Accordingly, we maintain engineering relationships with various hardware manufacturers and we develop our software in tandem with their development. Our engineering relationships with manufacturers, as well as with our major customers, are central to our product development efforts. We remain focused on the development and expansion of our technology, particularly in the wireless space. Research and development expenditures amounted to $7.9 million, $4.0 million and $2.6 million for the years ended December 2006, 2005 and 2004, respectively.

**Manufacturing**

Our software is sold in several forms. We offer a package or kit that may include: CD-ROM(s) for product and hardware-specific drivers; a cable; a manual; and certain other documentation or marketing material. We offer software on CD-ROMs. We also permit selected OEM customers to duplicate our products on their own CD-ROM s and pay a royalty based on usage. The majority of our OEM business requires that we provide a CD, which includes a soft copy of a user guide. In other cases, we provide a complete data connectivity kit that includes a CD, manual and cable. Finally, we grant licenses to certain OEM customers that enable those customers to preload a copy of our software onto a personal computer. With the enterprise sales program, we offer site licenses under which a corporate user is allowed to distribute copies of the software to users within the corporate sites.

Our product development group produces a product master for each product that is then duplicated and packaged into products by the manufacturing organization. All product components are purchased by our personnel in our Aliso Viejo, California facility. The manufacturing is subcontracted to outside vendors include the replication of CD-ROM s and the printing of documentation materials. Assembly of the final package is completed by an outside vendor or in our Aliso Viejo, California facility.

**Competition**

The markets in which we operate are highly competitive and subject to rapid changes in technology. Rapidly changing technology combined with relatively low barriers to entry in the communication software market is constantly creating new opportunities, and we expect new competitors to enter the market. We also believe that competition from established and emerging software companies will continue to intensify as the emerging mobile, wireless and Internet markets evolve. We compete with other software vendors for the attention of customers as well as in our efforts to acquire technology and qualified personnel.

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We believe that the principal competitive factors affecting the communication software market include: product features, ease of use, customization to customer-specific needs, product quality, price, customer service and effective sales and marketing efforts. Although we believe that our products currently compete favorably with respect to these factors, there can be no assurance that we can maintain our competitive position against current and potential competitors. We believe that the market for our software products has been and will continue to be characterized by significant price competition. A material reduction in the price of our products could negatively affect our profitability. We face competition from Microsoft due to its market dominance and the fact that it is the publisher of the most prevalent personal computer operating system, Windows. Microsoft represents a significant competitive threat to all personal computer software vendors, including us.

Many existing and potential OEM customers have technological capabilities to develop products that compete directly with our products. In such event, these customers may discontinue purchases of our products. Our future performance is substantially dependent upon the extent to which existing OEM customers elect to purchase communication software from us rather than design and develop their own software. Because our customers are not contractually obligated to purchase any of our products, they may cease to rely, or fail to expand their reliance on us as a source for communication software in the future.

**Proprietary Rights and Licenses**

Our success and ability to compete is dependent upon our software code base, our programming methodologies and other intellectual properties. To protect our proprietary technology, we rely on a combination of trade secrets, nondisclosure and patent, copyright and trademark law that may afford only limited protection. As of December 31, 2005, six currently effective U.S. patents have been issued since December 1997 and six patent applications are currently pending. These patents provide generalized protection to our intellectual property base, and we will continue to apply for various patents and trademarks in the future.

We seek to avoid disclosure of our intellectual property by requiring employees and consultants with access to our proprietary information to execute confidentiality agreements with us and by restricting access to our source code. The steps that we have taken to protect our proprietary technology may not be adequate to deter misappropriation of our proprietary information or prevent the successful assertion of an adverse claim to software utilized by us. In addition, we may not be able to detect unauthorized use of our intellectual property rights or take effective steps to enforce those rights.

In selling our products, we primarily rely on shrink wrap licenses that are not signed by licensees and may be unenforceable under the laws of certain jurisdictions. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the United States. Accordingly, the means we use currently to protect our proprietary rights may not be adequate. Moreover, our competitors may independently develop technology similar to ours. We also license technology on a non-exclusive basis from several companies for inclusion in our products and anticipate that we will continue to do so in the future. If we are unable to continue to license these technologies or to license other necessary technologies for inclusion in our products, or if we experience substantial increases in royalty payments under these third party licenses, our business could be materially and adversely affected.

**Employees**

As of December 31, 2006, we had a total of 128 employees: 64 engaged in engineering; 33 in sales and marketing; 17 in management and administration; seven in manufacturing and seven in customer support. We utilize temporary labor to assist during peak periods of manufacturing volume. We believe that our future success will depend in large part upon our continuing ability to attract and retain highly skilled managerial, sales, marketing, customer support, research and development personnel and consulting staff. Like other software companies, we face intense competition for such personnel, and we have at times experienced and continue to experience difficulty in recruiting qualified personnel. There can be no assurance that we will be successful in attracting, assimilating and retaining other qualified personnel in the future. We are not subject to any collective bargaining agreement and we believe that our relationships with our employees are good.

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## Item 1A. RISK FACTORS

*Our future operating results are highly uncertain. Before deciding to invest in our common stock or to maintain or increase your investment, you should carefully consider the risks described below, in addition to the other information contained in this report and in our other filings with the SEC, including our reports on Forms 10-K, 10-Q and 8-K. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business operations. If any of these risks actually occur, that could seriously harm our business, financial condition or results of operations. In that event, the market price for our common stock could decline and you may lose all or part of your investment.*

***We depend upon a single customer for a significant portion of our total net revenues.***

Our largest customer, Verizon Wireless, accounted for 74.4% and 57.1% of our net revenues in the years ended December 31, 2006 and December 31, 2005, respectively. In the past, we have derived a substantial portion of our revenues from sales to a small number of customers, including Verizon Wireless, and expect to continue to do so in the future. This concentration may increase in future quarters, particularly if our relationship with one major customer makes it more difficult to sell to its competitors. In that event, our revenue growth opportunities may be limited. The agreements we have with these customers are no-exclusive and do not require them to purchase any minimum quantity of our products and may be terminated by the customer or us at any time for any reason upon minimal prior written notice. These customers may not continue to place large orders for our products in the future, or purchase our products at all. If these customers fail to purchase our products at current levels, terminate or decide not to renew their agreements with us, or if the terms of our future agreements with them are less favorable to us, our revenues could decline.

Our customers may acquire products from our competitors or develop their own products that compete directly with ours. In addition, our customers may adopt new and emerging technologies that we are unable to serve effectively or that are served by more established competitors. Any substantial decrease or delay in our sales to one or more of these customers, particularly Verizon Wireless, in any quarter would have a material adverse effect on our results of operations. In addition, certain of our customers have in the past and may in the future acquire competitors in their industry or be acquired by competitors in their industry, causing further industry consolidation. In the past, such acquisitions have caused the purchasing departments of the combined companies to reevaluate their purchasing decisions. If one of our major customers engages in an acquisition transaction in the future, the resulting entity could change its current purchasing habits. As a result, we could lose the customer, or experience a decrease in orders from or profit margins related to that customer or a delay in orders previously made by that customer. Further, although we maintain allowances for doubtful accounts, the insolvency of one or more of our major customers could result in a substantial decrease in our revenues.

***Our quarterly revenues and operating results are difficult to predict and could fall below analyst or investor expectations, which could cause the price of our common stock to fall.***

Our quarterly revenue and operating results have fluctuated significantly in the past and may continue to vary from quarter to quarter due to a number of factors, many of which are not within our control. If our operating results do not meet the expectations of securities analysts or investors, our stock price may decline. Fluctuations in our operating results may be due to a number of factors, including the following:

- the gain or loss of a key customer;
- the size and timing of orders from and shipments to our major customers;
- the size and timing of any return product requests for our products;

our ability to maintain or increase gross margins;

variations in our sales channels or the mix of our product sales;

our ability to anticipate market needs and to identify, develop, complete, introduce, market and produce new products and technologies in a timely manner to address those needs;

the availability and pricing of competing products and technologies and the resulting effect on sales and pricing of our products;

acquisitions;

the effect of new and emerging technologies;

the timing of acceptance of new mobile services by users of our customers services;

deferrals of orders by our customers in anticipation of new products, applications, product enhancements or operating systems; and

general economic and market conditions.

We have difficulty predicting the volume and timing of orders. In any given quarter, our sales have involved, and we expect will continue to involve, large financial commitments from a relatively small number of customers. As a result, the cancellation or deferral of even a small number of orders would reduce our revenues, which would adversely affect our quarterly financial performance. Also, we have often booked a large amount of our sales in the last month of the quarter and often in the last week of that month. Accordingly, delays in the closing of sales near the end of a quarter could cause quarterly revenues to fall substantially short of anticipated levels. Significant sales may also occur earlier than expected, which could cause operating results for later quarters to compare unfavorably with operating results from earlier quarters.

A large portion of our operating expenses, including rent, depreciation and amortization is fixed and difficult to reduce or change. Accordingly, if our total revenue does not meet our expectations, we may not be able to adjust our expenses quickly enough to compensate for the shortfall in revenue. In that event, our business, financial condition and results of operations would be materially and adversely affected.

Due to all of the foregoing factors, and the other risks discussed in this report, you should not rely on quarter-to-quarter comparisons of our operating results as an indication of future performance.

***Our total net revenues currently depend on a small number of products, so our operating results are vulnerable to unexpected shifts in demand.***

Substantially all of our total net revenue in recent years was derived from sales of our wireless connectivity software products until the third quarter of 2005, when we began including sales of products acquired in the Allume Systems, Inc. acquisition. In addition, during 2006, a substantial portion of our total revenue has been derived from sales of our music management software, particularly sales of V CAST Music Essentials Kit for Verizon Wireless. Although we have introduced new products in recent quarters and our strategy is to continue to introduce new products, these efforts may not reduce the extent to which our total revenues are dependent on one or more of our products in future periods.

We also derive a significant portion of our revenues from a few vertical markets. In particular, our music management software products are primarily sold to wireless carriers. In order to sustain and grow our business, we must continue to sell our software products into these vertical markets. Shifts in the dynamics of these vertical markets, such as new product introductions by our competitors, could seriously harm our results of operations, financial condition and prospects.

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To increase our sales outside our core vertical markets, for example to large enterprises, requires us to devote time and resources to hire and train sales employees familiar with those industries. Even if we are successful in hiring and training sales teams, customers in other vertical markets may not need or sufficiently value our current products or new product introductions.

***Competition within our target markets is intense and includes numerous established competitors, which could negatively affect our revenues and results of operations.***

We operate in markets that are extremely competitive and subject to rapid changes in technology. Specifically, Microsoft Corporation poses a significant competitive threat to us because Microsoft operating systems may include some capabilities now provided by certain of our OEM and retail software products. If users are satisfied relying on the capabilities of the Windows-based systems or other operating systems, or other vendors products, sales of our products are likely to decline. In addition, because there are low barriers to entry into the software markets in which we participate and may participate in the future, we expect significant competition from both established and emerging software companies in the future. In fact, our growth opportunities in new product markets could be limited to the extent established and emerging software companies enter or have entered those markets. Furthermore, our existing and potential OEM customers may acquire or develop products that compete directly with our products.

Microsoft and many of our other current and prospective competitors have significantly greater financial, marketing, service, support, technical and other resources than we do. As a result, they may be able to adapt more quickly than us to new or emerging technologies and changes in customer requirements or to devote greater resources to the promotion and sale of their products. Announcements of competing products by large competitors such as Microsoft or other vendors could result in the cancellation of orders by customers in anticipation of the introduction of such new products. In addition, some of our competitors currently make complementary products that are sold separately. Such competitors could decide to enhance their competitive position by bundling their products to attract customers seeking integrated, cost-effective software applications. Some competitors have a retail emphasis and offer OEM products with a reduced set of features. The opportunity for retail upgrade sales may induce these and other competitors to make OEM products available at their own cost or even at a loss. We also expect competition to increase as a result of software industry consolidations, which may lead to the creation of additional large and well-financed competitors. Increased competition is likely to result in price reductions, fewer customer orders, reduced margins and loss of market share.

***Acquisitions of companies or technologies may disrupt our business and divert management attention and cause our current operations to suffer.***

In the past eighteen months we acquired Allume Systems, Inc. and PhoTags, Inc., As part of any such acquisition, including those of Allume and PhoTags, we will be required to assimilate the operations, products and personnel of the acquired businesses and train, retain and motivate key personnel from the acquired businesses. We may not be able to maintain uniform standards, controls, procedures and policies if we fail in these efforts. Similarly, acquisitions may cause disruptions in our operations and divert management s attention from our company s day-to-day operations, which could impair our relationships with our current employees, customers and strategic partners. Acquisitions may also subject us to liabilities and risks that are not known or identifiable at the time of the acquisition.

We may also have to incur debt or issue equity securities in order to finance future acquisitions. Our financial condition could be harmed to the extent we incur substantial debt or use significant amounts of our cash resources in acquisitions. The issuance of equity securities for any acquisition could be substantially dilutive to our existing stockholders. In addition, we expect our profitability could be adversely affected because of acquisition-related accounting costs, write offs amortization expenses and charges related to acquired intangible assets. In consummating acquisitions, we are also subject to risks of entering geographic and business markets in which we have had limited or no prior experience. If we are unable to fully integrate acquired businesses, products or technologies within existing operations, we may not receive the intended benefits of acquisitions.

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***We have recently entered new, emerging markets in which we have limited experience; if these markets do not develop or we are unable to otherwise succeed in them, our revenues will suffer and the price of our common stock will likely decline.***

Our recent product introductions, such as StuffIt Wireless, a technology for file compression, Active Images, an image-enhancement platform designed for portable devices, and the technology that underlies our QuickLink Music service, have allowed us to enter the digital image and music management markets. We have a short operating history in these emerging markets and limited experience with image and music management software and platforms. A viable market for these products may not develop or be sustainable, and we may face intense competition in these markets. In addition, our success in these markets depends on our carrier customers ability to successfully introduce new mobile services enabled by our products and our ability to broaden our carrier customer base, which we believe will be difficult and time-consuming. If the expected benefits from entering new markets do not materialize, our revenues will suffer and the price of our common stock would likely decline. In addition, to the extent we enter new markets through acquisitions of companies or technologies, our financial condition could be harmed or our stockholders could suffer dilution without a corresponding benefit to our company if we do not realize expected benefits of entering such new markets.

***If the adoption of and investments in new technologies and services grows more slowly than anticipated in our product planning and development, our operating results, financial condition and prospects may be negatively affected.***

If the adoption of and investments in new technologies and services does not grow or grows more slowly than anticipated, we will not obtain the anticipated returns from our planning and development investments. For example, our new QuickLink Mobile and QuickLink Enterprise products provide notebook users with the ability to roam between wireless wide area networks and Wi-Fi hot spots. In addition, our new QuickLink Music product enables users to download music files from a carrier s music store, organize their music library and upload songs to mobile devices. Future sales and any future profits from these and related products are substantially dependent upon the acceptance and use of Wi-Fi, and on the continued adoption of music-capable mobile devices.

Many of our customers and other communications service providers have made and continue to make major investments in next generation networks that are intended to support more complex applications. If communications service providers delay their deployment of networks or fail to deploy such networks successfully, demand for our products could decline, which would adversely affect our revenues. Also, to the extent we devote substantial resources and incur significant expenses to enable our products to be interoperable with new networks that have failed or have been delayed or not deployed, our operating results, financial condition and prospects may be negatively affected.

***Our growth depends in part on our carrier customers ability and willingness to promote services and attract and retain new customers or achieve other goals outside of our control.***

We sell our products for use on handheld devices primarily through our carrier customers. Losing the support of these customers may limit our ability to compete in existing and potential markets and could negatively affect our revenues. In addition, the success of these customers and their ability and willingness to market services supported by our products are critical to our future success. Our ability to generate revenues from sales of our software, including from Verizon Wireless s use of our software in its V CAST Music Essentials Kit for Verizon Wireless, is also constrained by our carrier customers ability to attract and retain customers. We have no input into or influence upon their marketing efforts and sales and customer retention activities. If our carrier customers, particularly our largest customer, Verizon Wireless, fail to maintain or grow demand for their services, revenues or revenue growth from of our products designed for use on mobile devices will decline and our results of operations will suffer.

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***Our gross margins may continue to decline due to shifts in our sales mix.***

Gross margins associated with revenues from our data and music kits are significantly lower than gross margins associated with revenues from sales of our software. This is primarily due to the fact that such kits contain hardware that must be purchased from third parties. As we have expanded our sales of these kits, our overall gross margins have declined from a high of 83% in the third quarter of 2005 to 68% in the fourth quarter of 2006. Our future gross margin could fluctuate based on the mix of products sold in a quarter.

***Our products may contain undetected software defects, which could negatively affect our revenues.***

Our software products are complex and may contain undetected defects. In the past, we have discovered software defects in certain of our products and have experienced delayed or lost revenues during the period it took to correct these problems. Although we and our OEM customers test our products, it is possible that errors may be found or occur in our new or existing products after we have commenced commercial shipment of those products. Defects, whether actual or perceived, could result in adverse publicity, loss of revenues, product returns, delay in market acceptance of our products, loss of competitive position or claims against us by customers. Any such problems could be costly to remedy and could cause interruptions, delays, or cessation of our product sales, which could cause us to lose existing or prospective customers and could negatively affect our results of operations.

***Technology and customer needs change rapidly in our market, which could render our products obsolete and negatively affect our business, financial condition and results of operations.***

Our success depends on our ability to anticipate and adapt to changes in technology and industry standards. We will also need to continue to develop and introduce new and enhanced products to meet our target markets changing demands, keep up with evolving industry standards, including changes in the Microsoft operating systems with which our products are designed to be compatible, and to promote those products successfully. The communications and utilities software markets in which we operate are characterized by rapid technological change, changing customer needs, frequent new product introductions, evolving industry standards and short product life cycles. Any of these factors could render our existing products obsolete and unmarketable. In addition, new products and product enhancements can require long development and testing periods as a result of the complexities inherent in today s computing environments and the performance demanded by customers and called for by evolving wireless networking technologies. If our target markets do not develop as we anticipate, our products do not gain widespread acceptance in these markets, or we are unable to develop new versions of our software products that can operate on future wireless networks and PC and mobile device operating systems and interoperate with other popular applications, our business, financial condition and results of operations could be materially and adversely affected.

***Delays or failure in deliveries from our third-party suppliers could cause our net revenue to decline and harm our results of operations.***

We rely on third party suppliers to provide us with services and components for our product kits. These components include: compact discs; cables; printed manuals; and boxes. We do not have long-term supply arrangements with any vendor to obtain these necessary services and components for our products. If we are unable to purchase components from these suppliers or if the compact disc replication services that we use do not deliver our requirements on schedule, we may not be able to deliver products to our customers on a timely basis or enter into new orders because of a shortage in components. Any delays that we experience in delivering our products to customers could impair our customer relationships and adversely impact our reputation and our business. In addition, if our third party suppliers raise their prices for components or services, our gross margins would be reduced.

***A shortage in the supply of wireless communication devices such as PC cards could adversely affect our revenues.***

Our products are utilized with major wireless networks throughout the world that support data communications through the use of wireless communication devices such as PC cards. Because wireless network providers generally incorporate our products into the wireless communication devices that they sell directly to individual consumers, our future success depends upon the availability of such devices to consumers at reasonable prices. A shortage in the supply of wireless communication devices could put upward pressure on prices or limit the quantities available to individual consumers which could materially affect the revenues that we generate from our products.

***If our products are not designed into customer products, our products may not be adopted by our target markets and customers, either of which could negatively impact our results of operations.***

Some of our products must be incorporated into our customers products at the design stage. As a result, we rely on OEM customers to select our products to be designed into their products. We may devote significant resources and incur significant expense on the development of a new product without any assurance that an OEM customer will select our product for design into its own product. Once an OEM customer designs a competitor s product into its product offering, it becomes significantly more difficult for us to sell our products to that customer because changing vendors involves significant cost, time, effort and risk for the customer. In addition, such design decisions are typically only made when a new system configuration is introduced, which may occur infrequently. Our development expenses may never be recovered and our results of operations and financial condition will be seriously harmed if our products are not selected at the design stage. Even if our products are selected at the design stage, sales of such products are outside of our control and we may never earn material revenues from such product sales.

***Regulations affecting our customers and us and future regulations to which they or we may become subject may harm our business.***

Certain of our customers in the communications industry are subject to regulation by the Federal Communications Commission, which could have an indirect effect on our business. In addition, the United States telecommunications industry has been subject to continuing deregulation since 1984. We cannot predict when, or upon what terms and conditions, further regulation or deregulation might occur or the effect regulation or deregulation may have on demand for our products from customers in the communications industry. Demand for our products may be indirectly affected by regulations imposed upon potential users of those products, which may increase our costs and expenses.

***We may be unable to adequately protect our intellectual property and other proprietary rights, which could negatively impact our revenues.***

Our success is dependent upon our software code base, our programming methodologies and other intellectual properties and proprietary rights. In order to protect our proprietary technology, we rely on a combination of trade secret, nondisclosure and copyright and trademark law. We currently own United States trademark registrations for certain of our trademarks and United States patents for certain of our technologies. However, these measures afford us only limited protection. Furthermore, we rely primarily on shrink wrap licenses that are not signed by the end user and, therefore, may be unenforceable under the laws of certain jurisdictions. Accordingly, it is possible that third parties may copy or otherwise obtain our rights without our authorization. It is also possible that third parties may independently develop technologies similar to ours. It may be difficult for us to detect unauthorized use of our intellectual property and proprietary rights.

We may be subject to claims of intellectual property infringement as the number of trademarks, patents, copyrights and other intellectual property rights asserted by companies in our industry grows and the coverage of these patents and other rights and the functionality of software products increasingly overlap. From time to time, we have received communications from third parties asserting that our trade name or features, content, or trademarks of certain of our products infringe upon intellectual property rights held by such third parties. We have also received correspondence from third parties separately asserting that our fax products may infringe on certain patents held by each of the parties. Although we are not aware that any of our products infringe on the proprietary rights of others, third parties may claim infringement by us with respect to our current or future products. Additionally, our customer agreements require that we indemnify our customers for infringement claims made by third parties involving our intellectual property embedded in their products. Infringement claims, whether with or without merit, could result in time-consuming and costly litigation, divert the attention of our management, cause product shipment delays or require us to enter into royalty or licensing agreements with third parties. If we are required to enter into royalty or licensing agreements, they may not be on terms that are acceptable to us. Unfavorable royalty or licensing agreements could seriously impair our ability to market our products.

***Our ability to predict our revenues and operating results is extremely limited.***

We have historically operated with little backlog because we have generally shipped our software products and recognized revenue shortly after we received orders because our production cycle has traditionally been very short. As a result, our sales in any quarter were generally dependent on orders that were booked and shipped in that quarter. As our wireless business has evolved, production cycle time for items such as data kits has increased to the point that orders received toward the end of a quarter may not ship until the subsequent quarter. From time to time, customers may issue purchase orders that have extended delivery dates that may cause the shipment to be deferred to a subsequent quarter. These situations make it difficult for us to predict what our revenues and operating results will be in any quarter. Therefore, our level of backlog is not necessarily indicative of trends in our business.

***If we are unable to retain key personnel, the loss of their services could materially and adversely affect our business, financial condition and results of operations.***

Our future performance depends in significant part upon the continued service of our senior management and other key technical and consulting personnel. We do not have employment agreements with our key employees that govern the length of their service. The loss of the services of our key employees would materially and adversely affect our business, financial condition and results of operations. Our future success also depends on our ability to continue to attract, retain and motivate qualified personnel, particularly highly skilled engineers involved in the ongoing research and development required to develop and enhance our products. Competition for these employees remains high and employee retention is a common problem in our industry. Our inability to attract and retain the highly trained technical personnel that are essential to our product development, marketing, service and support teams may limit the rate at which we can generate revenue, develop new products or product enhancements and generally would have an adverse effect on our business, financial condition and results of operations.

***If we fail to continue to establish and maintain strategic relationships with mobile device manufacturers, market acceptance of our products, and our profitability, may suffer.***

Most of our strategic relationships with mobile device manufacturers are not subject to written contract, but rather are in the form of informal working relationships. We believe these relationships are valuable to our success. In particular, these relationships provide us with insights into product development and emerging technologies, which allows us to keep abreast of, or anticipate, market trends and helps us serve our current and prospective customers. Because these relationships are not typically governed by written agreements, there is no obligation for many of our partners to continue working with us. If we are unable to maintain our existing strategic relationships with mobile device manufacturers or if we fail to enter into additional strategic relationships or the parties with whom we have strategic relationships favor one of our competitors, our ability to provide products that meet our current and prospective customers needs could be compromised and our reputation and future revenue prospects could suffer. For example, if our software does not function well with a popular mobile device because we have not maintained a relationship with its manufacturer, carriers seeking to provide that device to their respective customers could choose a competitor s software over ours or develop their own. Even if we succeed in establishing these relationships, they may not result in additional customers or revenues.

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***Certain individuals to whom we have granted stock options may have a right of rescission as to the options.***

Approximately 4,539,500 stock options having a weighted average exercise price of $3.74 that were granted under our 1995 Stock Option / Stock Issuance Plan and 2005 Stock Option / Stock Issuance Plan between August 5, 2002 and August 31, 2006 were not exempt from registration or qualification under the securities laws of certain states, nor were they registered or qualified in such states. As a result, holders of these stock options, subject to the securities laws of the state in which they live, have a right of rescission with respect to the options. This means that if a holder elects to exercise his or her right of rescission, he or she will have a right to require us to repurchase the option for cash. Rescission rights or similar remedies may be available to persons who were granted options and no longer hold them. No liability has been recorded for these rescission rights or remedies. In addition, we may be subject to fines, penalties or enforcement actions by applicable state regulatory agencies regarding these issuances.

***We may raise additional capital through the issuance of additional equity or convertible debt securities or by borrowing money, in order to meet our capital needs. Additional funds may not be available on terms acceptable to us to allow us to meet our capital needs.***

We believe that the cash, cash equivalents and investments on hand and the cash we expect to generate from operations will be sufficient to meet our capital needs for at least the next twelve months. However, it is possible that we may need or choose to obtain additional financing to fund our activities in the future. We could raise these funds by selling more stock to the public or to selected investors, or by borrowing money. We may not be able to obtain additional funds on favorable terms, or at all. If adequate funds are not available, we may be required to curtail our operations or other business activities significantly or to obtain funds through arrangements with strategic partners or others that may require us to relinquish rights to certain technologies or potential markets. If we raise additional funds by issuing additional equity or convertible debt securities, the ownership percentages of existing stockholders would be reduced. In addition, the equity or debt securities that we issue may have rights, preferences or privileges senior to those of the holders of our common stock. We currently have no established line of credit or other business borrowing facility in place.

It is possible that our future capital requirements may vary materially from those now planned. The amount of capital that we will need in the future will depend on many factors, including:

- the market acceptance of our products;
- the levels of promotion and advertising that will be required to launch our products and achieve and maintain a competitive position in the marketplace;
- our business, product, capital expenditure and research and development plans and product and technology roadmaps;
- the levels of inventory and accounts receivable that we maintain;
- capital improvements to new and existing facilities;
- technological advances;
- our competitors response to our products; and
- our relationships with suppliers and customers.

In addition, we may raise additional capital to accommodate planned growth, hiring, infrastructure and facility needs or to consummate acquisitions of other businesses, products or technologies.

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***Our business, financial condition and operating results could be adversely affected as a result of legal, business and economic risks specific to international operations.***

In recent years, our revenues derived from sales to customers outside the United States have not been material. Our revenues derived from such sales can vary from quarter to quarter and from year to year. We also frequently ship products to our domestic customers international manufacturing divisions and subcontractors. In the future, we may expand these international business activities. International operations are subject to many inherent risks, including:

- general political, social and economic instability;
- trade restrictions;
- the imposition of governmental controls;
- exposure to different legal standards, particularly with respect to intellectual property;
- burdens of complying with a variety of foreign laws;
- import and export license requirements and restrictions of the United States and any other country in which we operate;
- unexpected changes in regulatory requirements;
- foreign technical standards;
- changes in tariffs;
- difficulties in staffing and managing international operations;
- difficulties in securing and servicing international customers;
- difficulties in collecting receivables from foreign entities;
- fluctuations in currency exchange rates and any imposition of currency exchange controls; and
- potentially adverse tax consequences.

These conditions may increase our cost of doing business. Moreover, as our customers are adversely affected by these conditions, our business with them may be disrupted and our results of operations could be adversely affected.

***We may be subject to regulatory scrutiny and may sustain a loss of public confidence if we are unable to satisfy regulatory requirements relating to internal controls over financial reporting.***

Section 404 of the Sarbanes-Oxley Act of 2002 requires us to perform an evaluation of our internal controls over financial reporting and have our independent registered public accounting firm attest to such evaluation on an annual basis. Compliance with these requirements can be expensive and time-consuming. While we believe that we will be able to meet the required deadlines, no assurance can be given that we will meet the required deadlines in future years. If we fail to timely complete this evaluation, or if our auditors cannot timely attest to our evaluation, we may be subject to regulatory scrutiny and a loss of public confidence in our internal controls.

***Existing efforts to improve our disclosure controls and internal control over financial reporting, combined with new challenges of integrating the internal control environment of newly acquired companies with ours, underscores the risk that our internal controls may not be adequate.***

In the past several years, substantial downsizing and restructuring followed by rapid expansion have placed significant strains on our existing personnel, resources and infrastructure, which may be difficult to address. Our organization has grown from 52 employees as of December 31, 2004 based in Southern California to 128 as of

December 31, 2006 based primarily in Southern and Northern California and in Israel. Until our recent acquisition of PhoTags, we had not had significant operations outside of the United States. Our acquisitions and our internal growth have placed substantial demands on our management, resources and systems. To manage these acquisitions and our internal growth, we will have to implement new operational and financial systems, procedures and controls. We have already identified areas requiring improvement and are in the process of designing enhanced processes and controls to address these issues. Our efforts may not be effective or sufficient for us, or our independent registered accounting firm, to issue unqualified reports in the future.

It may be difficult to design and implement effective financial controls for combined operations and differences in existing controls of any acquired businesses may result in weaknesses that require remediation when the financial controls and reporting are combined. Our ability to manage our operations and growth will require us to improve our operational, financial and management controls, as well as our internal reporting systems and controls. We may not be able to implement improvements to our internal reporting systems and controls in an efficient and timely manner and may discover deficiencies in existing systems and controls.

***We may be subject to additional risks.***

Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also adversely affect our business operations.

**Item 1B. UNRESOLVED STAFF COMMENTS**

None.

**Item 2. PROPERTIES**

Our corporate headquarters, including our principal administrative, sales and marketing, customer support and research and development facility, is located in Aliso Viejo, California, where we currently lease and occupy approximately 26,000 square feet of space pursuant to leases that expires May 31, 2009. We operate both our products and services reporting segments within this facility.

We also lease approximately 13,600 square feet in Watsonville, California under leases that expires September 30, 2010. We occupy office space in Lee s Summit, Missouri on a month to month basis.

We believe that suitable additional or alternative space will be available in the future on commercially reasonable terms as needed.

**Item 3. LEGAL PROCEEDINGS**

The Company is not involved in any pending material legal proceedings at this time although we may become subject to legal proceedings or claims that arise in the ordinary course of business or otherwise.

**Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

There were no matters submitted to a vote of stockholders during the quarter ended December 31, 2006.

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## PART II