

INTELLIGENT SYSTEMS CORP

Form 10-Q

August 15, 2011

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

(Mark One)

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

**For the quarterly period ended June 30, 2011**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 1-9330**

**INTELLIGENT SYSTEMS CORPORATION**

(Exact name of registrant as specified in its charter)

**Georgia**

**58-1964787**

(State or other jurisdiction of incorporation or organization)

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

**4355 Shackleford Road, Norcross, Georgia**

**30093**

(Address of principal executive offices)

(Zip Code)

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

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (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 the latest practicable date.

As of July 31, 2011, 8,958,028 shares of Common Stock of the issuer were outstanding.



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**Table of Contents****Part I FINANCIAL INFORMATION****Item 1. Financial Statements**

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

	<b>June 30, 2011</b>	<b>December 31, 2010</b>
	<i>(unaudited)</i>	<i>(audited)</i>
<b>ASSETS</b>		
Current assets:		
Cash	\$ 3,190	\$ 2,942
Accounts receivable, net	2,941	2,227
Note and interest receivable, current portion	245	600
Inventories, net	928	833
Other current assets	517	404
Total current assets	7,821	7,006
Investments	1,306	1,286
Note and interest receivable, net of current portion	236	473
Property and equipment, at cost less accumulated depreciation	1,353	1,149
Patents, net	155	177
Total assets	\$ 10,871	\$ 10,091
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 490	\$ 322
Deferred revenue, current portion	1,901	1,604
Accrued payroll	460	550
Accrued expenses	782	640
Other current liabilities	277	307
Total current liabilities	3,910	3,423
Deferred revenue, net of current portion	60	70
Other long-term liabilities	146	137
Commitments and contingencies (Note 8)		
Intelligent Systems Corporation stockholders equity:		
Common stock, \$0.01 par value, 20,000,000 shares authorized, 8,958,028 shares issued and outstanding at June 30, 2011 and December 31, 2010	90	90
Additional paid-in capital	21,435	21,418
Accumulated other comprehensive income (loss)	(3)	3
Accumulated deficit	(16,283)	(16,566)
Total Intelligent Systems Corporation stockholders equity	5,239	4,945
Non-controlling interest	1,516	1,516

Total stockholders' equity	6,755	6,461
Total liabilities and stockholders' equity	\$ 10,871	\$ 10,091

*The accompanying notes are an integral part of these Consolidated Financial Statements.*

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

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Revenue				
Products	\$ 3,645	\$ 3,764	\$ 6,677	\$ 7,111
Services	512	844	1,024	1,194
Total net revenue	4,157	4,608	7,701	8,305
Cost of revenue				
Products	1,737	2,159	3,285	3,868
Services	341	387	620	560
Total cost of revenue	2,078	2,546	3,905	4,428
Expenses				
Marketing	565	553	1,085	1,119
General and administrative	595	672	1,513	1,397
Research and development	730	492	1,368	929
Income (loss) from operations	189	345	(170)	432
Other income (expense)				
Interest income, net	6	17	17	44
Equity in income (loss) of affiliate company	11	(10)	20	(22)
Other income, net	458	7	464	13
Income before income taxes	664	359	331	467
Income taxes	27	61	48	84
Net income	\$ 637	\$ 298	\$ 283	\$ 383
Income per share:				
Basic	\$ 0.07	\$ 0.03	\$ 0.03	\$ 0.04
Diluted	\$ 0.07	\$ 0.03	\$ 0.03	\$ 0.04
Basic weighted average common shares outstanding	8,958,028	8,958,028	8,958,028	8,958,028
Diluted weighted average common shares outstanding	8,968,253	8,962,735	8,958,069	8,962,493

*The accompanying notes are an integral part of these Consolidated Financial Statements.*





**Table of Contents****Intelligent Systems Corporation****CONSOLIDATED STATEMENTS OF CASH FLOWS***(unaudited, in thousands)*

	<b>Six Months Ended June 30,</b>	
	<b>2011</b>	<b>2010</b>
<b>OPERATIONS:</b>		
Net income	\$ 283	\$ 383
Adjustments to reconcile net income to net cash provided by (used for) operating activities:		
Depreciation and amortization	180	234
Stock-based compensation expense	17	5
Non-cash interest income, net	(8)	(36)
Equity in (income) loss of affiliate company	(20)	22
Changes in operating assets and liabilities		
Accounts receivable	(714)	(700)
Inventories	(95)	192
Other current assets	(113)	219
Accounts payable	167	48
Deferred revenue	227	(635)
Accrued payroll	(90)	10
Accrued expenses and other liabilities	181	182
Net cash provided by (used for) operating activities	15	(76)
<b>INVESTING ACTIVITIES:</b>		
Proceeds from note and interest receivable	600	2
Purchases of property and equipment	(361)	(226)
Net cash provided by (used for) investing activities	239	(224)
<b>FINANCING ACTIVITIES:</b>		
Payments on notes payable		(116)
Net cash used for financing activities		(116)
Effects of exchange rate changes on cash	(6)	21
Net increase (decrease) in cash	248	(395)
Cash at beginning of period	2,942	2,795
Cash at end of period	\$ 3,190	\$ 2,400

**SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:**

Cash paid during the period for interest	\$		\$	3
Cash paid during the period for income taxes	\$	19	\$	25

*The accompanying notes are an integral part of these Consolidated Financial Statements.*

**Table of Contents****Intelligent Systems Corporation****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(unaudited)**

- Throughout this report, the terms we, us, ours, ISC and company refer to Intelligent Systems Corporation, including its wholly-owned and majority-owned subsidiaries. The unaudited Consolidated Financial Statements presented in this Form 10-Q have been prepared in accordance with accounting principles generally accepted in the United States applicable to interim financial statements. Accordingly, they do not include all of the information and notes required for complete financial statements. In the opinion of ISC management, these Consolidated Financial Statements contain all adjustments (which comprise only normal and recurring accruals) necessary to present fairly the financial position and results of operations as of and for the three and six month periods ended June 30, 2011 and 2010. The interim results for the three and six months ended June 30, 2011 are not necessarily indicative of the results to be expected for the full year. These statements should be read in conjunction with our Consolidated Financial Statements and notes thereto for the fiscal year ended December 31, 2010, as filed in our Annual Report on Form 10-K.
- Other Income from Settlement Agreement* As described in more detail in Part II Other Information, Item 1 Legal Proceedings of this report, our ChemFree subsidiary is a party to an action it brought against J. Walter Co. Ltd. and J. Walter, Inc. in the United States District Court for the Northern District of Georgia. In 2007, ChemFree sought sanctions against J. Walter and the law firm then representing the defendants for asserting a frivolous defense and counterclaim. On May 3, 2011, ChemFree entered into a Settlement Agreement with the defendants former attorneys whereby they agreed to pay \$450,000 in settlement of ChemFree's claim. The Settlement Agreement was approved by the court on May 6, 2011 and the payment of \$450,000 was received by ChemFree on May 9, 2011. Accordingly, the company recorded \$450,000 of income in the quarter ended June 30, 2011, which is reported in the category Other Income in the Consolidated Statements of Operations.
- Comprehensive Income* Comprehensive income is the total of net income and all other non-owner changes in equity in a period. A summary follows:

**Consolidated Statements of**

<b>Comprehensive Income</b> <i>(unaudited, in thousands)</i>	<b>Three Months Ended June</b>		<b>Six Months Ended June</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Net income	\$ 637	\$ 298	\$ 283	\$ 383
Other comprehensive income:				
Foreign currency translation adjustment	3	4	6	20
Comprehensive income	\$ 640	\$ 302	\$ 289	\$ 403

- Stock-based Compensation* At June 30, 2011, we had two stock based compensation plans in effect. We record compensation cost related to unvested stock option awards by recognizing the unamortized grant date fair value on a straight line basis over the service periods of each award. We have estimated forfeiture rates based on our historical experience. Stock option compensation expense is recognized as a component of general and administrative expenses in the accompanying Consolidated Financial Statements. We recorded \$8,500 and \$2,000 of stock-based compensation expense in the three months ended June 30, 2011 and 2010, respectively and \$17,000 and \$5,000 for the six month periods ended June 30, 2011 and 2010, respectively. The estimated fair value of options granted is calculated using the Black-Scholes option pricing model with assumptions as previously disclosed in our 2010 Form 10-K. As of June 30, 2011, there is \$112,000 of unrecognized compensation cost related to stock options. During the quarter ended June 30, 2011, an aggregate of 12,000 options were granted to the three independent members of our board of directors pursuant to the 2011 Non-Employee Director Stock Option Plan (Director Plan). Pursuant

to the terms of the Director Plan, the options were granted at fair market value on the date of the Annual Shareholders meeting. In addition, during the six month period ended June 30, 2011, an aggregate of 80,000 options were granted on March 1, 2011 at fair market value under the terms of the 2003 Employee Stock Option Plan. No options were exercised or expired during the three and six month periods ended June 30, 2011.

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The following table summarizes stock options as of June 30, 2011:

	# of Shares	Wgt Avg Exercise Price	Wgt Avg Remaining Contractual Life in Years	Aggregate Intrinsic Value
Outstanding at June 30, 2011	286,000	\$ 1.99	5.3	\$ 9,840
Vested and exercisable at June 30, 2011	188,000	\$ 2.14	3.0	\$ 8,880

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the company's closing stock price on the last trading day of the second quarter of 2011 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on June 30, 2011. The amount of aggregate intrinsic value will change based on the fair market value of the company's stock.

5. *Fair Value of Financial Instruments* The carrying value of cash, accounts receivable, accounts payable and certain other financial instruments (such as short-term borrowings, accrued expenses, and other current liabilities) included in the accompanying consolidated balance sheets approximates their fair value principally due to the short-term maturity of these instruments. The carrying value of non-interest bearing notes receivable beyond one year have been discounted at a rate of 4% which approximates rates offered in the market for notes receivable with similar terms and conditions. The fair value of equity method and cost method investments has not been determined as it was impracticable to do so due to the fact that the investee companies are relatively small, early stage private companies for which there is no comparable valuation data available without unreasonable time and expense.

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash, trade accounts and note receivable. Our available cash is held in accounts managed by third-party financial institutions. Cash may exceed the Federal Deposit Insurance Corporation, or FDIC, insurance limits. While we monitor cash balances on a regular basis and adjust the balances as appropriate, these balances could be impacted if the underlying financial institutions fail. To date, we have experienced no loss or lack of access to our cash; however, we can provide no assurances that access to our cash will not be impacted by adverse conditions in the financial markets.

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

	Three Months Ended June		Six Months Ended June	
	2011	2010	2011	2010
(unaudited)				
ChemFree Customer A	27%	28%	30%	31%
ChemFree Customer B	13%	13%	12%	13%
CoreCard Customer C	12%			
CoreCard Customer D		11%		

7. *Short-term Borrowings* On June 30, 2011, we renewed our working capital line of credit with our bank. The revolving line of credit bears interest at the higher of the prime rate plus one and one half percent and 6.5% (6.5% at June 30, 2011); is secured by all assets of the company and our principal subsidiaries; is guaranteed by our subsidiaries; and expires June 30, 2012. We may borrow an aggregate of 80 percent of qualified accounts receivable of our consolidated subsidiaries plus 50 percent of inventory, up to a maximum of \$1,250,000. At June 30, 2011, our borrowing base calculation resulted in availability of \$1,250,000, of which we had drawn down \$0. The terms of the loan contain typical covenants not to sell or transfer material assets, to create liens against assets, to merge with another entity, to change corporate structure or the nature of our business, to declare or pay dividends, or to redeem shares of common stock. The loan agreement also contains covenants not to

change the chief executive and chief financial officers of the company or to make loans to or invest in new minority-owned companies, without first obtaining the consent of our bank in each case. Furthermore, the terms of the loan include a covenant requiring the company to maintain a minimum tangible net worth as defined in the loan agreement at the end of each calendar quarter during the loan term. As of June 30, 2011, we were in compliance with the loan covenants.

8. *Commitments and Contingencies* Please refer to Note 7 in the Consolidated Financial Statements included in our 2010 Form 10-K for a description of our commitments and contingencies in addition to those disclosed here.

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**Legal Matters ChemFree Patent Matter** As explained in detail in Part II, Item 1 of this report, our ChemFree subsidiary has been involved since 2004 in a legal matter related to a patent infringement action brought against J. Walter Co. Ltd. and J. Walter, Inc. ( J. Walter ) in the United States Court for the Northern District of Georgia. The complaint alleged that certain of the defendants' products infringed four U.S. patents held by ChemFree and sought a ruling to compel the defendants to cease their infringing activities. On June 18, 2010, the judge issued his Findings of Fact and Conclusions of Law which found (i) that certain of J. Walter's products did infringe on ChemFree's four patents-in-suit; (ii) in ChemFree's favor on the issue of the patents' named co-inventors and (iii) in J. Walter's favor on the issue of invalidity of the four patents-in-suit for obviousness. ChemFree filed a Motion for Reconsideration of the judge's findings and conclusions. In October 2010, the judge hearing the case was arrested on criminal charges by the FBI, subsequently resigned and ChemFree's case was reassigned to a new judge. On June 6, 2011, the new judge issued a final ruling in J. Walter's favor upholding the invalidity finding of the first judge and awarding recovery of allowable taxable costs from ChemFree. On July 1, 2011, ChemFree appealed the ruling to the United States Court of Appeals for the Federal Circuit. ChemFree also filed a motion to disallow the clerk's award for the recovery of allowable taxable costs. While the company presently believes it will prevail in its appeal, there can be no certainty that the Court of Appeals will find in its favor. If ChemFree does not prevail in the appeal, there is at least a reasonable possibility that ChemFree would incur some expenses for certain allowable taxable costs (which do not include attorney fees) in an amount to be determined by the court at the time.

In the ordinary course of business, we may be from time to time involved in various pending or threatened legal actions. The litigation process is inherently uncertain and it is possible that the resolution of such matters might have a material adverse effect upon our financial condition and/or results of operations.

Except as noted above, other commitments and contingencies described in Note 7 to our Consolidated Financial Statements included in our 2010 Form 10-K are unchanged.

9. **Industry Segments** Segment information is presented consistent with the basis described in our 2010 Form 10-K. The following table contains segment information for continuing operations for the three and six months ended June 30, 2011 and 2010.

	Three Months Ended June		Six Months Ended June	
	2011	30, 2010	2011	30, 2010
<i>(unaudited, in thousands)</i>				
<i>Information Technology</i>				
Revenue	\$ 991	\$ 1,376	\$ 1,541	\$ 1,938
Operating loss	(291)	(41)	(844)	(318)
<i>Industrial Products</i>				
Revenue	3,166	3,232	6,160	6,367
Operating income	687	641	1,269	1,311
<i>Consolidated Segments</i>				
Revenue	4,157	4,608	7,701	8,305
Operating income	396	600	425	993
Corporate expenses	(207)	(255)	(595)	(561)
Consolidated operating income ( loss)	\$ 189	\$ 345	\$ (170)	\$ 432
<i>Depreciation and Amortization</i>				
Information Technology	\$ 34	\$ 1	\$ 74	\$ 24
Industrial Products	82	100	100	202

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Consolidated segments		116		101		174		226
Corporate		3		4		6		8
Consolidated depreciation and amortization	\$	119	\$	105	\$	180	\$	234
<i>Capital Expenditures</i>								
Information Technology	\$	35	\$	59	\$	161	\$	158
Industrial Products		136		36		199		67
Consolidated segments		171		95		360		225
Corporate						1		1
Consolidated capital expenditures	\$	171	\$	95	\$	361	\$	226



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<i>(unaudited, in thousands)</i>	<b>June 30, 2011</b>	<b>December 31, 2010</b>
<i>Identifiable Assets</i>		
Information Technology	\$ 2,468	\$ 2,618
Industrial Products	7,022	6,016
Consolidated segments	9,490	8,634
Corporate	1,381	1,457
Consolidated assets	\$ 10,871	\$ 10,091

10. *Income Taxes* We have recognized tax benefits from all tax positions taken, and there has been no adjustment to any carry forwards, net operating loss or R&D credits in the past two years. As of June 30, 2011, the company has recorded a liability of \$122,228 in connection with unrecognized tax benefits related to uncertain tax positions. The liability includes \$19,711 of interest and penalties. As of December 31, 2010, the company has recorded a liability of \$90,000 in connection with unrecognized tax benefits, which included \$15,000 of interest and penalties. As of June 30, 2011, management expects some incremental but not significant changes in the balance of unrecognized tax benefits over the next twelve months.

Our policy is to recognize accrued interest related to uncertain tax positions in interest expense and related penalties, if applicable, in general and administrative expense. During the three and six months ended June 30, 2011, we recognized \$5,007 in interest expense and \$61 in penalties related to uncertain tax positions. During the three and six months ended June 30, 2010, we recognized \$4,113 in interest expense and \$4,509 in penalties related to the uncertain tax positions.

We file a consolidated U.S. federal income tax return for all subsidiaries in which our ownership exceeds 80 percent, as well as individual subsidiary returns in various states and foreign jurisdictions. For periods prior to April 15, 2008, our VISAer subsidiary filed a separate U.S. federal income tax return. With few exceptions we are no longer subject to U.S. federal, state and local or foreign income tax examinations by taxing authorities for years before 2006.

11. *Recent Accounting Pronouncements* We have considered all other recently issued accounting pronouncements and do not believe the adoption of such pronouncements will have a material impact on our Consolidated Financial Statements.
12. *Subsequent Events* We evaluated subsequent events through the date when these financial statements were issued. We are not aware of any significant events that occurred subsequent to the balance sheet date but prior to the filing of this report that would have a material impact on our Consolidated Financial Statements.

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

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

*For purposes of this discussion and analysis, we are assuming and relying upon the reader's familiarity with the information contained in Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations, in the Form 10-K for the year ended December 31, 2010 as filed with the Securities and Exchange Commission.*

**Overview**

Our consolidated subsidiaries operate in two industry segments: Information Technology Products and Services (Information Technology) and Industrial Products. The Industrial Products segment includes ChemFree Corporation (bio-remediating parts washer systems). The Information Technology sector consists of CoreCard Software, Inc. (CoreCard) (software for managing accounts receivables, prepaid, credit and debit cards).

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

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

Customers may decide to postpone or cancel a planned implementation of our software for any number of reasons, which may be unrelated to our software features or contract performance, but which may affect the amount, timing and characterization of our deferred and/or recognized revenue.

In the Information Technology sector, license revenue in a given period may consist of a relatively small number of contracts. Consequently, even small delays in a delivery under a software contract (which may be out of our control) could have an unpredictable impact on consolidated revenue that is recognized in a given quarterly or annual period.

We reported a net profit of \$637,000 and \$283,000 for the three and six months ended June 30, 2011. Included in these results is non-recurring income of \$450,000 earned by our ChemFree subsidiary upon the settlement of a legal action which is described in more detail in Note 2 to the Consolidated Financial Statements. Frequently we report consolidated operating losses on a quarterly or annual basis and are likely to do so in the future from time to time. Our ChemFree subsidiary generates an operating profit on a regular basis but our earlier stage subsidiary, CoreCard, is not consistently profitable, mainly due to significant research and development expense that is invested to complete new product offerings and the deferral of revenue recognition until new software license contracts are complete. Depending upon the size and number of software licenses recognized in a particular period and the level of expenses incurred to support development and sales activities, CoreCard may report operating profits on an irregular basis as it builds its customer base. A significant portion of our subsidiaries' expense is related to personnel. For these and other reasons, our operating profits or losses may vary from period to period and at the present time are generally not predictable with any degree of certainty.

From time to time, we also generate income or incur losses from non-operating sources and we may do so in the future. We may derive income from sales of subsidiary, affiliate and other minority-owned companies. Occasionally, we record a charge if we believe the value of a non-consolidated company is impaired. We also recognize on a quarterly basis our pro rata share of the income or losses of an affiliate company accounted for by the equity method. The timing and amount of any gain or loss recognized as a result of a sale or the amount of equity in the income or losses of affiliates generally are not under our control and are not necessarily indicative of future results, either on a quarterly or annual basis.

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

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

**Revenue** Total revenue from continuing operations in the three month period ended June 30, 2011 was \$4.2 million compared to \$4.6 million in the second quarter of 2010. For the six month period ended June 30, 2011, total revenue was \$7.7 million, compared with \$8.3 million in the same period in 2010.

Revenue from *products*, which includes sales and leases of equipment and supplies in our Industrial Products segment as well as software license fees related to the Information Technology segment, was \$3.6 million in the three month period ended June 30, 2011, a 3 percent decrease compared to the three month period ended June 30, 2010. Product revenue was \$6.7 million in the six month period ended June 30, 2011, a decline of 6 percent compared to the six month period ended June 30, 2010. The decline in product revenue in the second quarter and year-to-date period of 2011 compared to the prior year periods is the net effect of an increase in international revenue and total sales of consumable supplies at our ChemFree subsidiary which was offset in part by a decline in domestic sales of ChemFree's SmartWasher® parts washer machines. In addition, software license revenue associated with the Information Technology segment declined in the three and six month periods ended June 30, 2011 compared to the same periods in 2010 due to fewer new contracts completed with lower total value in 2011 than in the corresponding periods last year. As we have frequently cautioned, a number of factors, some of which may be outside of our control, can cause delays in delivery of our software and implementation by the customer, thus delaying license revenue recognition. *Service* revenue associated with the Information Technology segment was \$512,000 and \$1,024,000 in the three and six months ended June 30, 2011, respectively, compared to \$844,000 and \$1,193,000 in the respective periods in 2010. Service revenue includes three components: revenue from annual maintenance and support contracts for our installed customer base, revenue from professional services (such as software customizations or modifications) and revenue from our card processing services. The change in the quarter and year-to-date periods in 2011 compared to the same periods in 2010 is attributed to the net effect of an increase in the installed base of customers that pay for maintenance and technical support and card processing services, offset by fewer professional services projects that were completed for CoreCard customers. The number and timing of professional services contracts vary significantly from period to period based on customer requirements and priorities.

**Cost of Revenue** Total cost of revenue was 50 percent and 51 percent of total revenue in the three and six month periods ended June 30, 2011, respectively, compared to 55 percent and 53 percent of total revenue in the three and six month periods ended June 30, 2010, respectively. The changes between periods reflect changes in ChemFree's and CoreCard's product and service mix from period to period.

Cost of *product* revenue was 48 percent and 49 percent of product revenue in the three and six months ended June 30, 2011, respectively, compared to costs of 57 percent and 54 percent of product revenue in the respective periods in 2010. In 2011, the lower cost of sales as a percent of revenue reflects a favorable mix at ChemFree of higher margin consumable products in 2011 as well as some unit cost reductions from bringing its filter production in-house in 2011. In addition, CoreCard's costs associated with the software contracts recognized in 2011 were lower than the costs associated with contracts recognized in 2010, because they involved less complex implementations and were not fixed price contracts, as was the case in 2010.

Cost of *service* revenue (which relates to our CoreCard business only) was 67 percent and 61 percent of service revenue in the three and six month periods ended June 30, 2011, respectively, as compared to 46 percent and 47 percent of service revenue in the respective periods last year. The mix of service revenue in a given period, as well as the number of customers and new products being supported, impacts the gross margin on service revenue. Cost of service revenue includes three components: the costs to provide annual maintenance and support services to our installed base of licensed customers, costs to provide professional services and costs to provide our card processing services. The cost and gross margins on professional services revenue are tied to specific projects and vary depending on the specific project requirements and complexity as well as the mix of our U.S. and offshore employees working on the project. Our initial costs to

provide card processing services is high relative to the revenue earned because we are putting in place the systems and processes necessary to support this new service initiative. We had no such costs in the second quarter and year-to-date periods in 2010 because we were not yet offering card processing services. CoreCard is providing a high level of support to its customers for both maintenance and professional services activities to ensure it builds a solid base of reference customers and puts in place an infrastructure for future growth.

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**Operating Expenses** In the three and six month periods ended June 30, 2011, total consolidated operating expenses were higher by 10 percent and 15 percent, respectively, than in the corresponding periods in 2010. Consolidated marketing expenses were relatively unchanged in the three and six month periods ended June 30, 2011 compared to the same periods in 2010. Consolidated general and administrative expenses were lower by 11 percent (\$77,000) in the three month period ended June 30, 2011 reflecting lower legal, bonus and accounting fees than in the same period of 2010. General and administrative expenses were 8 percent (\$115,000) higher in the six month period ended June 30, 2011, compared to the same period of 2010, reflecting mainly higher legal, stock option and salary expenses. Consolidated research and development expenses were 48 percent and 47 percent higher in the three and six month periods ended June 30, 2011, respectively, compared to the same periods in 2010, due to a lower percentage of personnel related R&D expenses charged to cost of sales for revenue recognized in 2011, as well as an increase in the number of employees and compensation rates at the company's India based software development and testing operations.

**Interest Income, net** We recorded net interest income of \$6,000 and \$17,000, in the three and six month periods ended June 30, 2011, respectively, compared to net interest income of \$17,000 and \$44,000 in the three and six month periods ended June 30, 2010. The difference between periods reflects primarily the fact that our total note receivable related to the sale of our former VISAer subsidiary was lower in 2011 than in 2010 due to a write down of the carrying balance of the note receivable in the quarter ended December 31, 2010, as explained in more detail in Note 2 to the Consolidated Financial Statements contained in our 2010 Annual Report on Form 10-K.

**Equity in Income (Loss) of Affiliate Company** On a quarterly basis, we recognize our pro rata share of the earnings or losses of an affiliate company that we record on the equity method. We recorded \$11,000 and \$20,000 in net equity income of our affiliate company in the three and six month periods ended June 30, 2011, respectively, compared to net equity losses of \$10,000 and \$22,000 in the three and six months ended June 30, 2010, respectively. The change between periods reflects improved profitability of the affiliate company in 2011.

**Other Income** As explained in more detail in Note 2 to the Consolidated Financial Statements, the second quarter and year-to-date results for 2011 include income of \$450,000 earned by our ChemFree subsidiary upon the settlement of a legal matter.

**Income Taxes** We recorded \$27,000 and \$48,000, in the three and six month periods ended June 30, 2011, respectively, for state income tax expense, which amounts include \$26,000 in connection with uncertain tax positions. An expense of \$56,000 was recorded in the quarter ended June 30, 2010 in connection with uncertain tax positions.

**Liquidity and Capital Resources**

Our cash balance at June 30, 2011 was \$3.2 million compared to \$2.9 million at December 31, 2010. During the six months ended June 30, 2011, principal sources of cash include receipt of a \$600,000 payment from the purchaser of our former VISAer subsidiary (as explained in more detail in Note 2 to the Consolidated Financial Statements contained in our 2010 Annual Report on Form 10-K) as well as receipt of a \$450,000 payment related to the Settlement Agreement (as explained in more detail in Note 2 to the Consolidated Financial Statements contained herein). Major working capital changes included:

- an increase in accounts receivable of \$714,000 due to the timing of contract milestone billings as well as a change in payment terms for a large customer
- an increase of \$95,000 in inventory due mainly to higher levels of certain materials that had been backlogged at the end of December 2010
- a net increase in deferred revenue of \$227,000 reflecting billings to CoreCard customers in advance of revenue recognition
- an increase in accounts payable reflecting timing and level of inventory purchases

During the first six months of 2011, we used \$361,000 cash to invest in capital equipment mainly to upgrade CoreCard's data centers and India office for its new processing services, software testing automation initiatives and additional off-shore employees as well as vehicle and production equipment purchases at ChemFree.

We currently project that we will have sufficient liquidity from cash on hand, continued cash positive operations at ChemFree, projected customer payments at CoreCard and periodic working capital borrowings, if needed, to support our operations and capital equipment purchases in the foreseeable future. We renewed our line of credit in June 2011 with a maximum principal availability of \$1.25 million based on qualified receivables and inventory levels which we

will use as necessary to support short-term cash needs. We have not borrowed under the line of credit since its renewal. We presently project that we will have sufficient accounts receivable, inventory balances and tangible net worth for the foreseeable future to support the borrowing base and loan covenants for any required draws under our bank line of credit. The line of credit expires June 30, 2012, subject to the bank renewing the line for an additional period. If the bank does not renew our line of credit and if we have cash requirements, we may experience a short-term cash shortfall. Delays in meeting project milestones or software delivery commitments at CoreCard could cause customers to postpone payments and increase our need for cash. Presently, we do not believe there is a material risk that we will not perform successfully on any contracts but if customer payments are delayed for any reason, if we do not control costs or if we encounter unforeseen technical or quality problems, then we could require more cash than presently planned.

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Long-term, we currently expect that liquidity will continue to improve and consolidated operations will generate sufficient cash to fund their requirements with use of our credit facility to accommodate short-term needs. Other long-term sources of liquidity include potential sales of investments, subsidiaries or other assets although there are no current plans to do so. Furthermore, the timing and amount of any such transactions are uncertain and, to the extent they involve non-consolidated companies, generally not within our control.

### **Off-Balance Sheet Arrangements**

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

### **Critical Accounting Policies and Estimates**

The discussion and analysis of our financial condition and results of operations is based upon our Consolidated Financial Statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets, liabilities, revenues and expenses. We consider certain accounting policies related to revenue recognition, valuation of acquired intangibles and impairment of long-lived assets, and valuation of investments to be critical policies due to the estimation processes involved in each. Management discusses its estimates and judgments with the Audit Committee of the Board of Directors. For a detailed description on the application of these and other accounting policies, see Note 1 to the Consolidated Financial Statements contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010. Reference is also made to the discussion of the application of these critical accounting policies and estimates contained in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for 2010. During the three and six month periods ended June 30, 2011, there were no significant or material changes in the application of critical accounting policies that would require an update to the information provided in the Form 10-K.

### **Factors That May Affect Future Operations**

Future operations in both the Information Technology Products and Services and Industrial Products segments are subject to risks and uncertainties that may negatively impact our future results of operations or projected cash requirements. It is difficult to predict future quarterly and annual results with certainty. Any trend or delay that affects even one of our subsidiaries could have a negative impact on the company's consolidated results of operations or cash requirements on a quarterly or annual basis. In addition, the carrying value of our investments is impacted by a number of factors which are generally beyond our control since we are typically a non-controlling shareholder in a private company with limited liquidity.

Among the numerous factors that may affect our consolidated results of operations or financial condition are the following:

Further weakness in the global financial markets could have a negative impact on CoreCard due to potential customers (most of whom are financial institutions or services firms) delaying software purchase or implementation decisions.

Stricter regulations and reluctance by financial institutions to act as sponsor banks for prospective customers (such as issuers and processors of credit and prepaid cards) could increase CoreCard's losses and cash requirements.

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

Our CoreCard subsidiary could fail to deliver software products which meet the business and technology requirements of its target markets within a reasonable time frame and at a price point that supports a profitable, sustainable business model.

As an alternative to licensing its software, CoreCard is now offering outsourced processing services running on the CoreCard software system. There are numerous risks associated with entering any new line of business and if CoreCard fails to manage the risks associated with its processing operations, it could have a negative impact on our business.

One of ChemFree's customers represented 30 percent of our consolidated revenue in the first half of 2011 and any unplanned changes in the volume of orders or timeliness of payments from such customer could potentially have



a negative impact on inventory levels and cash, at least in the near-term.

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It is unclear whether the activity in the ChemFree legal action described in Note 8 to the Consolidated Financial Statements will have any impact on our ChemFree subsidiary in the foreseeable future but if the finding of invalidity of certain of ChemFree's patents is sustained by the Appeals court, it could result in increased competition in the marketplace and greater price pressure and lower margins, thus potentially impacting revenue, profits and projected cash flows. In addition, it is possible that a negative ruling could affect management's estimate of future cash flows related to the affected patents. This could result in a write down of some or all of the unamortized carrying value of the ChemFree patents, which was \$155,000 (for all ChemFree patents) as of June 30, 2011.

Delays in production or shortages of any sole-sourced parts for our ChemFree products could impact revenue and orders.

Anticipated increases in prices of raw materials and sub-assemblies could reduce ChemFree's gross profit if it is not able to offset such increased costs with higher selling prices for its products or other reductions in production costs.

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

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

Increasing and changing government regulations in the United States and foreign countries related to such issues as data privacy, financial and credit transactions could require changes to our products and services which could increase our costs and could affect our existing customer relationships or prevent us from getting new customers.

CoreCard could fail to expand its base of customers as quickly as anticipated, resulting in lower revenue and profits (or increased losses) and increased cash needs.

In certain situations, ChemFree's lease customers are permitted to terminate the lease covering a SmartWasher<sup>®</sup> machine, requiring the unamortized balance of the original machine cost to be written off which could reduce profits in that reporting period and result in lower revenue in future periods.

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

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

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

Failure to meet the continued listing standards of NYSE Amex could result in delisting of our common stock, with a potentially negative impact on the market price and liquidity of our common stock.

Our future capital needs are uncertain and depend on a number of factors; additional capital may not be available on acceptable terms, if at all.

Other general economic and political conditions could cause customers to delay or cancel software purchases.

## **Item 4. Controls and Procedures**

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



**Table of Contents****Part II. OTHER INFORMATION****Item 1. Legal Proceedings**

As previously reported in Part 1, Item 3 of our 2010 Annual Report on Form 10-K, our ChemFree subsidiary is a party to an action it brought against J. Walter Co. Ltd. and J. Walter, Inc. in the United States District Court for the Northern District of Georgia. The complaint alleged that certain of the defendants' products infringed four U.S. patents held by ChemFree and sought a ruling to compel the defendants to cease their infringing activities. The defendants asserted various defenses. The trial took place during the week of July 13, 2009. On June 18, 2010, the judge issued his Findings of Fact and Conclusions of Law which found (i) that certain of J. Walter's products did infringe on ChemFree's four patents-in-suit; (ii) in ChemFree's favor on the issue of the patents' named co-inventors and (iii) in J. Walter's favor on the issue of invalidity of the four patents-in-suit for obviousness. In his ruling on invalidity of four of ChemFree's patents due to obviousness, the judge relied heavily on a 2007 U.S. Supreme Court ruling (issued more than three years after ChemFree's lawsuit was filed) which modified the manner for determining obviousness of a patent by replacing the long-standing rigid application of the teaching, suggestion or motivation test for determining obviousness with an expansive and flexible approach. ChemFree filed a Motion for Reconsideration of the judge's findings and conclusions followed by the filing of a Second Motion for Additional Findings and Conclusions. In October 2010, the judge hearing the case was arrested on criminal charges by the FBI, subsequently resigned and ChemFree's case was reassigned to a new judge. On June 6, 2011, the new judge issued a final ruling in J. Walter's favor upholding the invalidity finding of the first judge and awarding recovery of allowable taxable costs from ChemFree. On July 1, 2011, ChemFree appealed the ruling to the United States Court of Appeals for the Federal Circuit. ChemFree also filed a motion to disallow the clerk's recovery of allowable taxable costs. While the company presently believes it will prevail in the appeal, there can be no certainty that the Court of Appeals will find in its favor. If ChemFree does not prevail in the appeal, there is at least a reasonable possibility that ChemFree would incur some expenses for certain allowable taxable costs (which do not include attorney fees) in an amount to be determined by the court at the time.

As previously reported in our Form 10-Q for the period ended March 31, 2011, in September 2007 ChemFree sought sanctions against the defendants J. Walter and the law firm then representing the defendants for asserting certain frivolous defenses and counterclaims. In June 2008, the court imposed sanctions on the law firm, which no longer represents the defendants, and ChemFree submitted an application to the court seeking an award of attorneys fees associated with defending the frivolous claims. The court found in ChemFree's favor and awarded sanctions against the former law firm. On May 3, 2011, ChemFree entered into a Settlement Agreement with the defendants' former attorneys whereby they agreed to pay \$450,000 to ChemFree in settlement of ChemFree's claim. The Settlement Agreement was approved by the court on May 6, 2011 and payment of the \$450,000 was received by ChemFree on May 9, 2011.

In the ordinary course of business, we may be from time to time involved in various pending or threatened legal actions. The litigation process is inherently uncertain and it is possible that the resolution of such matters might have a material adverse effect upon our financial condition and/or results of operations.

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**Item 6. Exhibits**

The following exhibits are filed or furnished with this report:

- 3.1 Amended and Restated Articles of Incorporation of the Registrant dated May 4, 2011 (Incorporated by reference to Exhibit 3.(1) to the Registrant's Form 10-Q for the period ended March 31, 2011)
- 3.2 Bylaws of the Registrant dated December 7, 2007. (Incorporated by reference to Exhibit 3.2 of the Registrant's Form 8-K dated December 7, 2007.)
- 10.1 Tenth Modification to Loan Documents by and among Intelligent Systems Corporation and Fidelity Bank dated June 30, 2011, filed herein.
- 10.2 Settlement Agreement executed May 3, 2011, filed herein.
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer and Chief Financial Officer furnished as required by Section 906 of the Sarbanes-Oxley Act of 2002.
- 101 XBRL Instance Document

**SIGNATURES**

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

INTELLIGENT SYSTEMS  
CORPORATION  
Registrant

Date: August 15, 2011

By: */s/ J. Leland Strange*  
J. Leland Strange  
Chief Executive Officer, President

Date: August 15, 2011

By: */s/ Bonnie L. Herron*  
Bonnie L. Herron  
Chief Financial Officer

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**EXHIBIT INDEX**

**Exhibit**

<b>No.</b>	<b>Descriptions</b>
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101	XBRL Instance Document