

SMITH MICRO SOFTWARE INC

Form 10-Q

August 14, 2006

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

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE QUARTER ENDED JUNE 30, 2006**

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

**COMMISSION FILE NUMBER 0-26536**

**SMITH MICRO SOFTWARE, INC.**

**(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)**

**DELAWARE**

**(STATE OR OTHER JURISDICTION OF  
ORGANIZATION)**

**33-0029027**

**(I.R.S. EMPLOYER INCORPORATION OR  
IDENTIFICATION NUMBER)**

**51 COLUMBIA, SUITE 200, ALISO VIEJO, CA**

**(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)**

**92656**

**(ZIP CODE)**

**REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (949) 362-5800**

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark if whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2).

YES  NO

As of July 28, 2006 there were 24,038,164 shares of Common Stock outstanding.

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**SMITH MICRO SOFTWARE, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In Thousands, Except Per Share Data)

	<b>June 30, 2006</b> (unaudited)	<b>December 31, 2005 (A)</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 31,319	\$ 21,215
Accounts receivable, net of allowances for doubtful accounts and other adjustments of \$376 (2006) and \$439 (2005)	4,200	6,786
Inventories, net	1,035	530
Prepaid expenses and other current assets	299	556
Total current assets	36,853	29,087
Equipment and improvements, net	384	241
Goodwill	15,039	9,288
Intangible assets, net	4,524	4,093
Other assets		7
Total assets	\$ 56,800	\$ 42,716
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 2,197	\$ 2,383
Accrued liabilities	3,186	1,376
Total current liabilities	5,383	3,759
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS EQUITY:</b>		
Preferred stock, par value \$0.001 per share; 5,000,000 shares authorized; none issued or outstanding		
Common stock, par value \$0.001 per share; 50,000,000 shares authorized; 24,038,000 and 22,147,000 shares issued and outstanding at June 30, 2006 and December 31, 2005, respectively	24	22
Additional paid-in capital	60,444	50,880
Accumulated deficit	(9,051)	(11,945)

Net stockholders' equity	51,417	38,957
Total liabilities and stockholders' equity	\$ 56,800	\$ 42,716

(A) DERIVED FROM  
THE AUDITED  
CONSOLIDATED  
FINANCIAL  
STATEMENTS AT  
DECEMBER 31,  
2005 SEE  
ACCOMPANYING  
NOTES TO  
UNAUDITED  
CONDENSED  
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FINANCIAL  
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**SMITH MICRO SOFTWARE, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In Thousands, Except Per Share Data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006 (Unaudited)	2005 (Unaudited)	2006 (Unaudited)	2005 (Unaudited)
NET REVENUES				
Products	\$ 12,362	\$ 3,179	\$ 22,072	\$ 5,038
Services	193	151	368	322
Total Net Revenues	12,555	3,330	22,440	5,360
COST OF REVENUES				
Products	5,226	476	8,455	746
Services	79	69	150	144
Total Cost of Revenues	5,305	545	8,605	890
GROSS PROFIT	7,250	2,785	13,835	4,470
OPERATING EXPENSES:				
Selling and marketing	2,293	369	4,166	809
Research and development	2,077	697	3,754	1,394
General and administrative	2,029	1,161	3,438	1,937
Total operating expenses	6,399	2,227	11,358	4,140
OPERATING INCOME	851	558	2,477	330
INTEREST INCOME	265	214	489	314
INCOME BEFORE INCOME TAXES	1,116	772	2,966	644
INCOME TAX EXPENSE	33	8	72	8
NET INCOME	\$ 1,083	\$ 764	\$ 2,894	\$ 636
NET INCOME PER SHARE, basic	\$ 0.05	\$ 0.04	\$ 0.13	\$ 0.03

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WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING, basic	23,635	21,584	22,973	20,629
NET INCOME PER SHARE, diluted	\$ 0.04	\$ 0.03	\$ 0.12	\$ 0.03
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING, diluted	25,598	22,713	24,740	21,901

SEE ACCOMPANYING NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL  
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**SMITH MICRO SOFTWARE, INC.**  
**CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY**  
(In Thousands)

	<b>Common stock</b>		<b>Additional paid-in capital</b>	<b>Accumulated deficit</b>	<b>Total</b>
	<b>Shares</b>	<b>Amount</b>			
BALANCE, December 31, 2005	22,147	\$ 22	\$ 50,880	\$ (11,945)	\$ 38,957
Exercise of common stock options	1,056	1	2,629		2,630
Acquisition of PhoTags, Inc.	385	1	4,730		4,731
Non cash compensation recognized on stock options			1,485		1,485
Non cash compensation recognized on Restricted Stock	450		720		720
Net income				2,894	2,894
BALANCE, June 30, 2006	24,038	\$ 24	\$ 60,444	\$ (9,051)	\$ 51,417

SEE ACCOMPANYING NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL  
STATEMENTS.

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**SMITH MICRO SOFTWARE, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In Thousands)

	<b>Six Months</b>	
	<b>Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
	(Unaudited)	(Unaudited)
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 2,894	\$ 636
Adjustments to reconcile net income to net cash provided by operating activities, net of the effect of the acquisition of PhoTags, Inc.:		
Depreciation and amortization	926	64
Provision for doubtful accounts and other adjustments to accounts receivable	221	15
Provision for slow moving inventory	35	
Non cash compensation related to stock options & restricted stock	2,204	
Change in operating accounts, net of effect from acquisition:		
Accounts receivable	2,368	(651)
Inventories	(540)	21
Prepaid expenses and other assets	183	(68)
Accounts payable and accrued liabilities	1,574	339
 Net cash provided by operating activities	 9,865	 356
 <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Acquisition of PhoTags, Inc., net of cash received	(2,165)	
Capital expenditures	(228)	(21)
 Net cash used in investing activities	 (2,393)	 (21)
 <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Cash received from issuance of common stock, net of offering costs		20,786
Cash received from exercise of stock options	2,632	191
 Net cash provided by financing activities	 2,632	 20,977
 <b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	 <b>10,104</b>	 <b>21,312</b>
 <b>CASH AND CASH EQUIVALENTS, beginning of period</b>	 <b>21,215</b>	 <b>8,634</b>
 <b>CASH AND CASH EQUIVALENTS, end of period</b>	 <b>\$ 31,319</b>	 <b>\$ 29,946</b>

SEE ACCOMPANYING NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.

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**SMITH MICRO SOFTWARE, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In Thousands)

	For the Six Months Ended June 30,	
	2006 (Unaudited)	2005 (Unaudited)
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash Paid for income taxes	\$ 66	\$ 2

SEE ACCOMPANYING NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.

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**Table of Contents****SMITH MICRO SOFTWARE, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Description of Business* Smith Micro Software, Inc. and subsidiaries (the Company) is a diversified developer and marketer of communications and utilities software products and services. The Company's strategic focus is to market and sell value-added wireless products targeted to the original equipment manufacturers (OEM) market, particularly wireless service providers and mobile phone manufacturers. The Company offers software products for Windows, Mac OS X, Unix and Linux operating systems. The Company also offers wireless communication software products and services to the enterprise market that include enhanced wireless security features.

On April 5, 2006, the Company acquired PhoTags, Inc. (PhoTags), a Delaware Corporation with offices in Jerusalem, Israel (see Note 3). PhoTags is a leading developer and marketer of revolutionary photo and music management technology. The company's pioneering product suite known as Active Images turns any JPEG file into a self-contained multimedia messaging system, allowing users to send text messages, music, sound files, documents and more all in a single JPEG file. Among PhoTags' product suite was Music Express, now known as QuickLink Music, an innovative music management solution which assists users enhance the media-rich capabilities of listening to music on their PCs. QuickLink Music allows users to simplify managing their music files, buy music from an online store, manage music files on a PC. PhoTags Inc.'s patented Active Images technology is designed to easily add any type of metadata or media file to a JPEG Image. 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 for the first time that carriers and handset manufacturers can provide enhanced music and photo management technology that can reside directly in the handset and on a consumer's PC. In addition to broadening Smith Micro's family of mobility products, the PhoTags acquisition will help expand Smith Micro's ability to serve OEM customers in Europe and Asia through an international sales and support office now based in Jerusalem, Israel that is now renamed Smith Micro Software, Israel.

On July 1, 2005, the Company acquired Allume Systems (Allume), which was a wholly owned subsidiary of International Microcomputer Software, Inc. (see Note 4). Allume develops and publishes award-winning software solutions that empower users in the area of information access, removal, recovery, security, productivity and online distribution. Allume's flagship product is StuffIt Deluxe. StuffIt Wireless, a new and advanced technology that is patent pending by Allume Systems, will compress an already compressed JPEG file by up to 30% more without losing any of the picture quality. This technology is particularly important to mobile phone manufacturers who now can store up to 30% more images and carriers who are interested in the reduction of utilized bandwidth. In addition, StuffIt Wireless has been enhanced to also compress and decompress handset resources, potentially reducing the cost to build handsets by reducing memory requirements. Other award winning products include icSpyware & Anti-Phishing Suite which targets spyware and phishing intrusions, Internet Cleanup which removes spyware and detects and prevents intruders from access to private information and Spring Cleaning® which cleans and optimizes computer operating systems.

*Basis of Presentation* The accompanying unaudited interim consolidated financial statements reflect adjustments (consisting of normal recurring adjustments) necessary to present fairly the consolidated financial position of the Company at June 30, 2006, the consolidated results of its operations for the three and six months ended June 30, 2006 and 2005 and its consolidated cash flows for the six month periods ended June 30, 2006 and 2005. Certain information and footnote disclosures normally included in the consolidated financial statements have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission (SEC), although the Company believes that the disclosures in the unaudited consolidated financial statements are adequate to ensure the information presented is not misleading. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005. The results of operations of interim periods are not necessarily indicative of future operating results. All intercompany amounts have been eliminated in consolidation.

*Cash and Cash Equivalents* Cash and cash equivalents generally consist of cash, government securities and money market funds. These securities are all held in one financial institution and are uninsured except for minimum FDIC coverage. As of June 30, 2006 and December 31, 2005, balances totaling approximately \$31.4 and \$21.4 million, respectively, were uninsured. All have original maturity dates of three months or less.

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*Accounts Receivable* The Company sells its products worldwide. The Company performs ongoing credit evaluations of its customers and generally does not require collateral. The Company maintains reserves for estimated credit losses, and those losses have been within management's estimates. Allowances for product returns are included in other adjustments to accounts receivable on the accompanying consolidated balance sheets. Product returns are estimated based on historical experience and have also been within management's estimates.

*Inventories* Inventories consist principally of cables, CDs, boxes and manuals and are stated at the lower of cost (determined by the first-in, first-out method) or market. The Company regularly reviews its inventory quantities on hand and records a provision for excess and obsolete inventory based primarily on management's forecast of product demand and production requirements. At June 30, 2006 our inventory balance consisted of approximately \$601,000 in assembled products and \$434,000 of components.

*Equipment and Improvements* Equipment and improvements are stated at cost. Depreciation is computed using the straight-line method based on the estimated useful lives of the assets, generally ranging from three to seven years. Leasehold improvements are amortized using the straight-line method over the shorter of the estimated useful life of the asset or the lease term.

*Long Lived Assets* The Company accounts for the impairment and disposition of long-lived assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*. This statement addresses financial accounting and reporting for the impairment of long-lived assets and for the disposal of long-lived assets. In accordance with SFAS No. 144, long-lived assets to be held are reviewed for events or changes in circumstances, which indicate that their carrying value may not be recoverable. The Company periodically reviews the carrying value of long-lived assets to determine whether or not an impairment to such value has occurred. The Company has determined that there was no impairment at June 30, 2006.

*Goodwill* The Company adopted SFAS No. 142, *Goodwill and Other Intangible Assets*, effective January 1, 2002. As a result of the adoption, the Company is no longer required to amortize goodwill. Prior to the adoption of SFAS 142, goodwill was amortized over 7 years. In accordance with SFAS No. 142, the Company reviews the recoverability of the carrying value of goodwill at least annually or whenever events or circumstances indicate a potential impairment. The Company's annual impairment testing date is December 31. Recoverability of goodwill is determined by comparing the fair value of the Company's reporting units to the carrying value of the underlying net assets in the reporting units. If the fair value of a reporting unit is determined to be less than the carrying value of its net assets, goodwill is deemed impaired and an impairment loss is recognized to the extent that the carrying value of goodwill exceeds the difference between the fair value of the reporting unit and the fair value of its other assets and liabilities. The Company determined that it did not have any impairment of goodwill at December 31, 2005.

The carrying amount of the Company's goodwill was approximately \$15,039,000 and \$9,288,000 as of June 30, 2006 and December 31, 2005, respectively. The Company's reporting units are equivalent to its operating segments. At June 30, 2006 the amount of goodwill allocated to the products segment is \$14,704,000 and the amount of goodwill allocated to the services segment is \$335,000. At December 31, 2005 the amount of goodwill allocated to the products segment is \$8,953,000 and the amount of goodwill allocated to the services segment is \$335,000.

*Other Intangible Assets* The following table sets forth the acquired intangible assets by major asset class:

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	Useful Life (Years)	June 30, 2006			December 31, 2005		
		Gross	Accumulated Amortization	Net Book Value	Gross	Accumulated Amortization	Net Book Value
(in thousands)							
Amortizing:							
Purchased and							
Licensed Technology	3	\$ 2,260	(2,260)		\$ 2,260	(2,260)	
Capitalized Software	4-5	3,849	(1,119)	2,730	2,649	(534)	2,115
Distribution Rights	5	482	(152)	330	482	(76)	406
Customer Lists	5	923	(184)	739	923	(92)	831
Trademarks	10	809	(136)	673	809	(68)	741
Customer Agreements	1.5	65	(13)	52			
Totals		\$ 8,388	\$ (3,864)	\$ 4,524	\$ 7,123	\$ (3,030)	\$ 4,093

Aggregate amortization expense on intangible assets was approximately \$449,000 and \$834,000 for the three and six months ended June 30, 2006, respectively. Expected future amortization expense is as follows: \$736,000 for the remainder of 2006, \$1,696,000 for the year 2007, \$1,121,000 for the year 2008, \$522,000 for the year 2009 and \$449,000 thereafter. Amortization expense related to intangibles acquired in the Allume acquisition is calculated on a discounted cash flow basis over five years for Capitalized Software, Distribution Rights and Customer Lists and ten years for Trademarks. Amortization is calculated on a straight line basis over five years for Customer Lists. Amortization expense related to intangibles acquired in the PhoTags acquisition is calculated on a discounted cash flow basis over four years for Capitalized Software and 18 months for Customer Agreements.

**Revenue Recognition** Software revenue is recognized in accordance with the Statement of Position (SOP) 97-2, *Software Revenue Recognition*, as amended, when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed and determinable, and collectibility is probable. The Company recognizes revenues from sales of its software to Retail and OEM customers or end users as completed products are shipped and title passes, or from royalties generated as authorized customers duplicate the Company's software, if the other requirements of SOP 97-2 are met. If the requirements of SOP 97-2 are not met at the date of shipment, revenue is not recognized until these elements are known or resolved. Returns from Retail and OEM customers are limited to defective goods or goods shipped in error. Historically, OEM customer returns have not been significant. The Company reviews available retail channel information and makes a determination of a return provision for sales made to distributors and retailers based on current channel inventory levels and historical return patterns. Certain sales to distributors or retailers are made on a consignment basis. Revenue for consignment sales are not recognized until sell through to the final customer is established.

Product sales directly to end-users are recognized upon delivery. End users have a thirty day right of return, but such returns are reasonably estimable and have historically been immaterial. The Company also provides technical support to its customers. Such costs have historically been insignificant.

Service revenues include sales of consulting services, web site hosting and fulfillment. Service revenues are recognized as services are provided or as milestones are delivered and accepted by our customers.

**Sales Incentives** Pursuant to the consensus of EITF 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Product)*, effective January 1, 2002, the cost of sales incentives the Company offers without charge to customers that can be used in, or that are exercisable by a customer as a result of, a single exchange transaction is accounted

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for as a reduction of revenue. We track incentives by program and use historical redemption rates to estimate the cost of customer incentives. These costs have historically been less than 10% of our revenues.

*Software Development Costs* Development costs incurred in the research and development of new software products and enhancements to existing software products are expensed as incurred until technological feasibility has been established. The Company considers technological feasibility to be established when all planning, designing, coding and testing has been completed according to design specifications. After technological feasibility is established, any additional costs are capitalized. Through June 30, 2006, software has been substantially completed concurrently with the establishment of technological feasibility; and, accordingly, no costs have been capitalized to date.

*Income Taxes* The Company accounts for income taxes under SFAS No. 109, *Accounting for Income Taxes*. This statement requires the recognition of deferred tax assets and liabilities for the future consequences of events that have been recognized in the Company's consolidated financial statements or tax returns. The measurement of the deferred items is based on enacted tax laws. In the event the future consequences of differences between financial reporting bases and the tax bases of the Company's assets and liabilities result in a deferred tax asset, SFAS No. 109 requires an evaluation of the probability of being able to realize the future benefits indicated by such asset. A valuation allowance related to a deferred tax asset is recorded when it is more likely than not that some portion or all of the deferred tax asset will not be realized. The Company currently has a full valuation allowance on its deferred tax assets. Based on the Company's assessment of all available evidence, the Company concluded that it is not more likely than not that its deferred tax assets will be realized. This conclusion is based primarily on our history of net operating losses as compared to only a recent trend of profitable operations, the potential for future stock option deductions to significantly reduce taxable income, annual net operating loss limitations under Section 382 of the Code and the need to generate significant amounts of taxable income in future periods on a consistent and prolonged basis in order to utilize the deferred tax assets. The Company will continue to monitor all available evidence and reassess the potential realization of our deferred tax assets. If the Company continues to meet our financial projections and improve our results of operations, or if circumstances otherwise change, it is reasonably possible that we may release all or a portion of our valuation allowance in the future. Any such release would result in recording a tax benefit that would increase net income in the period the valuation is released.

*Net Income per Share* Pursuant to SFAS No. 128, *Earnings per Share*, the Company is required to provide dual presentation of basic and diluted earnings per share (EPS). Basic EPS amounts are based upon the weighted average number of common shares outstanding. Diluted EPS amounts are based upon the weighted average number of common and potential common shares outstanding. Potential common shares for diluted EPS include stock options, using the treasury stock method, of 1,963,000 and 1,129,000 for the three months ended June 30, 2006 and June 30, 2005, respectively. Potential common shares for diluted EPS include stock options, using the treasury stock method, of 1,767,000 and 1,272,000 for the six months ended June 30, 2006 and June 30, 2005, respectively.

*Fulfillment Services* The Company currently holds consigned inventory for a customer, which is used to fulfill internet orders. As the Company does not hold title to the inventory, it is not recorded in the accompanying unaudited condensed consolidated balance sheet. In addition, the Company receives cash for internet fulfillment orders which is paid out to the fulfillment customer on a monthly basis. Such cash and the related payable are recorded on a net basis as the amounts are held for the benefit of this fulfillment customer. Revenue is recognized for fulfillment services as services are performed.

*Segment Information* The Company currently operates in two business segments: products and services. In addition, revenues are broken down into three units, Wireless and OEM Sales, and Consumer Sales and Enterprise Sales. The Company's Enterprise Sales unit includes Enterprise software products as well as consulting, fulfillment and hosting revenue.

The Company does not separately allocate operating expenses to these segments, nor does it allocate specific assets to these segments. Therefore, segment information reported includes only revenues and cost of revenues.

The following table shows the net revenues and cost of revenues generated by each segment:



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	<b>Three Months Ended June 30,</b>				<b>Six Months Ended June 30,</b>			
	<b>2006</b>		<b>2005</b>		<b>2006</b>		<b>2005</b>	
	(in thousands)							
	<b>Products</b>	<b>Services</b>	<b>Products</b>	<b>Services</b>	<b>Products</b>	<b>Services</b>	<b>Products</b>	<b>Services</b>
Wireless & OEM Revenues	\$ 10,115	\$	\$ 2,963	\$	\$ 17,237	\$	\$ 4,623	\$
Consumer Revenues	2,169		185		4,638		366	
Enterprise Revenues	78	193	31	151	197	368	49	322
Total Revenues	12,362	193	3,179	151	22,072	368	5,038	322
Cost of Revenues	5,226	79	476	69	8,455	150	746	144
Gross Profit	\$ 7,136	\$ 114	\$ 2,703	\$ 82	\$ 13,617	\$ 218	\$ 4,292	\$ 178

Sales to individual customers and their affiliates which amounted to more than 10% of the Company's net revenues for the three months ended June 30, 2006 and 2005, respectively, included one OEM customer at 74.4% in 2006 and one OEM customer at 81.7% in 2005. Sales to individual customers and their affiliates which amounted to more than 10% of the Company's net revenues for the six months ended June 30, 2006 and 2005, respectively, included one OEM customer at 72.5% in 2006 and one OEM customer at 71.6% in 2005.

*Use of Estimates* The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could materially differ from those estimates.

*Comprehensive Income* Comprehensive income, as defined, includes all changes in equity (net assets) during a period from non-owner sources. For each of the periods ended June 30, 2006 and 2005, there was no difference between net income, as reported, and comprehensive income.

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On February 18, 2005, the Company entered into a Securities Purchase Agreement with certain institutional investors related to the private placement of 3,500,000 shares of our common stock, par value \$0.001 per share. The transaction closed on February 18, 2005 and the Company realized gross proceeds of \$22.4 million from the financing before deducting commissions and other expenses. Offering costs related to the transaction totaled \$1,613,000, comprised of \$1,344,000 in commissions and \$269,000 cash payments for legal and investment services, resulting in net proceeds of \$20,786,000. The Company agreed to register for resale the shares of Common Stock issued in the private placement. Such registration statement became effective on June 17, 2005. The agreement provides for penalties of one percent (1%) of the purchase price per month should effectiveness of the registration not be maintained.

**3. ACQUISITION OF PHOTAGS INC.**

On April 3, 2006, the Company entered into an Agreement and Plan of Merger (the Merger Agreement) by and among the Company, Tag Acquisition Corporation, a Delaware corporation and a wholly owned subsidiary of the Company (Merger Sub), Tag Acquisition Corporation II, a Delaware corporation and wholly owned subsidiary of the Company (Merger Sub II), PhoTags, Inc., a Delaware corporation (PhoTags), Harry Fox, as Stockholders Agent, and certain stockholders of PhoTags, that provides for, among other things, the merger of Merger Sub with and into PhoTags and, immediately upon the completion thereof, the merger of PhoTags with and into Merger Sub II pursuant to which PhoTags became a wholly owned subsidiary of the Company (the Merger). The transaction closed on April 5, 2006.

In connection with the Merger, the Company acquired the underlying technology of PhoTags, Inc. which includes patented JPEG enhancements. As a result, the Company assumed \$2,000,000 in liabilities of PhoTags, which were paid at closing, and issued 384,897 shares of the Company's common stock with an aggregate fair market value of \$4,730,384 (based on a closing share price on the closing date, April 5, 2006, of \$12.29) as consideration for the purchase of all of the outstanding shares of PhoTags. In addition, the Company agreed to pay an earn-out payment of up to an additional \$3,500,000 in either cash or the Company's common stock, at the Company's sole election, if the PhoTags business line achieves certain milestones over a 15-month period beginning April 1, 2006. As of June 30, 2006, approximately \$300,000 in Wireless & OEM revenues have been attributed to the acquisition. The Company estimates that \$241,000 in direct costs (legal and professional services) were incurred to close the transaction.

As part of the transaction, CDI, a company organized under the laws of the State of Israel and a related party of PhoTags (CDI), agreed to grant the Company an option to acquire CDI for a period of ten (10) years following the effective time of the Merger at a purchase price of \$3,000.

The Merger is intended to constitute a reorganization under Section 368 of the Internal Revenue Code of 1986, as amended, and is subject to the requisite approval of PhoTags' stockholders and receipt of certain third-party consents to assignments of PhoTags' customer contracts.

As part of the transaction, the Company filed a registration statement with the Securities and Exchange Commission as soon as reasonably practicable but no later than ninety (90) days after date of the Merger Agreement covering the resale of the shares of the Company's common stock issued to the stockholders of PhoTags.

A copy of the Merger Agreement has been filed under Form 8-K with the Securities and Exchange Commission and with this Report on Form 10-Q.

The results of operations of the business acquired have been included in the Company's consolidated financial statements from the date of acquisition. Amortization related to the acquisition was calculated based on an independent valuation for certain identifiable intangibles acquired.

The total purchase price is summarized as follows (in thousands):

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Cash consideration	\$ 2,000
Common stock	4,730
Acquisition related costs	241
<b>Total purchase price</b>	<b>\$ 6,971</b>

The Company's preliminary allocation of the purchase price is summarized as follows (in thousands):

**Assets:**

Cash	\$ 2
Accounts Receivable, net	3
Intangible Assets	1,265
Goodwill	5,751
<b>Total Assets</b>	<b>7,021</b>

**Liabilities:**

Accrued Liabilities	50
<b>Total Liabilities</b>	<b>50</b>

<b>Total purchase price</b>	<b>\$ 6,971</b>
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As the cost of the acquisition did not exceed 20% of the Company's net assets at the date of the transaction, proforma information is not required.

**4. ACQUISITION OF ALLUME INC.**

On July 1, 2005, the Company acquired 100% of the issued and outstanding capital stock of Allume, Inc. from International Microcomputer Software, Inc. (IMSI) for \$10.6 million in cash and 397,547 restricted shares of its common stock. Allume, Inc. is a leading developer of compression software solutions for JPEG, MPEG and MP3 platforms. A portion of the purchase price, including \$1,250,000 cash and shares of common stock having a market value of \$750,000, was deposited in an indemnity escrow to secure certain representations and warranties included in the Stock Purchase Agreement. The aggregate purchase price was approximately \$12.8 million, which includes \$10.6 million cash paid, the 397,547 shares issued which have been valued using the average closing market price of the Company's common stock over the two-day period before and after the sale was announced and \$316,000 of direct acquisition costs. The direct acquisition costs incurred to date include \$116,000 for legal and professional services, as well as a transaction fee of \$200,000.

The results of operations of the business acquired have been included in the Company's consolidated financial statements from the date of acquisition. Depreciation and amortization related to the acquisition were calculated based on the estimated fair market values and estimated lives for property and equipment and an independent valuation for certain identifiable intangibles acquired.

The total purchase price is summarized as follows (in thousands):

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Cash consideration	\$ 10,626
Common stock	1,858
Acquisition related costs	316
<b>Total purchase price</b>	<b>\$ 12,800</b>

The purchase price is contingent upon a final calculation of Allume's net assets. If the final net asset calculation is less than the minimum amount specified in the purchase agreement, the purchase price will be adjusted downward accordingly. Any such adjustment will be recorded as an adjustment to the cost of Allume Systems, Inc. and reflected in the final purchase price allocation.

The Company's preliminary allocation of the purchase price is summarized as follows (in thousands):

**Assets:**

Cash	\$ 46
Accounts Receivable, net	822
Inventories, net	237
Property & Equipment	67
Other Assets	244
Intangible Assets	4,863
Goodwill	7,573
<b>Total Assets</b>	<b>13,852</b>

**Liabilities:**

Accounts Payable	659
Accrued Liabilities	393
<b>Total Liabilities</b>	<b>1,052</b>
<b>Total purchase price</b>	<b>\$ 12,800</b>

Unaudited pro forma consolidated results of operations for the three and six months ended June 30, 2005 as if the acquisition had occurred January 1, 2005 are as follows (in thousands, except per share data):

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30, 2005</b>		<b>June 30, 2005</b>	
	<b>Historical</b>	<b>Proforma</b>	<b>Historical</b>	<b>Proforma</b>
Net Revenues	\$ 3,330	\$ 5,178	\$ 5,360	\$ 9,749
Net Income (Loss)	\$ 764	\$ (75)	\$ 636	\$ 2
Net Income (Loss) per share, basic	\$ 0.04	\$	\$ 0.03	\$
Net Income (Loss) per share, diluted	\$ 0.03	\$	\$ 0.03	\$
Weighted average shares outstanding, basic	21,584	21,982	20,629	21,027

Weighted average shares outstanding, diluted	22,713	21,982	21,901	22,299
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Pro forma adjustments have been applied to reflect the addition of amortization related to the intangible assets and the fixed assets acquired and reduction in interest income as if the acquisition had occurred at the beginning of such period presented. The pro forma adjustment for amortization related to intangible assets acquired was \$385,000 and \$770,000 for the three and six month pro forma periods ended June 30, 2005.

**5. STOCK BASED COMPENSATION.**

In July 2005, the Shareholders approved the 2005 Stock Option/Stock Issuance Plan ( 2005 Plan ), which replaced by the 1995 Stock Incentive Plan ( 1995 Plan ). All outstanding options under the 1995 Plan will remain outstanding, but no further grants will be made under that Plan. The 2005 Plan provides for the issuance of non-qualified or incentive stock options to employees, non-employee members of the board and consultants. The exercise price per share is not to be less than the fair market value per share of the Company's common stock on the date of grant. The Board of Directors has the discretion to determine the vesting schedule. Options may be either immediately exercisable or in installments, but generally vest over a four-year period from the date of grant. In the event the holder ceases to be employed by the Company, all unvested options terminate and all vested installment options may be exercised within an installment period following termination. In general, options expire ten years from the date of grant.

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment* (SFAS 123(R)), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including stock options based on their fair values. SFAS 123(R) supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), which the Company previously followed in accounting for stock-based awards. In March 2005, the SEC issued *Staff Accounting Bulletin No. 107* (SAB 107) to provide guidance on SFAS 123(R). The Company has applied SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method as of and for the three and six months ended June 30, 2006. In accordance with the modified prospective transition method, the Company's financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Share-based compensation expense recognized is based on the value of the portion of share-based payment awards that is ultimately expected to vest. Share-based compensation expense recognized in the Company's Condensed Consolidated Statement of Operations during the three and six months ended June 30, 2006 includes compensation expense for share-based payment awards granted prior to, but not yet vested as of, December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123.

In conjunction with the adoption of SFAS 123(R), the Company elected to attribute the value of share-based compensation to expense using the straight-line method, which was previously used for its pro forma information required under SFAS 123. Share-based compensation expense related to stock options and restricted stock grants was \$1.7 million and \$2.4 million for the three and six months ended June 30, 2006, and was recorded in the financial statements as follows (in thousands):

	Three Months	Six Months
Cost of Goods Sold	\$ 9	\$ 15
Selling and Marketing	673	904
Research and Development	401	652
General and Administrative	618	842
Total Stock Compensation Expense	\$ 1,701	\$ 2,413

In the six months ended June 30, 2006 a total of 50,000 shares of Restricted Stock, with a total value of \$440,000, were granted to the Board of Directors. This cost will be amortized over 12 months. In addition, 400,000 shares of Restricted Stock, with a total value \$3.6 million, were granted to key officers and employees of the Company. This cost will be amortized over 24 months.

During the three and six months ended June 30, 2005, there was no share-based compensation expense related to stock options recognized under the intrinsic value method in accordance with APB 25. In addition, there was no compensation expense for restricted stock grants as the Company had not issued any restricted stock. Had compensation cost for the Company's stock options been recognized based upon the estimated fair value on the grant date under the fair value methodology prescribed by SFAS No. 123, as amended by SFAS No. 148, the Company's net income and income per share would have been as follows (in thousands):

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	<b>Three Months Ended June 30, 2005</b>	<b>Six Months June 30, 2005</b>
Net income, as reported	\$ 764	\$ 636
Less: total stock based compensation	(162)	(294)
Net income, as adjusted	\$ 602	\$ 342
Income per common share		
Basic, as reported	\$ 0.04	\$ 0.03
Basic, pro forma	\$ 0.03	\$ 0.02
Fully Diluted, as reported	\$ 0.03	\$ 0.03
Fully Diluted, pro forma	\$ 0.03	\$ 0.02

In the three months ended June 30, 2006 and 2005, respectively, the Company's calculations were made using the Black-Scholes option pricing model with the following weighted average assumptions: expected life, 48 months following the grant date; stock volatility, 81.7% and 109%; risk-free interest rates of 4.95% and 3.79%; and no dividends during the expected term. As stock-based compensation expense recognized in the consolidated statement of operations pursuant to SFAS No. 123(R) is based on awards ultimately expected to vest, expense for grants beginning upon adoption of SFAS No. 123(R) on January 1, 2006 will be reduced for estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures are estimated based on historical experience.

A summary of the Company's stock option activity is as follows:

	<b># of Shares</b>	<b>Weighted Ave. Exercise Price</b>	<b>Aggregate Intrinsic Value</b>
Outstanding as of December 31, 2005	3,856,000	\$ 3.57	
Granted	241,000	\$ 11.45	
Exercised	(1,057,000)	\$ 2.49	
Cancelled	(117,000)	\$ 5.00	
Outstanding as of June 30, 2006	2,923,000	\$ 4.56	\$ 33,508,000
Exercisable as of June 30, 2006	474,000	\$ 2.81	\$ 6,259,000

Additional information regarding options outstanding as of June 30, 2006 is as follows :



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Range of exercise prices	Number outstanding	Options outstanding		Options exercisable	
		Weighted average remaining contractual life (years)	Weighted average exercise price	Number exercisable	Weighted average exercise price
\$ 0.24 \$0.50	168,000	6.6	\$ 0.25	95,000	\$ 0.25
\$ 0.51 \$1.00	13,000	8.0	\$ 0.88	13,000	\$ 0.90
\$ 1.01 \$2.00	612,000	7.9	\$ 1.89	159,000	\$ 1.88
\$ 2.01 \$4.00	45,000	7.9	\$ 3.56	42,000	\$ 7.07
\$ 4.01 \$5.00	1,782,000	9.1	\$ 4.95	144,000	\$ 2.06
\$ 5.01 \$14.00	303,000	9.7	\$ 10.38	21,000	\$ 7.36
	2,923,000	8.7	\$ 4.56	474,000	\$ 2.81

During the six months ended June 30, 2006 approximately 1,057,000 options have been exercised with an intrinsic value of \$14.3 million, resulting in cash proceeds to the Company of \$2.6 million. The weighted-average grant-date fair value of options granted during the six months ended June 30, 2006 was \$7.22. At June 30, 2006 there was \$5.7 million of total unrecognized compensation costs related to non-vested stock options granted under the Plan, which will be recognized over a period not to exceed four years. At June 30, 2006, 2,172,000 shares were available for future grants under the Stock Issuance / Stock Option Plan.

**6. NEW ACCOUNTING PRONOUNCEMENTS**

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments*, which amends SFAS No. 133, *Accounting for Derivatives Instruments and Hedging Activities* and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*. SFAS No. 155 amends SFAS No. 133 to narrow the scope exception for interest-only and principal-only strips on debt instruments to include only such strips representing rights to receive a specified portion of the contractual interest or principle cash flows. SFAS No. 155 also amends SFAS No. 140 to allow qualifying special-purpose entities to hold a passive derivative financial instrument pertaining to beneficial interests that itself is a derivative instrument. The Company is currently evaluating the impact this new Standard but believes that it will not have a material impact on the Company's financial position, results of operations, or cash flows.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets* (SFAS No. 156), which provides an approach to simplify efforts to obtain hedge-like (offset) accounting. This Statement amends FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, with respect to the accounting for separately recognized servicing assets and servicing liabilities. The Statement (1) requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations; (2) requires that a separately recognized servicing asset or servicing liability be initially measured at fair value, if practicable; (3) permits an entity to choose either the amortization method or the fair value method for subsequent measurement for each class of separately recognized servicing assets or servicing liabilities; (4) permits at initial adoption a one-time reclassification of available-for-sale securities to trading securities by an entity with recognized servicing rights, provided the securities reclassified offset the entity's exposure to changes in the fair value of the servicing assets or liabilities; and (5) requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the balance sheet and additional disclosures for all separately recognized servicing assets and servicing liabilities.

SFAS No. 156 is effective for all separately recognized servicing assets and liabilities as of the beginning of an entity's fiscal year that begins after September 15, 2006, with earlier adoption permitted in certain circumstances. The Statement also describes the manner in which it should be initially applied. The Company does not believe that SFAS No. 156 will have a material impact on its financial position, results of operations or cash flows.

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In July 2006, the FASB released FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting and reporting for uncertainties in income tax law. This interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. This statement is effective for fiscal years beginning after December 15, 2006. The Company is currently in the process of evaluating the expected effect of FIN 48 on its results of operations and financial position.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*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, the protection of our intellectual property, and the need for additional capital. 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;*

*our ability to integrate Allume and PhoTags into our business model;*

*our depressed market capitalization; and*

*those additional factors which are listed under the section Risk Factors beginning on page 23.*

*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.*

**OVERVIEW**

Our business model is based primarily upon developing and marketing innovative software solutions for the wireless industry. Our leading-edge mobility and music management products simplify communications access over Wireless Wide Area Networks (WWANs) and Wireless Local Area Networks (WLANs); our mobile media manager manages content from PC to mobile device and back; and our compression technologies are well on the way to being established as industry standards.

Today, Smith Micro Software develops productivity and entertainment software solutions for an expanding universe of customers. Our leading QuickLink® Mobile 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.

We began adding value to QuickLink Mobile with new features and security protocol enhancements for secure enterprise level connectivity compliance, thus allowing enterprise users to move between cellular networks and

WLAN coverage securely. We

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anticipate that this market will grow over the next several years as enterprise customers provide wireless connectivity for their workforce.

In addition, late in 2005 Smith Micro began shipping its first music management software to help manage the transfer of music files to a mobile device. Our launch of QuickLink Music is expected to have a positive impact as we gain market-share within the wireless carrier space. As with all our mobility solutions our product strategies revolve around driving wireless data usage on our customer's wireless networks.

Our business is primarily dependent upon the demand for wireless communications and connectivity software. During the last three years, demand for these types of products has fluctuated dramatically, and there has been a significant increase in price competition within our industry.

We continue to invest in research and the development of wireless software products, and we believe we have one of the industry's leading wireless product lines in terms of performance and innovative features. Our unique out-of-the-box design focusing on ease-of-use further differentiates our products and help to reduce support costs for our customers.

During 2006, we have maintained a sharp focus on our operating cost structure while ensuring that we maintain our operating flexibility to support future growth in the industry. We measure success by monitoring our net sales and gross margin dollars and operating cash flow. We believe that there continues to be excellent growth opportunities within the wireless software marketplace and we continue to focus on positioning Smith Micro to benefit from these opportunities.

**RESULTS OF OPERATIONS**

The following table sets forth, for the periods indicated, certain statement of operations data expressed as a percentage of total revenue.

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Net Revenues:				
Products	98.5%	95.5%	98.4%	94.0%
Services	1.5%	4.5%	1.6%	6.0%
Total net revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues:				
Products	41.6%	14.3%	37.7%	13.9%
Services	0.6%	2.1%	0.7%	2.7%
Total cost of revenues	42.2%	16.4%	38.4%	16.6%
Gross profit	57.8%	83.6%	61.6%	83.4%
Operating expenses:				
Selling and marketing	18.3%	11.1%	18.6%	15.1%
Research and development	16.5%	20.9%	16.7%	26.0%
General and administrative	16.2%	34.9%	15.3%	36.1%
Total operating expenses	51.0%	66.9%	50.6%	77.2%
Operating income	6.8%	16.7%	11.0%	6.2%
Interest income	2.1%	6.4%	2.2%	5.9%
Income before income taxes	8.9%	23.1%	13.2%	12.1%

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Income tax expense	0.3%	0.2%	0.3%	0.2%
Net income	8.6%	22.9%	12.9%	11.9%

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Revenues**

Total net revenues were \$12.6 million and \$3.3 million for the three months ended June 30, 2006 and 2005, respectively, representing an increase of \$9.2 million, or 277.0% from 2005 to 2006. Sales to individual customers and their affiliates which amounted to more than 10% of the Company's net revenues for the three months ended June 30, 2006 and 2005, consisted of Verizon at 74.4% and 81.7% respectively. If our sales to this customer are reduced, it could have a material adverse effect on our results of operations. The current quarter results include approximately \$2.1 million of net revenue attributable to the Allume acquisition.

Total net revenues were \$22.4 million and \$5.4 million for the six months ended June 30, 2006 and 2005, respectively, representing an increase of \$17 million, or 318.7% from 2005 to 2006. Sales to individual customers and their affiliates which amounted to more than 10% of the Company's net revenues for the six months ended June 30, 2006 and 2005, consisted of Verizon at 72.5% and 71.6% respectively. The 2006 period includes approximately \$4.5 million of net revenues attributable to the Allume acquisition, which was completed in the third quarter of 2005.

We currently operate in two business segments: products and services. In addition, revenues are broken down into three business units, Wireless and OEM, Consumer and Enterprise. Our Enterprise unit sales include software products as well as consulting, fulfillment and hosting.

The following table shows the net revenues and cost of revenues generated by each segment (in thousands):

	<b>Three Months Ended June 30,</b>				<b>Six Months Ended June 30,</b>			
	<b>2006</b>		<b>2005</b>		<b>2006</b>		<b>2005</b>	
	<b>Products</b>	<b>Services</b>	<b>Products</b>	<b>Services</b>	<b>Products</b>	<b>Services</b>	<b>Products</b>	<b>Services</b>
Wireless & OEM	\$ 10,115	\$	\$ 2,963	\$	\$ 17,237	\$	\$ 4,623	\$
Consumer	2,169		185		4,638		366.00	
Enterprise	78	193	31	151	197	368	49	322
Total Net Revenues	12,362	193	3,179	151	22,072	368	5,038	322
Cost of Revenues	5,226	79	476	69	8,455	150	746	144
Gross Profit	\$ 7,136	\$ 114	\$ 2,703	\$ 82	\$ 13,617	\$ 218	\$ 4,292	\$ 178

*Products.* Net product revenues were \$12.4 million and \$3.2 million in the three months ended June 30, 2006 and 2005, respectively, representing an increase of \$9.2 million, or 288.9%, from 2005 to 2006. Wireless and OEM sales increased \$7.2 million, or 241.4%, as a result of the continued success of the EVDO rollout by our carrier customers and the success of our Music Essentials Kit product, which was launched in the fourth quarter of 2005. Consumer sales primarily represent the sales of Allume products to distributors, retail customers and individuals. Allume was acquired on July 1, 2005 (see Note 4 of Notes to Unaudited Condensed Consolidated Financial Statements). Enterprise sales increased \$47,000 or 151.6% as a result of the addition of Allume's site license and enterprise sales of its Stuffit product line. Product revenues accounted for 98.5% of total revenues in the three months ended June 30, 2006 compared with 95.5% of total revenues in the comparable period of 2005.

Net product revenues were \$22.1 million and \$5.0 million in the six months ended June 30, 2006 and 2005, respectively, representing an increase of \$17.1 million, or 338.1%, from 2005 to 2006. Wireless and OEM sales increased \$12.6 million, or 272.9%, as a result of the continued success of the EVDO rollout by our carrier customers and the success of our Music Essentials Kit product, which was launched in the fourth quarter of 2005. Consumer sales primarily represent the sales of Allume products to distributors, retail customers and individuals. Allume was



acquired on July 1, 2005 (see Note 4 of Notes to Unaudited Condensed Consolidated Financial Statements). Enterprise sales increased \$148,000 or 302.0% as a result of the addition of Allume's site license and enterprise sales of its Stuffit product line. Product revenues accounted for 98.4% of total revenues in the six months ended June 30, 2006 compared with 94.0% of total revenues in the comparable period of 2005.

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*Services.* Service revenues were \$193,000 and \$151,000 in the three months ended June 30, 2006 and 2005, respectively, with an increase of \$42,000 or 27.8%, from 2005 to 2006. Service revenues accounted for 1.5% of total revenues in the three months ended June 30, 2006 compared with 4.5% of total revenues in the comparable period of 2005.

Service revenues were \$368,000 and \$322,000 in the six months ended June 30, 2006 and 2005, respectively, with an increase of \$46,000 or 14.3%, from 2005 to 2006. Service revenues accounted for 1.6% of total revenues in the six months ended June 30, 2006 compared with 6.0% of total revenues in the comparable period of 2005.

**Cost of Revenues and Gross Margin**

*Cost of Product Revenues.* Cost of product revenues were \$5.2 million and \$476,000 in the three months ended June 30, 2006 and 2005, respectively, representing an increase of \$4.8 million, or 997.9%, from 2005 to 2006. Cost of product revenues as a percentage of product revenues was 42.3% and 15.0% for 2006 and 2005, respectively. Product gross margin as a percentage of product revenues was 57.7% as compared to 85.0% for the year earlier period. Cost of product revenues for the 2006 quarter includes \$318,000 of amortization of intangibles associated with the acquisitions of Allume and PhoTags and \$9,000 of stock based compensation expense which is not included in 2005 expenses. Factoring out such amortization of intangibles and compensation expense, product gross margin for the three months ending June 30, 2006 was 60.4%. The 24.6% pro-forma decrease from the year earlier period is attributed to product mix, in particular the significant success of the lower margin Music Essentials Kits in 2006.

Cost of product revenues were \$8.5 million and \$746,000 in the six months ended June 30, 2006 and 2005, respectively, representing an increase of \$7.7 million, or 1033.4%, from 2005 to 2006. Cost of product revenues as a percentage of product revenues was 38.3% and 14.8% for 2006 and 2005, respectively. Product gross margin as a percentage of product revenue was 61.7% as compared to 85.2% for the year earlier period. Cost of product revenues for the 2006 period includes \$585,000 of amortization of intangibles associated with the acquisitions of Allume and PhoTags and \$15,000 of stock based compensation expense which is not included in 2005 expenses. Factoring out such amortization of intangibles and compensation expense, product gross margin for the six month period ending June 30, 2006 was 64.4%. The 20.8% pro-forma decrease from the year earlier period is attributed to product mix and as noted above, significant sales of the lower margin Music Essentials Kits in 2006.

*Cost of Service Revenues.* Cost of service revenues were \$79,000 and \$69,000 in the three months ended June 30, 2006 and 2005, respectively, representing an increase of \$10,000 or 14.5%, from 2005 to 2006. Cost of service revenues as a percentage of service revenues was 40.9% and 45.7% for 2006 and 2005, respectively. Cost of service revenues includes the cost of our consulting personnel and the cost of hiring outside contractors to support our staff of consultants and vary by contract.

Cost of service revenues were \$150,000 and \$144,000 in the six months ended June 30, 2006 and 2005, respectively, representing an increase of \$6,000 or 4.2%, from 2005 to 2006. Cost of service revenue as a percentage of service revenues was 40.7% and 44.7% for 2006 and 2005, respectively. Cost of service revenues includes the cost of our consulting personnel and the cost of hiring outside contractors to support our staff of consultants and vary by contract.

**Operating Expenses**

The following table presents a breakdown of our operating expenses by functional category and as a percentage of total net revenues (in thousands):

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	<b>Three Months Ended June 30,</b>				<b>Six Months Ended June 30,</b>			
	<b>2006</b>		<b>2005</b>		<b>2006</b>		<b>2005</b>	
Operating expenses:								
Selling and marketing	\$ 2,293	18.3%	\$ 369	11.1%	\$ 4,166	18.6%	\$ 809	15.1%
Research and development	2,077	16.5%	697	20.9%	3,754	16.7%	1,394	26.0%
General and administrative	2,029	16.2%	1,161	34.9%	3,438	15.3%	1,937	36.1%
Total operating expenses	\$ 6,399	51.0%	\$ 2,227	66.9%	\$ 11,358	50.6%	\$ 4,140	77.2%

*Selling and Marketing.* Selling and marketing expenses were \$2.3 million and \$369,000 in the three months ended June 30, 2006 and 2005, respectively, representing an increase of \$1.9 million, or 521.4%, from 2005 to 2006. Our selling and marketing expenses consist primarily of personnel costs, advertising costs, sales commissions and trade show expenses. These expenses vary significantly from quarter to quarter based on the timing of trade shows and product introductions. Selling and marketing expenses for the current period include \$131,000 of amortization of intangibles associated with acquisitions and \$673,000 of stock based compensation expense which is not included in 2005 expenses. Factoring out such amortization of intangibles and compensation expense, selling and marketing expenses increased \$1.1 million, or 303.5% from the prior year quarter. While most of the increases in selling and marketing expenses were due to the Allume acquisition, we also had a slight increase in headcount and increases in costs related to trade shows and to product collateral concept and design. As a percentage of revenues, selling and marketing expenses increased to 18.3% for the three months ended June 30, 2006 from 11.2% in the six months ended June 30, 2005, as a result of the increase in absolute dollars spent.

Selling and marketing expenses were \$4.2 million and \$809,000 in the six months ended June 30, 2006 and 2005, respectively, representing an increase of \$3.4 million, or 415.0%, from 2005 to 2006. Selling and marketing expenses for the current period include \$249,000 of amortization of intangibles associated with acquisitions and \$904,000 of stock based compensation expense which is not included in 2005 expenses. Factoring out such amortization of intangibles and compensation expense, selling and marketing expenses increased \$2.2 million, or 272.4% from the prior year quarter. While most of the increases in selling and marketing expenses were due to the Allume acquisition, we also had a slight increase in headcount and increases in costs related to trade shows and to product collateral concept and design. As a percentage of revenues, selling and marketing expenses increased to 18.6% for the six months ended June 30, 2006 from 15.1% in the six months ended June 30, 2005 as a result of the increase in absolute dollars spent.

*Research and Development.* Research and development expenses were \$2.1 million and \$697,000 in the three months ended June 30, 2006 and 2005, respectively, representing an increase of \$1.4 million, or 198.0%, from 2005 to 2006. 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 and compression software technologies. Research and development expenses for the current period include \$401,000 of stock based compensation expense which is not included in 2005 expenses. Factoring out such compensation expense, research and development expenses increased \$979,000 million, or 140.6% from the prior year quarter. The increase in our research and development expenses was primarily due to the addition of the Allume operations, increases to headcount and a refocus of our consulting services to internal product development. Despite the increase in absolute dollars, as a percentage of revenues, research and development expenses decreased to 16.5% for the three months ended June 30, 2006 from 20.9% in the three months ended June 30, 2005, as a result of the increase in sales.

Research and development expenses were \$3.8 million and \$1.4 million in the six months ended June 30, 2006 and 2005, respectively, representing an increase of \$2.4 million, or 169.3%, from 2005 to 2006. Research and development expenses for the current period include \$652,000 of stock based compensation expense which is not included in 2005 expenses. Factoring out such compensation expense, research and development expenses increased \$1.7 million, or 122.5% from the prior year quarter. The increase in our research and development expenses was

primarily due to the addition of the Allume operations, increases to headcount and a refocus of our consulting services to internal product development. Despite the increase in absolute dollars, as a percentage of revenues, research and development expenses decreased to 16.7% for the six months ended June 30, 2006 from 26.0% in the six months ended June 30, 2005, as a result of the increase in sales.

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*General and Administrative.* General and administrative expenses were \$2.0 million and \$1.2 million in the three months ended June 30, 2006 and 2005, respectively, representing an increase of \$868,000, or 74.8%, from 2005 to 2006. General and administrative expenses for the current period include \$618,000 of stock based compensation expense which is not included in 2005 expenses. Factoring out such compensation expense, general and administrative increased \$250,000, or 21.5% from the prior year quarter. The increase in our general and administrative expenses is due to the Allume acquisition and increases in headcount, legal and consulting expenses, partially offset by a reduction in benefit costs. Despite the increase in absolute dollars, as a percentage of revenues, general and administrative expenses decreased to 16.2% for the three months ended June 30, 2006 from 34.9% in the three months ended June 30, 2005, as a result of the increase in sales.

General and administrative expenses were \$3.4 million and \$1.9 million in the six months ended June 30, 2006 and 2005, respectively, representing an increase of \$1.5 million, or 77.5%, from 2005 to 2006. General and administrative expenses for the current period include \$842,000 of stock based compensation expense which is not included in 2005 expenses. Factoring out such compensation expense, general and administrative increased \$659,000, or 34.0% from the prior year quarter. The increase in our general and administrative expenses is due to the Allume acquisition and increases in headcount, legal and consulting expenses, partially offset by a reduction in benefit costs. Despite the increase in absolute dollars, as a percentage of revenues, general and administrative expenses decreased to 15.3% for the six months ended June 30, 2006 from 36.1% in the six months ended June 30, 2005, as a result of the increase in sales.

*Interest Income.* Interest income was \$265,000 and \$214,000 in the three months ended June 30, 2006 and 2005, respectively, representing an increase of \$51,000 or 23.8% from 2005 to 2006. Interest income was \$489,000 and \$314,000 in the six months ended June 30, 2006 and 2005, respectively, representing an increase of \$175,000 or 55.7% from 2005 to 2006. Interest income is directly related to our average cash balance during the period and varies among periods. On February 18, 2005, we closed a private placement equity transaction, netting approximately \$20.8 million in cash. We have not changed our investment strategy during the periods being reported on, with our excess cash consistently being invested in short term marketable debt securities classified as cash equivalents.

*Provision for Income Taxes.* The provision for income taxes was \$33,000 and \$8,000 in the three months ended June 30, 2006 and 2005, respectively, representing an increase of \$25,000, or 312.5% from 2005 to 2006. The provision for income taxes was \$72,000 and \$8,000 in the six months ended June 30, 2006 and 2005, respectively, representing an increase of \$64,000, or 800.0% from 2005 to 2006. In all periods, the provision for income taxes relates to an accrual for alternative minimum taxes which are expected to be owed on income as well as certain state minimum tax payments. The Company has a full valuation allowance on its net deferred tax assets.

**Liquidity and Capital Resources**

Since our inception, we have financed operations primarily through cash generated from operations and from proceeds of \$18.1 million generated by our initial public offering in 1995. On February 18, 2005, the Company entered into a Common Stock Purchase Agreement for the private placement of 3,500,000 shares of the Company's common stock, \$0.001 par value, at a price of \$6.40 per share, resulting in aggregate gross cash proceeds to the Company of \$22,400,000 and approximate net cash proceeds to the Company of \$20,786,000 after expenses. The transaction closed simultaneously with the execution of the Purchase Agreement on February 18, 2005. C.E. Unterberg, Towbin LLC, the placement agent for the transaction, received a cash fee equal to 6% of the aggregate gross proceeds of the Private Placement.

Net cash provided by operating activities was \$9.9 million and \$356,000 in the six months ended June 30, 2006 and 2005, respectively. The primary source of operating cash in 2006 was the net income, the non-cash stock based compensation expense and the collection of accounts receivable, partially offset by the increase in inventory. The primary source of cash in 2005 was the net income and increase in accounts payable and accrued liabilities, offset by the increase in accounts receivable.

During the six months ended June 30, 2006, we used \$2.4 million in investing activities, consisting of primarily of the PhoTags acquisition (\$2 million) and the purchase of office equipment. In 2005, our capital expenditures consisted of purchases of office equipment in the amount of \$21,000.

We received \$2.6 million in cash from the exercise of employee stock options during the six months ended June 30, 2006 compared to \$191,000 during the comparable period of 2005.

At June 30, 2006, we had \$31.3 million in cash and cash equivalents and \$31.5 million of working capital. Our accounts receivable balance, net of allowance for doubtful accounts and other adjustments, was \$4.2 million at June 30, 2006. We have no

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significant capital commitments, and currently anticipate that capital expenditures will not vary significantly from recent periods. We believe that our existing cash, cash equivalents and cash flow from operations will be sufficient to finance our working capital and capital expenditure requirements through at least the next 12 months. We may require additional funds to support our working capital requirements or for other purposes and may seek to raise additional funds through public or private equity or debt financing or from other sources. If additional financing is needed, we cannot assure you that such financing will be available to us at commercially reasonable terms or at all.

Our corporate headquarters, which includes our principal administrative, sales and marketing, customer support and research and development facilities, is located in Aliso Viejo, California. We have leased this space through May 2009. Effective September 1, 2006, we have signed a new lease to expand our corporate headquarters. This lease for additional space runs concurrently with the original lease and will also expire in May 2009. We also lease approximately 7,700 square feet in Watsonville, California under a new lease that expires September 30, 2010. We are currently working on a new operating lease for our facility in Lees Summit, Missouri to replace the lease that expired in June 2005.

As of June 30, 2006, we had no debt and no long term liabilities. The following table summarizes our contractual obligations as of June 30, 2006 (in thousands):

	<b>Total</b>	<b>Payments due by period</b>			<b>More than 5 Years</b>
		<b>1 year or less</b>	<b>1-3 Years</b>	<b>3-5 Years</b>	
<b>Contractual obligations:</b>					
Operating lease obligation	\$ 1,680	\$ 510	\$ 1,034	\$ 136	\$ 0
Employment agreements	560	360	200	0	0
Purchase obligations	1,158	1,158	0	0	0
<b>Total</b>	<b>\$ 3,398</b>	<b>\$ 2,028</b>	<b>\$ 1,234</b>	<b>\$ 136</b>	<b>\$ 0</b>

During our normal course of business, we have made certain indemnities, commitments and guarantees under which we may be required to make payments in relation to certain transactions. These include: intellectual property indemnities to our customers and licensees in connection with the use, sale and/or license of our products; indemnities to various lessors in connection with facility leases for certain claims arising from such facility or lease; indemnities to vendors and service providers pertaining to claims based on the negligence or willful misconduct; indemnities involving the accuracy of representations and warranties in certain contracts; and indemnities to directors and officers of the Company to the maximum extent permitted under the laws of the State of Delaware. We may also issue a guarantee in the form of a standby letter of credit as security for contingent liabilities under certain customer contracts. The duration of these indemnities, commitments and guarantees varies, and in certain cases, may be indefinite. The majority of these indemnities, commitments and guarantees may not provide for any limitation of the maximum potential for future payments we could be obligated to make. We have not recorded any liability for these indemnities, commitments and guarantees in the accompanying consolidated balance sheets.

**CRITICAL ACCOUNTING POLICIES**

Our discussion and analysis of results of operations, financial condition and liquidity are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may materially differ from these estimates under different

assumptions or conditions. On an on-going basis, we review our estimates to ensure that the estimates appropriately reflect changes in our business or new information as it becomes available.

We believe the following critical accounting policies affect our more significant estimates and assumptions used in the preparation of our consolidated financial statements:



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*Revenue Recognition* Software revenue is recognized in accordance with the Statement of Position ( SOP ) 97-2, *Software Revenue Recognition*, as amended, when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed and determinable, and collectibility is probable. We recognize revenues from sales of our software to OEM customers or end users as: completed products are shipped and title passes; or from royalties generated as authorized customers duplicate our software, if the other requirements of SOP 97-2 are met. If the requirements of SOP 97-2 are not met at the date of shipment, revenue is not recognized until these elements are known or resolved. Returns from OEM customers are limited to defective goods or goods shipped in error. Historically, OEM customer returns have not exceeded the very nominal estimates and reserves. Management reviews available retail channel information and makes a determination of a return provision for sales made to distributors and retailers based on current channel inventory levels and historical return patterns. Certain sales to distributors or retailers are made on a consignment basis. Revenue for consignment sales are not recognized until sell through to the final customer is established.

Product sales directly to end-users are recognized upon delivery. End users have a thirty day right of return, but such returns are reasonably estimable and have historically been immaterial. We also provide technical support to our customers. Such costs have historically been insignificant.

Service revenues include sales of consulting services, website hosting and fulfillment. We recognize service revenues as services are provided or as milestones are delivered and accepted by our customers.

*Accounts Receivable* We sell our products worldwide. We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history, the customer's current credit worthiness and various other factors, as determined by our review of their current credit information. We continuously monitor collections and payments from our customers. We estimate credit losses and maintain a bad debt reserve based upon these estimates. While such credit losses have historically been within our estimated reserves, we cannot guarantee that we will continue to experience the same credit loss rates that we have in the past. If not, this could have an adverse effect on our consolidated financial statements.

*Goodwill* We have adopted SFAS No. 142, *Goodwill and Other Intangible Assets*, effective January 1, 2002. As a result of the adoption, we are no longer required to amortize goodwill. Prior to the adoption of SFAS 142, goodwill was amortized over 7 years. In accordance with SFAS No. 142, we review the recoverability of the carrying value of goodwill at least annually or whenever events or circumstances indicate a potential impairment. Our annual impairment testing date is December 31. Recoverability of goodwill is determined by comparing the estimated fair value of our reporting units to the carrying value of the underlying net assets in the reporting units. If the estimated fair value of a reporting unit is determined to be less than the carrying value of its net assets, goodwill is deemed impaired and an impairment loss is recognized to the extent that the carrying value of goodwill exceeds the difference between the estimated fair value of the reporting unit and the fair value of its other assets and liabilities. We determined that we did not have any impairment of goodwill at December 31, 2005. Estimates of reporting unit fair value are based upon market capitalization and therefore are volatile being sensitive to market fluctuations. To the extent that our market capitalization decreases significantly or the allocation of value to our reporting units changes, we could be required to write off some or all of our goodwill.

*Deferred Income Taxes* We account for income taxes under SFAS No. 109, *Accounting for Income Taxes*. This statement requires the recognition of deferred tax assets and liabilities for the future consequences of events that have been recognized in our financial statements or tax returns. The measurement of the deferred items is based on enacted tax laws. In the event the future consequences of differences between financial reporting bases and the tax bases of our assets and liabilities result in a deferred tax asset, SFAS No. 109 requires an evaluation of the probability of being able to realize the future benefits indicated by such asset. A valuation allowance related to a deferred tax asset is recorded when it is more likely than not that some portion or all of the deferred tax asset will not be realized. We currently have a full valuation allowance on our deferred tax assets. Based on our assessment of all available evidence, we concluded that it is not more likely than not that our deferred tax assets will be realized. This conclusion is based primarily on our history of net operating losses as compared to only a recent trend of profitable operations, the potential for future stock option deductions to significantly reduce taxable income, annual net operating loss limitations under Section 382 of the Code and the need to generate significant amounts of taxable income in future

periods on a consistent and prolonged basis in order to utilize the deferred tax assets. We will continue to monitor all available evidence and reassess the potential realization of our deferred tax assets. If we continue to meet our financial projections and improve our results of operations, or if circumstances otherwise change, it is possible that we may release all or a portion of our valuation allowance in the future. Any such release would result in recording a tax benefit that would increase net income in the period the valuation is released.

*Stock-Based Compensation* We currently account for the issuance of stock options to employees using the fair market value method according to SFAS No. 123R, *Share-Based Payment*.

**Table of Contents****NEW ACCOUNTING PRONOUNCEMENTS**

In February 2006, the FASB issued Statement SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments*, which amends SFAS No. 133, *Accounting for Derivatives Instruments and Hedging Activities* and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*. SFAS No. 155 amends SFAS No. 133 to narrow the scope exception for interest-only and principal-only strips on debt instruments to include only such strips representing rights to receive a specified portion of the contractual interest or principle cash flows. SFAS No. 155 also amends SFAS No. 140 to allow qualifying special-purpose entities to hold a passive derivative financial instrument pertaining to beneficial interests that itself is a derivative instrument. We are currently evaluating the impact this new Standard but believe that it will not have a material impact on our financial position, results of operations, or cash flows.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets* (SFAS NO. 156), which provides an approach to simplify efforts to obtain hedge-like (offset) accounting. This Statement amends FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, with respect to the accounting for separately recognized servicing assets and servicing liabilities. The Statement (1) requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations; (2) requires that a separately recognized servicing asset or servicing liability be initially measured at fair value, if practicable; (3) permits an entity to choose either the amortization method or the fair value method for subsequent measurement for each class of separately recognized servicing assets or servicing liabilities; (4) permits at initial adoption a one-time reclassification of available-for-sale securities to trading securities by an entity with recognized servicing rights, provided the securities reclassified offset the entity's exposure to changes in the fair value of the servicing assets or liabilities; and (5) requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the balance sheet and additional disclosures for all separately recognized servicing assets and servicing liabilities. SFAS No. 156 is effective for all separately recognized servicing assets and liabilities as of the beginning of an entity's fiscal year that begins after September 15, 2006, with earlier adoption permitted in certain circumstances. The Statement also describes the manner in which it should be initially applied. We do not believe that SFAS No. 156 will have a material impact on our financial position, results of operations or cash flows.

In July 2006, the FASB released FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting and reporting for uncertainties in income tax law. This interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. This statement is effective for fiscal years beginning after December 15, 2006. We are currently in the process of evaluating the expected effect of FIN 48 on our results of operations and financial position.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Smith Micro's financial instruments include cash and cash equivalents. At June 30, 2006, the carrying values of our financial instruments approximated fair values based on current market prices and rates.

It is our policy not to enter into derivative financial instruments. We do not currently have any significant foreign currency exposure, as we do not transact business in foreign currencies. As such, we do not have significant currency exposure at June 30, 2006.

**ITEM 4. CONTROLS AND PROCEDURES**

- a) *Evaluation of disclosure controls and procedures.* We conducted an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness

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of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934 ( Exchange Act )) as of June 30, 2006. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have determined that our disclosure controls and procedures have been designed and are being operated in a manner that provides reasonable assurance that the information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and our management necessarily is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

- b) *Management's responsibility for financial statements.* Our management is responsible for the integrity and objectivity of all information presented in this report. The consolidated financial statements were prepared in conformity with accounting principles generally accepted in the United States of America and include amounts based on management's best estimates and judgments. Management believes the consolidated financial statements fairly reflect the form and substance of transactions and that the financial statements fairly represent the Company's financial position and results of operations for the periods and as of the dates stated therein.

The Audit Committee of the Board of Directors, which is composed solely of independent directors, meets regularly with our independent registered public accounting firm, Singer Lewak Greenbaum & Goldstein LLP, and representatives of management to review accounting, financial reporting, internal control and audit matters, as well as the nature and extent of the audit effort. The Audit Committee is responsible for the engagement of the independent auditors. The independent auditors have free access to the Audit Committee.

- c) *Changes in internal control over financial reporting.* There have been no changes in our internal control over financial reporting during the quarter ended June 30, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

None.

**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 Annual Report on Form 10-K, Amendment No. 2 for the year ended December 31, 2004 and our subsequent reports on Forms 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.*

***Our quarterly operating results may fluctuate and 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:

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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;

the gain or loss of a key customer;

our ability to specify, develop, complete, introduce, market and transition to volume production new products and technologies in a timely manner;

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

the effect of new and emerging technologies;

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

general economic and market conditions.

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.

***Although we have begun reporting backlog, 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 towards the end of a quarter may not ship until the subsequent quarter. Additionally, customers may issue purchase orders that have extended delivery dates that may cause the shipment to fall in a subsequent quarter. These situations make it difficult for us to predict what our revenues and operating results will be in any quarter. Therefore, the level of backlog is not necessarily indicative of trends in our business. As of June 30, 2006, we had a backlog of approximately \$4.2 million.

***We depend upon a small number of customers for a significant portion of our revenues.***

In the past we have derived a substantial portion of our revenues from sales to a small number of customers and expect to continue to do so in the future. The agreements we have with these entities do not require them to purchase any minimum quantity of our products and may be terminated by the entity or us at any time for any reason upon minimal prior written notice. Accordingly, we cannot be certain that these customers will continue to place large orders for our products in the future, or purchase our products at all. Our largest OEM customer accounted for 72.5% and 71.6% of our net revenues in the six months ended June 30, 2006 and 2005, respectively.

Our customers may acquire products from our competitors or develop their own products that compete directly with ours. Any



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substantial decrease or delay in our sales to one or more of these entities in any quarter would have an adverse effect on our results of operations. In addition, certain of our customers have in the past and may in the future acquire competitors or be acquired by competitors, 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 in the future, it could change its current purchasing habits. In that event, we could lose the customer, or experience a decrease in orders from 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.

***Competition within our product markets is intense and includes numerous established competitors, which could negatively affect our revenues.***

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 market, we expect significant competition from both established and emerging software companies in the future. Furthermore, many of 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 to new or emerging technologies and changes in customer requirements or to devote greater resources to the promotion and sale of their products. There is also a substantial risk that 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.***

We recently acquired all the outstanding capital stock of Allume Systems, Inc. (see note 4 of Notes to Unaudited Condensed Consolidated Financial Statements) and, in April 2006, PhoTags, Inc. (see note 3 of Notes to Unaudited Condensed Consolidated Financial Statements). We expect to continue to consider acquisitions of complementary companies, products or technologies. As part of any such acquisition, including that of Allume, Inc., 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 be unable 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. 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 and write offs. 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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***If the adoption of new technologies and services grows more slowly than anticipated in our product planning and development, our future sales and profits may be negatively affected.***

If the adoption of new technologies and services does not grow or grows more slowly than anticipated in our product planning and development, demand for certain of our products and services will be reduced. For example, our new QuickLink Mobile and QuickLink Enterprise products provide notebook users with the ability to roam between wireless wide area networks ( WWAN ) and Wi-Fi hot spots. Therefore, future sales and any future profits from these and related products are substantially dependent upon the widespread acceptance and use of Wi-Fi as an effective medium of communication by consumers and businesses.

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

Our software products are complex and may contain undetected errors. In the past, we have discovered software errors in certain of our products and have experienced delayed or lost revenues during the period it took to correct these errors. Although we and our OEM customers test our products, it is possible that errors may be found in our new or existing products after we have commenced commercial shipment of those products. These undetected errors could result in adverse publicity, loss of revenues, delay in market acceptance of our products or claims against us by customers.

***Technology and customer needs change rapidly in our market, which could render our products obsolete and negatively affect our revenue.***

Our future success will depend 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 customers 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. If our software markets do not develop as we anticipate, or our products do not gain widespread acceptance in these markets or if we are unable to develop new versions of our software products that can operate on future operating systems, our business, financial condition and results of operations could be materially and adversely affected.

***Delays or failure in deliveries from our component 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.***

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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. Since 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.

***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. 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 stock price is highly volatile. Accordingly, you may not be able to resell your shares of common stock at or above the price you paid for them.***

The market price of our common stock has fluctuated substantially in the past and is likely to continue to be highly volatile and subject to wide fluctuations. These fluctuations have occurred and may continue to occur in response to various factors, many of which we cannot control, including:

quarter-to-quarter variations in our operating results;

announcements of technological innovations or new products by our competitors, customers or us;

market conditions within our retail and OEM software markets;

general global economic and political instability;

changes in earnings estimates or investment recommendations by analysts;

changes in investor perceptions; or

changes in expectations relating to our products, plans and strategic position or those of our competitors or customers.



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In addition, the market prices of securities of high technology companies have been especially volatile. This volatility has significantly affected the market prices of securities of many technology companies. Accordingly, you may not be able to resell your shares of common stock at or above the price you paid. In the past, companies that have experienced volatility in the market price of their securities have been the subjects of securities class action litigation. If we were the object of a securities class action litigation, it could result in substantial losses and divert management's attention and resources from other matters.

***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 communication software products as well those in our highly specialized consulting business. 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, consulting services, 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. Additionally, retaining key employees during restructuring efforts is critical to our company's success.

***We may need to raise additional capital in the future 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. 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 right 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;

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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 require additional capital to accommodate planned growth, hiring, infrastructure and facility needs or to consummate acquisitions of other businesses, products or technologies.

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

Each year, a percentage of our revenues are derived from sales to customers outside the United States. This percentage can vary significantly from quarter to quarter and from year to year. In recent years this percentage has been less than 10%. 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 each 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; 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.

***The market price of our common stock may be adversely affected by the sale of significant numbers of shares of our common stock by our principal stockholder.***

A large block of shares is held by William W. Smith, Jr., our President and Chief Executive Officer, who held 3,052,115 shares at July 31, 2006 which are eligible for resale under Rule 144. Overall, our trading volume fluctuates widely and at times is relatively limited. The market price for our common stock could decline as a result of the sale

of a large number of the shares or the

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perception that such sales may occur. The sale of a large number of our common stock also might make it more difficult for us to sell equity or equity-related securities in the future at a time and at the prices that we deem appropriate.

*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.

*Provisions of our charter and bylaws and Delaware law could make a takeover of our company difficult.*

Our certificate of incorporation and bylaws contain provisions that may discourage or prevent a third party from acquiring us, even if doing so would be beneficial to our stockholders. For instance, our certificate of incorporation authorizes the board of directors to fix the rights and preferences of shares of any series of preferred stock, without action by our stockholders. As a result, the board can authorize and issue shares of preferred stock, which could delay or prevent a change of control because the rights given to the holders of such preferred stock may prohibit a merger, reorganization, sale or other extraordinary corporate transaction. In addition, we are organized under the laws of the State of Delaware and certain provisions of Delaware law may have the effect of delaying or preventing a change in our control.

*We may be subject to additional risks.*

The risks and uncertainties described above are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also adversely affect our business operations.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

On April 5, 2006, we issued an aggregate of 384,897 shares of our common stock to the shareholders of Photags, Inc. in connection with our acquisition of Photags, Inc., which closed on that date. The offer and sale of those securities were not registered under the Securities Act of 1933, or any state securities laws, in reliance on an exemption from registration pursuant to Section 4(2) of the Securities Act and Regulation D promulgated thereunder..

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

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

An Annual Meeting of the Stockholders of the Company was held on June 29, 2006. At the Annual Meeting, the Stockholders voted as follows:

The Stockholders elected Thomas G. Campbell (with 19,427,410 votes for and 1,339,018 withheld) and Ted L. Hoffman (with 20,204,208 votes for and 562,220 withheld) as directors, to hold office until the 2009 Annual Meeting, or until their successors are elected and qualified.

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In addition to Messrs. Campbell and Hoffman, the following directors will continue to hold office: Samuel Gulko, William C. Keiper, William W. Smith, Jr. and Gregory Szabo.

The Stockholders elected to ratify the appointment of Singer, Lewak, Greenbaum and Goldstein LLP as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2006 (with 20,734,350 shares for, 26,173 shares against and 5,905 shares abstaining).

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

**EXHIBITS**

<b>Exhibit No.</b>	<b>Exhibit Description</b>
2.1	Agreement and Plan of Merger, dated April 3, 2006, by and by and among Smith Micro Software, Inc., Tag Acquisition Corporation, Tag Acquisition Corporation II, Photags, Inc., Harry Fox, as Stockholders' Agent, and certain stockholders of Photags, Inc. (incorporated by reference from Exhibit 2.1 to the Company's Current Report on Form 8-K filed on April 7, 2006).
31.1	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**SIGNATURES**

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

SMITH MICRO SOFTWARE, INC.

August 14, 2006

By /s/ William W. Smith, Jr.

William W. Smith, Jr.  
President and Chief Executive Officer  
(Principal Executive Officer)

August 14, 2006

By /s/ Andrew C. Schmidt

Andrew C. Schmidt  
Vice President and Chief Financial Officer  
(Principal Financial Officer)