

SMITH MICRO SOFTWARE INC

Form 10-Q

November 04, 2010

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

(Mark One)

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

**For the quarterly period ended September 30, 2010  
OR**

☐ **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  
incorporation or organization)

**33-0029027**  
(I.R.S. Employer  
Identification No.)

**51 COLUMBIA  
ALISO VIEJO, CA 92656**  
(Address of principal executive offices, including zip code)  
**(949) 362-5800**

(Registrant's telephone number, including area code)

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

Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ☐ No ☐

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

Large accelerated filer <input type="radio"/>	Accelerated filer <input checked="" type="radio"/>	Non-accelerated filer <input type="radio"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="radio"/>
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Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2).

Yes ☐ No ☒

As of October 29, 2010 there were 34,279,087 shares of common stock outstanding.

**SMITH MICRO SOFTWARE, INC.**  
**QUARTERLY REPORT ON FORM 10-Q**  
**September 30, 2010**  
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**SMITH MICRO SOFTWARE, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(in thousands except share, and par value data)

	September 30, 2010 (unaudited)	December 31, 2009 (audited)
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 12,302	\$ 14,577
Short-term investments	45,222	31,284
Accounts receivable, net of allowances for doubtful accounts and other adjustments of \$915 (2010) and \$1,045 (2009)	32,277	24,147
Income tax receivable	980	980
Inventories, net of reserves for excess and obsolete inventory of \$1,341 (2010) and \$1,221 (2009)	382	406
Prepaid expenses and other current assets	1,106	1,506
Deferred tax asset	2,693	2,696
Total current assets	94,962	75,596
Equipment and improvements, net	10,339	8,193
Goodwill	94,231	94,320
Intangible assets, net	21,537	27,662
Other assets	190	163
Total assets	\$ 221,259	\$ 205,934
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 4,140	\$ 4,215
Accrued liabilities	11,519	11,359
Deferred revenue	2,098	1,317
Total current liabilities	17,757	16,891
Non-current liabilities:		
Deferred rent and other long-term liabilities	170	70
Deferred tax liability	997	994
Total non-current liabilities	1,167	1,064
Commitments and contingencies		
Stockholders equity:		
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; 34,279,087 and 33,380,496 shares issued and outstanding at September 30,	34	33

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2010 and December 31, 2009, respectively

Additional paid-in capital	191,550	183,756
Accumulated other comprehensive loss	(12)	(2)
Accumulated earnings	10,763	4,192
Total stockholders' equity	202,335	187,979
Total liabilities and stockholders' equity	\$ 221,259	\$ 205,934

See accompanying notes to the consolidated financial statements.

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**SMITH MICRO SOFTWARE, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Revenues	\$ 34,008	\$ 27,820	\$ 95,227	\$ 77,594
Cost of revenues	3,771	3,540	11,468	11,985
Gross profit	30,237	24,280	83,759	65,609
Operating expenses:				
Selling and marketing	7,344	5,946	22,032	18,371
Research and development	10,972	9,229	31,195	26,066
General and administrative	6,059	4,967	18,082	13,962
Total operating expenses	24,375	20,142	71,309	58,399
Operating income	5,862	4,138	12,450	7,210
Interest and other income	82	121	115	495
Income before taxes	5,944	4,259	12,565	7,705
Income tax expense	2,850	2,278	5,994	4,169
Net income	\$ 3,094	\$ 1,981	\$ 6,571	\$ 3,536
Net income per share:				
Basic	\$ 0.09	\$ 0.06	\$ 0.19	\$ 0.11
Diluted	\$ 0.09	\$ 0.06	\$ 0.19	\$ 0.11
Weighted average shares outstanding:				
Basic	34,274	32,523	34,091	32,182
Diluted	34,736	33,145	34,560	32,641

See accompanying notes to the consolidated financial statements.

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**SMITH MICRO SOFTWARE, INC.**  
**CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY**  
(in thousands)

	Common stock Shares	Common stock Amount	Additional paid-in capital	Accumulated other comprehensive loss	Accumulated earnings	Total
<b>BALANCE, December 31, 2009</b>	<b>33,380</b>	<b>\$ 33</b>	<b>\$ 183,756</b>	<b>\$ (2)</b>	<b>\$ 4,192</b>	<b>\$ 187,979</b>
Exercise of common stock options	69		349			349
Non cash compensation recognized on stock options			3,387			3,387
Restricted stock grants	854	1	3,624			3,625
Cancellation of shares for payment of withholding tax	(24)		(212)			(212)
Excess tax benefit related to stock compensation			648			648
Tax deficiencies related to stock compensation			(2)			(2)
Other comprehensive income:						
Unrealized loss on short-term investments				(10)		(10)
Net income					6,571	6,571
Total comprehensive income						6,561
<b>BALANCE, September 30, 2010 (unaudited)</b>	<b>34,279</b>	<b>\$ 34</b>	<b>\$ 191,550</b>	<b>\$ (12)</b>	<b>\$ 10,763</b>	<b>\$ 202,335</b>

See accompanying notes to the consolidated financial statements.

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**SMITH MICRO SOFTWARE, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)

	Nine Months Ended September 30,	
	2010 (unaudited)	2009 (unaudited)
<b>Operating activities:</b>		
Net income	\$ 6,571	\$ 3,536
Adjustments to reconcile net income to net cash provided by operating activities, net of the effect of acquisitions:		
Depreciation and amortization	8,911	7,645
Loss on disposal of assets		20
Provision for doubtful accounts and other adjustments to accounts receivable	908	1,190
Provision for excess and obsolete inventory	167	896
Tax benefits from stock-based compensation	(648)	(779)
Non cash compensation related to stock options & restricted stock	7,012	6,660
Change in operating accounts, net of effect from acquisitions:		
Accounts receivable	(9,038)	(6,059)
Deferred income taxes	4	
Inventories	(143)	(305)
Prepaid expenses and other assets	373	68
Accounts payable and accrued liabilities	1,301	709
Net cash provided by operating activities	15,418	13,581
<b>Investing activities:</b>		
Adjustments made to the acquisition of Core Mobility	143	
Acquisition of Avot Media, net of cash received	(675)	
Capital expenditures	(4,210)	(4,006)
Purchase of short-term investments	(13,948)	(9,762)
Net cash used in investing activities	(18,690)	(13,768)
<b>Financing activities:</b>		
Tax benefits from stock-based compensation	648	779
Cash received from exercise of stock options	349	1,617
Net cash provided by financing activities	997	2,396
Net increase (decrease) in cash and cash equivalents	(2,275)	2,209
Cash and cash equivalents, beginning of period	14,577	13,966
Cash and cash equivalents, end of period	\$ 12,302	\$ 16,175



Supplemental disclosures of cash flow information:

Cash paid for income taxes	\$	3,389	\$	5,189
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See accompanying notes to the consolidated financial statements.

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**SMITH MICRO SOFTWARE, INC.  
Notes to the Consolidated Financial Statements**

**1. The Company**

Smith Micro Software, Inc. ( we, us, our, Smith Micro, or the Company ) designs, develops and markets software products and services primarily for the mobile computing and communications industries. The Company is focused on developing connectivity, communications and content management solutions for a converging world of wireless and wired networks. The Company's portfolio of wireless software products and services includes a wide range of software solutions including our QuickLink® family of products. We provide mobile voice and data connectivity across 3G, 4G, Wi-Fi, and LTE networks. Our mobile communications portfolio includes solutions for Push-To-Talk, Visual Voicemail and mobile device management. We also offer user-friendly solutions for the management of mobile content, contacts and calendar data. We sell our products and services to many of the world's leading mobile network operators, original equipment manufacturers ( OEM ), device manufacturers and enterprise businesses, as well as directly to consumers.

**2. Basis of Presentation**

The accompanying interim consolidated balance sheet and statement of stockholders' equity as of September 30, 2010, the related statements of operations for the three and nine months ended September 30, 2010 and 2009 and the related statements of cash flows for the nine months ended September 30, 2010 and 2009 are unaudited. The unaudited consolidated financial statements have been prepared according to the rules and regulations of the Securities and Exchange Commission ( SEC ) and, therefore, certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been omitted.

In the opinion of management, the accompanying unaudited consolidated financial statements for the periods presented reflect all adjustments, which are normal and recurring, necessary to fairly state the financial position, results of operations and cash flows. These unaudited consolidated financial statements should be read in conjunction with the audited financial statements included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009 filed with the SEC on March 2, 2010.

Intercompany balances and transactions have been eliminated in consolidation.

Operating results for the three and nine months ended September 30, 2010 are not necessarily indicative of the results that may be expected for any other interim period or for the fiscal year ending December 31, 2010.

**3. Net Income Per Share**

The Company calculates earnings per share ( EPS ) as required by the Earnings Per Share Topic No. 260 of the Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ). Basic EPS is calculated by dividing the net income available to common stockholders by the weighted average number of common shares outstanding for the period, excluding common stock equivalents. Diluted EPS is computed by dividing the net income available to common stockholders by the weighted average number of common shares outstanding for the period plus the weighted average number of dilutive common stock equivalents outstanding for the period determined using the treasury-stock method. For purposes of this calculation, common stock subject to repurchase by the Company and options are considered to be common stock equivalents and are only included in the calculation of diluted earnings per share when their effect is dilutive.

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	Three Months Ended September 30, 2010		September 30, 2009		Nine Months Ended September 30, 2010		2009	
	(unaudited, in thousands, except per share amounts)							
<b>Numerator:</b>								
Net income available to common stockholders	\$	3,094	\$	1,981	\$	6,571	\$	3,536
<b>Denominator:</b>								
Weighted average shares outstanding basic		34,274		32,523		34,091		32,182
Potential common shares options (treasury stock method)		462		622		469		459
Weighted average shares outstanding diluted		34,736		33,145		34,560		32,641
Shares excluded due to an exercise price greater than weighted average stock price for the period								
		2,410		2,462		2,410		2,501
Net income per common share:								
Basic	\$	0.09	\$	0.06	\$	0.19	\$	0.11
Diluted	\$	0.09	\$	0.06	\$	0.19	\$	0.11

**4. Acquisitions*****Core Mobility, Inc.***

On October 26, 2009, the Company acquired Core Mobility, Inc. ( Core Mobility ), a developer of mobility software and solutions, for \$10.0 million in cash and 700,000 shares of Smith Micro common stock. Core Mobility became a wholly-owned subsidiary of Smith Micro. In addition, the former shareholders of Core Mobility had the ability to earn additional cash consideration of up to \$1.8 million contingent on Core Mobility achieving certain milestone deliverables for product development and deployment. In March 2010, a milestone payment of \$0.6 million was made. Of the \$10.0 million of cash consideration, \$3.0 million was held back ( Holdback ) as security against possible indemnification obligations. In June 2010, \$1.5 million of the Holdback was paid. Assuming there are no claims, the remaining 50% of the Holdback will be paid on the one year anniversary. Acquisition-related costs of \$0.2 million were recorded as expense in the fiscal year ended December 31, 2009 in the general and administrative section of the consolidated statement of operations.

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

Cash paid at closing	\$	6,970
Holdback (including interest)		3,041
Common stock issued		6,881
Milestone payments		1,839
Total purchase price	\$	18,731



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

Assets:	
Cash	\$ 63
Accounts receivable	997
Unbilled receivable	324
Prepaid and other assets	279
Fixed assets	856
Deferred tax assets	1,735
Intangible assets	8,858
Goodwill	10,694
Total assets	23,806
Liabilities:	
Accounts payable	26
Accrued expenses	258
Deferred revenue	1,280
Deferred tax liability	3,511
Total liabilities	5,075
Total purchase price	\$ 18,731

The results of operations of Core Mobility have been included in the Company's consolidated financial statements from the date of acquisition. The pro-forma effect of the acquisition on historical periods is not material and therefore not included.

**5. Stock-Based Compensation***Stock Plans*

On July 28, 2005, our Shareholders approved the 2005 Stock Option / Stock Issuance Plan ( 2005 Plan ). The 2005 Plan, which became effective the same date, replaced the 1995 Stock Option / Stock Issuance Plan ( 1995 Plan ), which expired on May 24, 2005. All outstanding options under the 1995 Plan remained 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 and restricted stock 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 exercisable immediately 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 options may be exercised within a period following termination. In general, options expire ten years from the date of grant. Restricted stock is valued using the closing stock price on the date of the grant. The total value is expensed over the vesting period of 12 to 48 months. The maximum number of shares of the Company's common stock that were available for issuance over the term of the original 2005 Plan could not exceed 5,000,000 shares, plus that number of additional shares equal to 2.5% of the number of shares of common stock outstanding on the last trading day of the calendar year commencing with calendar year 2006 (but not in excess of 750,000 shares). On October 11, 2007, our shareholders voted to approve an amendment to the 2005 Plan to increase the maximum number of shares of common stock that may be issued under the 2005 Plan from 5,000,000 shares (plus an annual increase) to 7,000,000 shares (plus an annual increase).

*Stock Compensation Expense*

The Company accounts for all stock-based payment awards made to employees and directors based on their fair values and recognized as compensation expense over the vesting period using the straight-line method over the requisite service period for each award as required by FASB ASC Topic No. 718, Compensation-Stock Compensation.

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Stock-based non-cash compensation expenses related to stock options and restricted stock grants were recorded in the financial statements as follows (in thousands):

	Three Months Ended September 30, (unaudited)		Nine Months Ended September 30, (unaudited)	
	2010	2009	2010	2009
Cost of revenues	\$ 23	\$ 28	\$ 76	\$ 157
Selling and marketing	627	592	1,890	1,898
Research and development	615	643	1,817	1,899
General and administrative	1,079	782	3,229	2,706
Total non-cash stock compensation expense	\$ 2,344	\$ 2,045	\$ 7,012	\$ 6,660

Total share-based compensation for each quarter includes cash payment of income taxes related to grants of restricted stock in the amount of \$0.4 million for both of the three months ended September 30, 2010 and 2009. The cash payment of income taxes related to grants of restricted stock totaled \$1.5 million and \$0.8 million for the nine months ended September 30, 2010 and 2009, respectively.

**Stock Options**

There were no stock options granted during the three months ended September 30, 2010. There were 20,000 stock options granted during the nine months ended September 30, 2010. There were 25,000 stock options granted during the three and nine months ended September 30, 2009. The weighted average grant-date fair value of stock options granted during the nine months ended September 30, 2010 was \$2.97. The weighted average grant-date fair value of stock options granted during the three and nine months ended September 30, 2009 was \$3.23 for both periods. The assumptions used to compute the stock-based compensation costs for the stock options granted during the three and nine months ended September 30, 2010 and 2009, using the Black-Scholes option pricing model, were as follows:

	Three Months Ended September 30, 2010 (unaudited)		Nine Months Ended September 30, 2010 (unaudited)	
	2009 (unaudited)		2009 (unaudited)	
<b>Employee Stock Options</b>				
Risk-free interest rate	0.5%		0.32%	0.5%
Expected dividend yield				
Weighted average expected life (years)	1		1	1
Volatility	71.0%		72.0%	71.0%
Forfeiture rate				

The risk-free interest rate assumption was based on the United States Treasury's rates for U.S. Treasury zero-coupon bonds with maturities similar to those of the expected term of the award being valued. The Company assumed no dividend yield because it does not expect to pay dividends for the foreseeable future.

A summary of the Company's stock options outstanding under the 2005 Plan as of September 30, 2010, and the activity during the nine months then ended, are as follows:

Shares	Weighted Ave. Exercise Price	Aggregate Intrinsic Value
(in thousands except per share amounts)		

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Outstanding as of December 31, 2009	3,536	\$	11.29	
Granted (unaudited)	20	\$	10.51	
Exercised (unaudited)	(69)	\$	5.04	
Cancelled (unaudited)	(80)	\$	13.51	
Outstanding as of September 30, 2010 (unaudited)	3,407	\$	11.36	\$
Exercisable as of September 30, 2010 (unaudited)	3,097	\$	11.10	\$



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During the nine months ended September 30, 2010, options to acquire 69,341 shares were exercised with an intrinsic value of \$0.3 million, resulting in cash proceeds to the Company of \$0.3 million. As of September 30, 2010, there was \$1.9 million total unrecognized compensation costs related to unvested stock options granted under the Plan, which will be recognized over a period not to exceed four years. At September 30, 2010, there were 1.5 million shares available for future grants under the 2005 Plan.

Additional information regarding options outstanding as of September 30, 2010 is as follows:

Range of exercise prices		Number outstanding (in thousands)	Options outstanding		Options exercisable	
			Weighted average remaining contractual life (years)	Weighted average exercise price	Number exercisable (in thousands)	Weighted average exercise price
\$0.24	\$4.00	177	3.4	\$ 1.55	177	\$ 1.55
\$4.01	\$6.00	643	4.8	\$ 4.95	643	\$ 4.95
\$6.01	\$12.00	299	6.5	\$ 9.16	273	\$ 9.28
\$12.01	\$14.00	1,271	6.4	\$12.67	1,136	\$12.67
\$14.01	\$16.00	637	6.5	\$15.18	557	\$15.18
\$16.01	\$19.00	380	6.7	\$17.73	311	\$17.79
		3,407	6.0	\$11.36	3,097	\$11.10

**Restricted Stock Awards**

There were 0.9 million shares of restricted stock with a total value of \$7.0 million granted to key officers and employees of the Company during the nine months ended September 30, 2010. This cost will be amortized over a period of 48 months. In addition, 50,000 shares of restricted stock with a total value of \$0.4 million were granted to members of the Board of Directors during the nine months ended September 30, 2010. This cost will be amortized over a period of 12 months. Grants of restricted stock are valued using the closing stock price on the date of grant.

A summary of the Company's restricted stock awards outstanding under the 2005 Plan as of September 30, 2010, and the activity during the nine months then ended, are as follows (in thousands):

	Shares
Unvested at December 31, 2009	1,415
Granted (unaudited)	902
Cancelled/forfeited (unaudited)	(48)
Vested (unaudited)	(517)
Unvested at September 30, 2010 (unaudited)	1,752

**6. Fair Value of Financial Instruments**

The Company measures and discloses fair value measurements as required by FASB ASC Topic No. 820, Fair Value Measurements and Disclosures.

The carrying value of accounts receivable, foreign cash accounts, prepaid expenses, other current assets, accounts payable, and accrued liabilities are considered to be representative of their respective fair values because of the short-term nature of those instruments.

Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that

is determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, the FASB establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

Level 1    Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2    Include other inputs that are directly or indirectly observable in the marketplace.

Level 3    Unobservable inputs which are supported by little or no market activity.

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The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

As required by FASB ASC Topic No. 820, we measure our cash equivalents and short-term investments at fair value. Our cash equivalents and short-term investments are classified within Level 1 by using quoted market prices utilizing market observable inputs.

As required by FASB ASC Topic No. 825, Financial Instruments, an entity can choose to measure at fair value many financial instruments and certain other items that are not currently required to be measured at fair value. Subsequent changes in fair value for designated items are required to be reported in earnings in the current period. This Topic also establishes presentation and disclosure requirements for similar types of assets and liabilities measured at fair value. As permitted, the Company has elected not to use the fair value option to measure our available-for-sale securities under this Topic and will continue to report as required by FASB ASC Topic No. 320, Investments-Debt and Equity Securities. We have made this election because the nature of our financial assets and liabilities are not of such complexity that they would benefit from a change in valuation to fair value.

**7. Cash and Cash Equivalents**

Cash and cash equivalents generally consist of cash, government securities, mutual funds, and money market funds. These securities are primarily held in two financial institutions and are uninsured except for the minimum Federal Deposit Insurance Corporation ( FDIC ) coverage, and have original maturity dates of three months or less. As of September 30, 2010 and December 31, 2009, bank balances totaling approximately \$12.1 million and \$4.6 million, respectively, were uninsured. On January 1, 2010, our primary United States bank exited the Federal Deposit Insurance Corp. s Transaction Account Guarantee Program. Our uninsured bank balances would have been \$14.3 million for the year ended December 31, 2009 if our primary United States bank exited Federal Deposit Insurance Corp. s Transaction Account Guarantee Program prior to January 1, 2010.

**8. Short-Term Investments**

Short-term investments consist of U.S. government agency and government sponsored enterprise obligations. The Company accounts for these short-term investments as required by FASB ASC Topic No. 320, Investments-Debt and Equity Securities. These debt and equity securities are not classified as either held-to-maturity securities or trading securities. As such, they are classified as available-for-sale securities. Available-for-sale securities are recorded at fair value, with unrealized gains or losses recorded as a separate component of accumulated other comprehensive income in stockholders equity until realized. Available-for-sale securities with contractual maturities of less than 12 months were as follows (in thousands):

	<b>September 30, 2010</b>		<b>December 31, 2009</b>	
	(unaudited)		(audited)	
	<b>Fair value</b>	<b>Unrealized (loss)</b>	<b>Fair value</b>	<b>Unrealized (loss)</b>
Corporate bonds and notes	\$ 22,946	\$ (12)	\$ 3,499	\$
Government-backed securities	22,276		27,785	(2)
Total	\$ 45,222	\$ (12)	\$ 31,284	\$ (2)

**9. Accounts Receivable**

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.

**10. Inventories**

Inventories consist principally of cables, compact disks ( 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 September 30, 2010, our net inventory balance of \$0.4 million consisted of approximately \$0.2 million of assembled products and \$0.2 million of components.

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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.

**12. Goodwill**

In accordance with FASB ASC Topic No. 350, Intangibles-Goodwill and Other, we review 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. We determined that we did not have any impairment of goodwill at December 31, 2009 and we have not noted any triggering events that would indicate an impairment as of September 30, 2010.

The carrying amount of the Company's goodwill was \$94.2 million as of September 30, 2010 and was \$94.3 million as of December 31, 2009.

**13. Intangible Assets**

The following table sets forth our acquired intangible assets by major asset class as of September 30, 2010 and December 31, 2009 (in thousands except useful life data):

	Useful life (years)	September 30, 2010 (unaudited)			December 31, 2009		
		Gross	Accumulated amortization	Net book value	Gross	Accumulated amortization	Net book value
<i><u>Amortizing:</u></i>							
Purchased technology	1-3	\$ 7,347	\$ (4,830)	\$ 2,517	\$ 6,667	\$ (3,349)	\$ 3,318
In process R&D	2	990		990	990		990
Capitalized software	1-7	23,846	(14,546)	9,300	23,846	(11,485)	12,361
Distribution rights	5	482	(482)		482	(447)	35
Customer lists	3-5	1,484	(1,281)	203	1,484	(1,048)	436
Database	10	182	(52)	130	182	(38)	144
Trademarks	5-10	926	(514)	412	926	(445)	481
Trade names	1-7	2,121	(1,108)	1,013	2,121	(807)	1,314
Non-compete	2	21	(10)	11	21	(2)	19
Customer agreements	1-2	1,135	(1,135)		1,135	(1,135)	
Customer relationships	4-7	11,130	(4,169)	6,961	11,130	(2,566)	8,564
Totals		\$ 49,664	\$ (28,127)	\$ 21,537	\$ 48,984	\$ (21,322)	\$ 27,662

Aggregate amortization expense on intangible assets was \$2.3 million and \$6.8 million for the three and nine months ended September 30, 2010, respectively. Expected future amortization expense is as follows: \$2.3 million for the remainder of 2010, \$8.6 million for 2011, \$6.4 million for 2012, \$3.5 million for 2013, and \$0.7 million thereafter.

**Table of Contents****14. Comprehensive Income**

Comprehensive income includes unrealized gains and losses on short-term investments of U.S. government agency and government sponsored enterprise debt and equity securities. The following table sets forth the calculation of comprehensive income (in thousands):

	Three Months Ended September 30, (unaudited)		Nine Months Ended September 30, (unaudited)	
	2010	2009	2010	2009
Net income	\$ 3,094	\$ 1,981	\$ 6,571	\$ 3,536
Change in unrealized gain (loss) on investments, net	2	(13)	(10)	(50)
Total comprehensive income	\$ 3,096	\$ 1,968	\$ 6,561	\$ 3,486

**15. Segment and Geographical Information***Segment Information*

Public companies are required to report financial and descriptive information about their reportable operating segments as required by FASB ASC Topic No. 280, Segment Reporting. The Company identifies its operating segments based on how management internally evaluates separate financial information, business activities and management responsibility. The Company has two primary business units. Wireless includes our connectivity and security, backup and messaging, multimedia and mobile device solutions product lines. Productivity & Graphics includes retail and direct sales of our compression and broad consumer-based software. Corporate/Other revenue includes the consulting portion of our services sector which has been de-emphasized and is no longer considered a strategic element of our future plans.

The Company does not separately allocate operating expenses to these business units, nor does it allocate specific assets. Therefore, business unit information reported includes only revenues.

The following table shows the revenues generated by each business unit (in thousands):

	Three Months Ended September 30, (unaudited)		Nine Months Ended September 30, (unaudited)	
	2010	2009	2010	2009
Wireless	\$ 31,340	\$ 22,665	\$ 86,631	\$ 63,295
Productivity & Graphics	2,615	4,986	8,296	13,569
Corporate/Other	53	169	300	730
Total Revenues	\$ 34,008	\$ 27,820	\$ 95,227	\$ 77,594

Revenues to three customers and their respective affiliates in the Wireless business segment accounted for 41.7%, 15.0% and 11.9% of the Company's total revenues for the three months ended September 30, 2010. Revenues to three customers and their respective affiliates in the Wireless business segment accounted for 33.0%, 12.0% and 11.0% of the Company's total revenues for the three months ended September 30, 2009. Revenues to three customers and their respective affiliates in the Wireless business segment accounted for 36.5%, 14.7% and 14.6% of the Company's total revenues for the nine months ended September 30, 2010. Revenues to two customers and their respective affiliates in the Wireless business segment accounted for 32.4% and 13.0% of the Company's total revenues for the nine months ended September 30, 2009.

**Table of Contents***Geographical Information*

During the three and nine months ended September 30, 2010 and 2009, the Company operated in three geographic locations: the Americas, Asia Pacific, and Europe, the Middle East, and Africa ( EMEA ). Revenues, attributed to the geographic location of the customer's bill-to address, were as follows (in thousands):

	Three Months Ended September 30, (unaudited)		Nine Months Ended September 30, (unaudited)	
	2010	2009	2010	2009
Americas	\$ 32,384	\$ 25,496	\$ 88,169	\$ 70,881
Asia Pacific	398	1,198	1,231	3,183
EMEA	1,226	1,126	5,827	3,530
Total Revenues	\$ 34,008	\$ 27,820	\$ 95,227	\$ 77,594

The Company does not separately allocate specific assets to these geographic locations.

**16. Recent Accounting Pronouncements**

In February 2010, the FASB issued Accounting Standards Update ( ASU ) No. 2010-09, *Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*. This guidance states that an entity that is an SEC filer is required to evaluate subsequent events through the date that the financial statements are issued. As such, an entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. This change alleviates potential conflicts between Subtopic 855-10 and the SEC's requirements. The guidance has become effective for the interim or annual reporting periods after June 15, 2010. The Company adopted this guidance on its effective date and it did not have an impact on its consolidated results of operations and financial condition.

In January 2010, the FASB issued ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. This guidance amends the disclosure requirements related to recurring and nonrecurring fair value measurements and requires new disclosures on the transfers of assets and liabilities between Level 1 (quoted prices in active market for identical assets or liabilities) and Level 2 (significant other observable inputs) of the fair value measurement hierarchy, including the reasons and the timing of the transfers. Additionally, the guidance requires a roll forward of activities on purchases, sales, issuance and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). The guidance has become effective for the reporting period beginning January 1, 2010, except for the disclosure on the roll forward activities for Level 3 fair value measurements, which will become effective for the reporting period beginning January 1, 2011. The Company adopted this guidance on its effective date and since it currently only has Level 1 assets and liabilities, it did not have an impact on its consolidated results of operations and financial condition.

In December 2009, the FASB issued ASU No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*. This new guidance addresses (1) the effects on certain provisions of Financial Accounting Standards Board Interpretation ( FIN ) No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, as a result of the elimination of the qualifying special-purpose entity concept in SFAS No. 166, *Accounting for Transfers of Financial Assets*, and (2) constituent concerns about the application of certain key provisions of FIN No. 46(R), including those in which the accounting and disclosures under the Interpretation do not always provide timely and useful information about an enterprise's involvement in a variable interest entity. This Statement shall be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited. The Company adopted ASU No. 2009-17 this year and its adoption did not have an impact on its consolidated results of operations and financial condition.

In December 2009, the FASB issued ASU No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*. This guidance was issued to improve the relevance, representational faithfulness, and

comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. This Statement must be applied as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. Earlier application is prohibited. This Statement must be applied to transfers occurring on or after the effective date. The Company adopted ASU No. 2009-16 this year and its adoption did not have an impact on its consolidated results of operations and financial condition.

In October 2009, the FASB issued ASU No. 2009-14, *Software (Topic 985): Certain Revenue Arrangements That Include Software Elements (a consensus of the FASB Emerging Issues Task Force)*. This new guidance amends the scope of existing software revenue recognition accounting. Tangible products containing software components and non-software components that function together to deliver the product's essential functionality would be scoped out of the accounting guidance on software and accounted for



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based on other appropriate revenue recognition guidance. For the Company, this guidance is effective for all new or materially modified arrangements entered into on or after January 1, 2011 with earlier application permitted as of the beginning of a fiscal year. Full retrospective application of the new guidance is optional. This guidance must be adopted in the same period that the company adopts the amended accounting for arrangements with multiple deliverables described in the preceding paragraph. The Company is currently assessing its implementation of this new guidance, but does not expect a material impact on the consolidated financial statements.

In October 2009, the FASB issued ASU No. 2009-13, *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements*. ASU No. 2009-13 amends revenue recognition guidance for arrangements with multiple deliverables. The new guidance eliminates the residual method of revenue recognition and allows the use of management's best estimate of selling price for individual elements of an arrangement when vendor specific objective evidence (VSOE), vendor objective evidence (VOE) or third-party evidence (TPE) is unavailable. For the Company, this guidance is effective for all new or materially modified arrangements entered into on or after January 1, 2011 with earlier application permitted as of the beginning of a fiscal year. Full retrospective application of the new guidance is optional. The Company is currently assessing its implementation of this new guidance, but does not expect a material impact on the consolidated financial statements.

**17. Commitments and Contingencies***Leases*

The Company leases its buildings under operating leases that expire on various dates through 2022. Future minimum annual lease payments under such leases as of September 30, 2010 are as follows (in thousands):

<b>Year Ending December 31,</b>	<b>Operating</b>
2010-3 months	\$ 563
2011	2,130
2012	1,885
2013	1,602
2014	1,259
2015	1,216
Beyond	3,294
<b>Total</b>	<b>\$ 11,949</b>

Rent expense under operating leases for the three months ended September 30, 2010 and 2009 was \$0.6 million and \$0.5 million, respectively. Rent expense under operating leases for the nine months ended September 30, 2010 and 2009 was \$1.8 million and \$1.4 million, respectively.

**18. Income Taxes**

The Company accounts for income taxes as required by FASB ASC Topic No. 740, Income Taxes. This Topic clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Topic also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. 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, we are required to evaluate 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 the entire deferred tax asset will not be realized. In 2006, the Company reversed all of its valuation allowance on its deferred tax assets as a result of the Company's improving financial performance and projected income in future years.

In July 2006, the FASB clarified the accounting for uncertainty in income taxes recognized in the financial statements. A tax benefit from an uncertain tax position may be recognized when it is more likely than not that the position will be sustained upon examination, including resolutions of any related appeals or litigation process, based

on the technical merits. Based on our evaluation, we have concluded that there are no significant uncertain tax positions requiring recognition on our financial statements. Our evaluation was performed for the tax years ended December 31, 2006, 2007, 2008, and 2009, the tax years which remain subject to examination by major tax jurisdictions as of September 30, 2010.

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We may from time to time be assessed interest or penalties by major tax jurisdictions, although any such assessments historically have been minimal and immaterial to our financial results. In the event we have received an assessment for interest and/or penalties, it has been classified in the financial statements as general and administrative expense.

**19. Subsequent Events**

In May 2009, the FASB issued new accounting guidance found under ASC Topic No. 855, Subsequent Events. The Topic establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued. The Company has adopted this Topic. Subsequent events have been evaluated as of the date of this filing and there are no further disclosures required.

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

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

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

*the duration and depth of the current economic slowdown and its effects on capital expenditures by our customers and their end users;*

*our ability to predict consumer needs, introduce new products, gain broad market acceptance for such products and ramp up manufacturing in a timely manner;*

*changes in demand for our products from our customers and their end-users;*

*the intensity of the competition and our ability to successfully compete;*

*the pace at which the market for new products develop;*

*the response of competitors, many of whom are bigger and better financed than us;*

*our ability to successfully execute our business plan and control costs and expenses;*

*our ability to protect our intellectual property and our ability to not infringe on the rights of others; and*

*those additional factors which are listed under the section Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2009.*

*The forward-looking statements contained in this report are made on the basis of the views and assumptions of management regarding future events and business performance as of the date this report is filed with the SEC. We do not undertake any obligation to update these statements to reflect events or circumstances occurring after the date this report is filed.*

#### **Overview**

Smith Micro Software, Inc. designs, develops and markets software products and services primarily for the mobile computing and communications industries. The Company is focused on developing connectivity, communications, and content management solutions for a converging world of wireless and wired networks. The Company's portfolio of wireless software products and services includes a wide range of software solutions including our QuickLink® family of products. We provide mobile voice and data connectivity across 3G, 4G, Wi-Fi, and LTE networks. Our mobile communications portfolio includes solutions for Push-To-Talk, Visual Voicemail and mobile device management. We also offer user-friendly solutions for the management of mobile content, contacts and calendar data.

Our patented compression technologies are utilized within various Smith Micro products including our line of Personal Computer ( PC ) and Smartphones compression products and our new file-transfer solution.

We sell our products and services to many of the world's leading mobile network operators, original equipment manufacturers (OEM), device manufacturers and enterprise businesses, as well as directly to consumers. The proliferation of broadband mobile wireless technologies is providing new opportunities for our products and services on a global basis. When these broadband wireless technologies EVDO, UMTS/HSPA, Wi-Fi, LTE and WiMAX are combined with new devices such as mobile

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phones, PCs, Smartphones, Netbooks, and tablets and emerging Machine-to-Machine ( M2M ) devices, opportunities emerge for new communications software products. Our core technologies are designed to address these emerging mobile convergence opportunities.

Our innovative line of productivity and graphics products are distributed through a variety of consumer channels worldwide, our online stores, and third-party wholesalers, retailers and value-added resellers. We offer products that operate on Windows, Mac, UNIX, Linux, Apple iPhone/iPad, Android, Windows Mobile, Symbian and Java platforms.

Revenues to three customers and their respective affiliates in the Wireless business segment accounted for 41.7%, 15.0% and 11.9% of the Company's total revenues for the three months ended September 30, 2010. Revenues to three customers and their respective affiliates in the Wireless business segment accounted for 33.0%, 12.0% and 11.0% of the Company's total revenues for the three months ended September 30, 2009. Revenues to three customers and their respective affiliates in the Wireless business segment accounted for 36.5%, 14.7% and 14.6% of the Company's total revenues for the nine months ended September 30, 2010. Revenues to two customers and their respective affiliates in the Wireless business segment accounted for 32.4% and 13.0% of the Company's total revenues for the nine months ended September 30, 2009.

On October 26, 2009, the Company acquired Core Mobility, Inc. ( Core Mobility ), a developer of mobility software and solutions, for \$10.0 million in cash and 700,000 shares of Smith Micro common stock. Core Mobility became a wholly-owned subsidiary of Smith Micro. Of the \$10.0 million of cash consideration, \$3.0 million was held back ( Holdback ) as security against possible indemnification obligations. As of October 26, 2010, the entire \$3.0M holdback has been paid.

**Results of Operations**

The table below sets forth certain statements of operations data expressed as a percentage of revenues for the three and nine months ended September 30, 2010 and 2009. Our historical results are not necessarily indicative of the operating results that may be expected in the future.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	11.1	12.7	12.0	15.4
Gross profit	88.9	87.3	88.0	84.6
Operating expenses:				
Selling and marketing	21.6	21.4	23.1	23.7
Research and development	32.3	33.2	32.8	33.6
General and administrative	17.8	17.8	19.0	18.0
Total operating expenses	71.7	72.4	74.9	75.3
Operating income	17.2	14.9	13.1	9.3
Interest and other income	0.3	0.4	0.1	0.6
Income before taxes	17.5	15.3	13.2	9.9
Income tax expense	8.4	8.2	6.3	5.3
Net income	9.1%	7.1%	6.9%	4.6%

***Revenues and Expense Components***

The following is a description of the primary components of our revenues and expenses:

*Revenues.* Revenues are net of sales returns and allowances. Our operations are organized into two business segments:

Wireless, which includes our connectivity and security management solutions, mobile VPN, music and multimedia management, device management, Push-To-Talk, Visual Voicemail and contact and calendar syncing solutions; and

Productivity & Graphics, which includes retail and direct sales of our compression and broad consumer-based software.

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The following table shows the revenues generated by each business unit (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Wireless	\$ 31,340	\$ 22,665	\$ 86,631	\$ 63,295
Productivity & Graphics	2,615	4,986	8,296	13,569
Corporate/Other	53	169	300	730
Total Revenues	34,008	27,820	95,227	77,594
Cost of revenues	3,771	3,540	11,468	11,985
Gross Profit	\$ 30,237	\$ 24,280	\$ 83,759	\$ 65,609

Corporate/Other refers to the consulting portion of our services sector which has been de-emphasized and is no longer considered a strategic element of our future plans.

*Cost of revenues.* Cost of revenues consists of direct product costs, royalties, and the amortization of purchased intangibles and capitalized software.

*Selling and marketing.* Selling and marketing expenses consist primarily of personnel costs, advertising costs, sales commissions, trade show expenses, and the amortization of certain purchased intangibles. These expenses vary significantly from quarter to quarter based on the timing of trade shows and product introductions.

*Research and development.* Research and development expenses consist primarily of personnel and equipment costs required to conduct our software development efforts and the amortization of certain acquired intangibles.

*General and administrative.* General and administrative expenses consist primarily of personnel costs, professional services and fees paid for external service providers, space and occupancy costs, and legal and other public company costs.

*Interest and other income.* Interest and other income are directly related to our average cash and short term investment balances during the period and vary among periods. Our other excess cash is invested in short term marketable equity and debt securities classified as cash equivalents.

*Income tax expense.* The Company accounts for income taxes as required by FASB ASC Topic No. 740, 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 financial statements or tax returns. Measurement of the deferred items is based on enacted tax laws. In the event the future consequences of differences between financial reporting bases and tax bases of the Company's assets and liabilities result in a deferred tax asset, we are required to evaluate 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 the entire deferred tax asset will not be realized. Based on our evaluation, we believe all of the deferred tax assets at September 30, 2010 are likely to be realized.

In July 2006, the FASB clarified the accounting for uncertainty in income taxes recognized in the financial statements. A tax benefit from an uncertain tax position may be recognized when it is more likely than not that the position will be sustained upon examination, including resolutions of any related appeals or litigation process, based on the technical merits.

Income tax positions must meet a more likely-than-not recognition threshold at the effective date to be recognized upon the adoption of new FASB guidance, and in subsequent periods. The interpretation also provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. We adopted this FASB guidance effective January 1, 2007. Based on our evaluation, we have concluded that there are no significant uncertain tax positions requiring recognition on our financial statements.

***Three Months Ended September 30, 2010 Compared to the Three Months Ended September 30, 2009***



*Revenues.* Revenues were \$34.0 million and \$27.8 million for the three months ended September 30, 2010 and 2009, respectively, representing an increase of \$6.2 million, or 22.2%. Wireless revenues increased \$8.7 million, or 38.3%, primarily due to new connectivity and security product licenses of \$5.6 million, \$2.5 million of visual voicemail and push-to-talk revenues and \$0.6 million of new multimedia and device solutions revenue. Productivity & Graphics revenues decreased \$2.4 million, or 47.6%, due to continued unfavorable consumer spending trends. Corporate/Other revenues decreased \$0.1 million as we have de-emphasized this business.

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*Cost of revenues.* Cost of revenues were \$3.8 million and \$3.6 million for the three months ended September 30, 2010 and 2009, respectively, representing an increase of \$0.2 million, or 6.5%. Direct product costs decreased \$0.1 million primarily due to a shift in product mix. Amortization of intangibles increased from \$1.2 million to \$1.5 million, or \$0.3 million primarily due to the Core Mobility acquisition which closed in the fourth quarter of 2009. Stock-based compensation expense was essentially zero for both of the three months ended September 30, 2010 and 2009.

*Gross profit.* Gross profit was \$30.2 million, or 88.9% of revenues for the three months ended September 30, 2010, an increase of \$5.9 million, or 24.5%, from \$24.3 million, or 87.3% of revenues for the three months ended September 30, 2009. The 1.6 percentage point increase was primarily due to improved product margins of 1.9 points due to the change in product mix. This was partially offset by higher amortization of intangibles due to the Core Mobility acquisition of 0.3 points.

*Selling and marketing.* Selling and marketing expenses were \$7.3 million and \$5.9 million for the three months ended September 30, 2010 and 2009, respectively, representing an increase of \$1.4 million, or 23.5%. This increase was primarily due to personnel costs associated with increased headcount of \$1.0 million and increased travel, advertising and media relations related to our new product launches of \$0.2 million. Stock-based compensation expense was \$0.8 million and \$0.7 million for the three months ended September 30, 2010 and 2009, respectively, representing an increase of \$0.1 million. Amortization of intangible assets was \$0.7 million and \$0.6 million for the three months ended September 30, 2010 and 2009, respectively, an increase of \$0.1 million due to the Core Mobility acquisition.

*Research and development.* Research and development expenses were \$11.0 million and \$9.2 million for the three months ended September 30, 2010 and 2009, respectively, representing an increase of \$1.8 million, or 18.9%. This increase was primarily due to personnel costs associated with newly hired and acquired headcount of \$2.2 million. Stock-based compensation expense was \$0.6 million and \$0.7 million for the three months ended September 30, 2010 and 2009, respectively, representing a decrease of \$0.1 million. Amortization of purchased technologies was zero for the period ended September 30, 2010 versus \$0.3 million for period ended September 30, 2009, a decrease of \$0.3 million.

*General and administrative.* General and administrative expenses were \$6.1 million and \$5.0 million for the three months ended September 30, 2010 and 2009, respectively, representing an increase of \$1.1 million, or 22.0%. This increase was primarily due to an increase in space and occupancy costs as a result of our acquisition of Core Mobility and the expansion of our corporate headquarters campus of \$0.5 million and acquired headcount of \$0.2 million. Stock-based compensation expense was \$1.3 million and \$0.9 million for the three months ended September 30, 2010 and 2009, respectively, representing an increase of \$0.4 million.

*Interest and other income.* Interest and other income was \$0.1 million for both the three months ended September 30, 2010 and 2009.

*Income tax expense.* Income tax expense was \$2.9 million and \$2.3 million for the three months ended September 30, 2010 and 2009, respectively. The high effective tax rate for both periods is due to stock-based compensation book expense which is a permanent difference to the taxable income.

### ***Nine Months Ended September 30, 2010 Compared to the Nine Months Ended September 30, 2009***

*Revenues.* Revenues were \$95.2 million and \$77.6 million for the nine months ended September 30, 2010 and 2009, respectively, representing an increase of \$17.6 million, or 22.7%. Wireless revenues increased \$23.3 million, or 36.9%, primarily due to connectivity and security product OEM licenses of \$10.2 million, \$8.7 million of visual voicemail and push-to-talk revenues, new device solutions revenues of \$3.3 million, and new multimedia revenues of \$1.1 million. Productivity & Graphics revenues decreased \$5.3 million, or 38.9%, due to continued unfavorable consumer spending trends. Corporate/Other revenues decreased \$0.4 million as we have de-emphasized this business.

*Cost of revenues.* Cost of revenues were \$11.5 million and \$12.0 million for the nine months ended September 30, 2010 and 2009, respectively, representing a decrease of \$0.5 million, or 4.3%. Direct product costs decreased \$1.4 million primarily due to a change in product mix. Amortization of intangibles increased from \$3.5 million to \$4.5 million, or \$1.0 million, due to the Core Mobility acquisition. Stock-based compensation expense was \$0.1 million and \$0.2 million for the nine months ended September 30, 2010 and 2009, respectively, representing a

decrease of \$0.1 million.

*Gross profit.* Gross profit was \$83.8 million, or 88.0% of revenues for the nine months ended September 30, 2010, an increase of \$18.2 million, or 27.7%, from \$65.6 million, or 84.6% of revenues for the nine months ended September 30, 2009. The 3.4 percentage point increase was due to improved product margins as a result of the change in product mix to more downloads and licenses of 3.5 percentage points. Lower stock-based compensation expense as a percentage of revenue increased gross profit by 0.1

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point for the nine months ended September 30, 2010 from 2009. Higher amortization of intangibles due to the Core Mobility acquisition as a percentage of revenue decreased gross profit by 0.2 points for the nine months ended September 30, 2010 from 2009.

*Selling and marketing.* Selling and marketing expenses were \$22.0 million and \$18.4 million for the nine months ended September 30, 2010 and 2009, respectively, representing an increase of \$3.6 million, or 19.9%. This increase was primarily due to personnel costs associated with increased headcount and higher commissions of \$3.0 million and other cost increases of \$0.1 million. Stock-based compensation expense was \$2.3 million and \$2.1 million for the nine months ended September 30, 2010 and 2009, respectively, representing an increase of \$0.2 million. Amortization of intangible assets was \$2.2 million and \$1.9 million for the nine months ended September 30, 2010 and 2009, respectively, an increase of \$0.3 million due to the Core Mobility acquisition.

*Research and development.* Research and development expenses were \$31.2 million and \$26.1 million for the nine months ended September 30, 2010 and 2009, respectively, representing an increase of \$5.1 million, or 19.7%. This increase was primarily due to the addition of engineers through new hiring or by acquisition of \$5.8 million and travel and small equipment of \$0.4 million to support our new product initiatives and new contracts. Stock-based compensation expense was \$1.9 million and \$2.0 million for the nine months ended September 30, 2010 and 2009, respectively, representing a decrease of \$0.1 million. Amortization of intangible assets was zero and \$1.0 million for the nine months ended September 30, 2010 and 2009, respectively, a decrease of \$1.0 million.

*General and administrative.* General and administrative expenses were \$18.1 million and \$14.0 million for the nine months ended September 30, 2010 and 2009, respectively, representing an increase of \$4.1 million, or 29.5%. This increase was primarily due to an increase in space and occupancy costs due to our acquisition of Core Mobility and the expansion of our corporate headquarters campus of \$1.6 million, increased headcount of \$0.9 million, increased depreciation and amortization of fixed assets of \$0.4 million, and other cost increases of \$0.2 million. Stock-based compensation expense was \$4.1 million and \$3.1 million for the nine months ended September 30, 2010 and 2009, respectively, representing an increase of \$1.0 million.

*Interest and other income.* Interest and other income was \$0.1 million and \$0.5 million for the nine months ended September 30, 2010 and 2009, respectively. This decrease was due to lower interest rates and smaller gains on our short-term investments.

*Income tax expense.* Income tax expense was \$6.0 million and \$4.2 million for the nine months ended September 30, 2010 and 2009, respectively. The high effective tax rate is due to stock-based compensation book expense which is a permanent difference to the taxable income.

## **Liquidity and Capital Resources**

At September 30, 2010, we had \$57.5 million in cash, cash equivalents, and short-term investments and \$77.2 million of working capital. On October 26, 2009, we acquired Core Mobility for \$10.0 million in cash (\$7.0 million upon closing and \$3.0 million held back as security against possible indemnification obligations) and 700,000 shares of Smith Micro common stock. We currently have no 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 short-term investment balances and cash flow from operations will be sufficient to finance our working capital and capital expenditure requirements through at least the next twelve 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 that such financing will be available to us at commercially reasonable terms or at all.

### *Operating activities*

Net cash provided by operating activities was \$15.4 million for the nine months ended September 30, 2010. Our net cash provided by operating activities resulted from net income of \$6.6 million adjusted for non-cash expenses including depreciation and amortization of \$8.9 million, stock-based compensation of \$7.0 million, other non-cash expenses of \$0.4 million, and increases of current liabilities net of other assets of \$1.7 million. The primary use of cash affecting operating cash flow was an increase in accounts receivable of \$9.0 million and an increase of inventory of \$0.2 million. Net cash provided by operating activities was \$13.6 million for the nine months ended September 30, 2009. Our net cash provided by operating activities resulted from net income of \$3.5 million adjusted for non-cash

expenses including depreciation and amortization of \$7.6 million, stock-based compensation of \$6.7 million, other non-cash expenses of \$1.4 million, and increases of current liabilities net of other assets of \$0.7 million. The primary use of cash affecting operating cash flow was an increase in accounts receivable of \$6.1 million and an increase of inventory net of other assets of \$0.2 million.

*Investing activities*

During the nine months ended September 30, 2010, we used \$18.7 million in investing activities due to investing in short-term investments of \$14.0 million, capital expenditures for leasehold improvements, business systems, and other computer equipment of \$4.2 million, and acquisitions of \$0.5 million. During the nine months ended September 30, 2009, we used \$13.8

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million in investing activities due to investing in short-term investments of \$9.8 million and capital expenditures for leasehold improvements, a new phone system, a new ERP system, and other computer equipment of \$4.0 million.

*Financing activities*

We received \$1.0 million in cash during the nine months ended September 30, 2010; \$0.3 million from the exercise of stock options and \$0.7 million for tax benefits from stock-based compensation. We received \$2.4 million in cash during the nine months ended September 30, 2009; \$1.6 million from the exercise of stock options and \$0.8 million for tax benefits from stock-based compensation.

*Contractual obligations and commercial commitments*

As of September 30, 2010 we had no debt. The following table summarizes our contractual obligations as of September 30, 2010 (in thousands):

		Payments due by period			
		1 year	1-3	3-5	More than
<b>Contractual obligations:</b>	<b>Total</b>	<b>or less</b>	<b>years</b>	<b>years</b>	<b>5 years</b>
Operating lease obligations	\$ 11,949	\$ 2,191	\$ 3,585	\$ 2,571	\$ 3,602
Purchase obligations	1,407	1,407			
<b>Total</b>	<b>\$ 13,356</b>	<b>\$ 3,598</b>	<b>\$ 3,585</b>	<b>\$ 2,571</b>	<b>\$ 3,602</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.

*Real Property Leases*

Our corporate headquarters, including our principal administrative, sales and marketing, customer support and research and development facility, is located in Aliso Viejo, California, where we currently lease and occupy approximately 52,700 square feet of space pursuant to leases that expire on May 31, 2016 and January 31, 2022. We lease approximately 21,000 square feet in Mountain View, California under a lease that expires February 28, 2014. We lease approximately 14,400 square feet in Chicago, Illinois under a lease that expires August 31, 2012. We lease approximately 15,300 square feet in Watsonville, California under a lease that expires September 30, 2018. We lease approximately 7,700 square feet in Herndon, Virginia under a lease that expires May 31, 2011. We lease approximately 4,200 square feet in Austin, Texas under a lease that expires June 30, 2011. Internationally, we lease space in Stockholm, Sweden; Belgrade, Serbia; Oslo, Norway; and Vancouver, Canada. These leases are for one to three-year terms.

**Critical Accounting Policies and Estimates**

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*

We currently report our net revenues under two operating groups: Wireless and Productivity & Graphics. Within each of these groups software revenue is recognized based on the customer and contract type. We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed and determinable, and collectibility is probable as required by FASB ASC Topic No. 985-605, Software-Revenue Recognition. We recognize revenues from sales of our software to OEM customers or end users as completed products are shipped and titles passes; or from royalties generated as authorized customers duplicate our software, if the other requirements are met. If the requirements 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. Within the Productivity & Graphics group certain revenues are booked net of revenue sharing payments. We have a few multiple element agreements for which we have contracted to provide a perpetual license for use of proprietary software, to provide non-recurring engineering, and in some cases to provide software maintenance (post contract support). For multiple element agreements, vendor specific objective evidence of fair value for all contract elements is reviewed and the timing of the individual element revenue streams is determined and recognized as required. Sales directly to end-users are recognized upon shipment. 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.

### *Sales Incentives*

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 for as a reduction of revenue as required by FASB ASC Topic No. 985-605, Software-Revenue Recognition. We use historical redemption rates to estimate the cost of customer incentives. Total sales incentives were \$0.5 million and \$0.7 million for the nine months ended September 30, 2010 and 2009, respectively.

### *Accounts Receivable and Allowance for Doubtful Accounts*

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 an allowance for doubtful accounts 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.

### *Internal 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 September 30, 2010, software has been substantially completed concurrently with the establishment of technological feasibility; accordingly, no costs have been capitalized to date.

### *In-Process Research and Development*

In 2009, we capitalized \$1.0 million of IPR&D costs related to our acquisition of Core Mobility in accordance with accounting standards that became effective in 2009. Upon completion, the related IPR&D asset will be amortized over its estimated useful life. If the project is abandoned, we will be required to impair the related IPR&D asset.

The fair value of the IPR&D was determined using the discounted cash flow approach. The expected future cash flows were estimated and discounted to their net present values at an appropriate risk-adjusted rate of return. Significant factors considered in the calculation of the rate of return were the weighted average cost of capital and



return on assets, as well as the risks inherent in the development process, including the likelihood of achieving technological success and market acceptance. Future cash flows were estimated based on forecasted revenue and costs, taking into account the expected product life cycle, market penetration and growth rates.

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### *Capitalized Software and Amortization*

We capitalize internally developed software and software purchased from third parties if the related software product under development has reached technological feasibility or if there are alternative future uses for the purchased software as required by FASB ASC Topic No. 985-20, Software-Costs of Software to be Sold, Leased, or Marketed. These costs are amortized on a product-by-product basis, typically over an estimated life of five to seven years, using the larger of the amount calculated using the straight-line method or the amount calculated using the ratio between current period gross revenues and the total of current period gross revenues and estimated future gross revenues. At each balance sheet date, we evaluate on a product-by-product basis the unamortized capitalized cost of computer software compared to the net realizable value of that product. The amount by which the unamortized capitalized costs of a computer software product exceed its net realizable value is written off.

### *Intangible Assets and Amortization*

Amortization expense related to other intangibles acquired in previous acquisitions is calculated on a straight line basis over various useful lives.

### *Impairment or Disposal of Long Lived Assets*

Long-lived assets to be held are reviewed for events or changes in circumstances which indicate that their carrying value may not be recoverable. They are tested for recoverability using undiscounted cash flows to determine whether or not impairment to such value has occurred as required by FASB ASC Topic No. 360, Property, Plant, and Equipment. The Company has determined that there was no impairment at September 30, 2010.

### *Valuation of Goodwill and Intangible Assets*

The Company accounts for goodwill and intangible assets as required by FASB ASC Topic No. 350, Intangibles-Goodwill and Other. This statement requires us to periodically assess the impairment of our goodwill and intangible assets, which requires us to make assumptions and judgments regarding the carrying value of these assets. These assets are considered to be impaired if we determine that their carrying value may not be recoverable based upon our assessment of the following events or changes in circumstances:

- a determination that the carrying value of such assets cannot be recovered through undiscounted cash flows;

- loss of legal ownership or title to the assets;

- significant changes in our strategic business objectives and utilization of the assets; or

- the impact of significant negative industry or economic trends.

If the intangible assets are considered to be impaired, the impairment we recognize is the amount by which the carrying value of the intangible assets exceeds the fair value of the intangible assets. In addition, we base the useful lives and the related amortization expense on our estimate of the useful life of the intangible assets. Due to the numerous variables associated with our judgments and assumptions relating to the carrying value of our intangible assets and the effects of changes in circumstances affecting these valuations, both the precision and reliability of the resulting estimates are subject to uncertainty, and as additional information becomes known, we may change our estimate, in which case, the likelihood of a material change in our reported results would increase. As of September 30, 2010, we have not noted any triggering events that would indicate an impairment of goodwill or our intangible assets.

### *Deferred Income Taxes*

We account for income taxes as required by FASB ASC Topic No. 740, 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, we are required to evaluate 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 the entire deferred tax asset will not be realized. The Company's net deferred tax assets were not reduced by a tax valuation allowance at September 30, 2010. Management evaluated the positive and negative

evidence in determining the realizability of the net deferred tax assets at September 30, 2010 and concluded it is more likely than not that the Company should realize its net deferred tax assets through future operating results and the reversal of taxable temporary differences.

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### *Stock-Based Compensation*

The Company accounts for all stock-based payment awards made to employees and directors based on their fair values and recognized as compensation expense over the vesting period using the straight-line method over the requisite service period for each award as required by FASB ASC Topic No. 718, Compensation-Stock Compensation.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

#### *Interest Rate Risk*

Our financial instruments include cash and cash equivalents, and short-term investments. At September 30, 2010, the carrying values of our financial instruments approximated fair values based on current market prices and rates.

#### *Foreign Currency Risk*

While a majority of our business is denominated in U.S. dollars, we do occasionally invoice in foreign currencies. For the three months ended September 30, 2010 and 2009, our revenues denominated in foreign currencies were \$0.4 million and \$0.5 million, respectively. For the nine months ended September 30, 2010 and 2009, our revenues denominated in foreign currencies were both \$1.2 million. Fluctuations in the rate of exchange between the U.S. dollar and certain other currencies may affect our results of operations and period-to-period comparisons of our operating results. We do not currently engage in hedging or similar transactions to reduce these risks. The operational expenses of our foreign entities reduce the currency exposure we have because our foreign currency revenues are offset in part by expenses payable in foreign currencies. As such, we do not believe we have a material exposure to foreign currency rate fluctuations at this time.

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

#### *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 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 September 30, 2010. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have determined that as of September 30, 2010, our disclosure controls and procedures were effective to ensure 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.

#### *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, SingerLewak LLP, and representatives of management to review accounting, financial

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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.

*Changes in internal control over financial reporting*

There have been no changes in our internal control over financial reporting during the quarter ended September 30, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings.**

From time to time we may be party to litigation incidental to our business, none of which is expected to have a material adverse effect on us.

**Item 1A. Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for our fiscal year ended December 31, 2009. The risks discussed in our Annual Report on Form 10-K could materially affect our business, financial condition and future results. The risks described in our Annual Report on Form 10-K are not the only risks facing us. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially and adversely affect our business, financial condition or operating results.

**Item 6. Exhibits.**

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

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

32.1 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURES**

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

SMITH MICRO SOFTWARE, INC.

November 4, 2010

By /s/ William W. Smith, Jr.  
William W. Smith, Jr.  
President and Chief Executive Officer  
(*Principal Executive Officer*)

November 4, 2010

By /s/ Andrew C. Schmidt  
Andrew C. Schmidt  
Vice President and Chief Financial  
Officer  
(*Principal Financial Officer*)

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**Exhibit Index**

- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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