ZIX CORP
Form 10-Q
August 09, 2006

Table of Contents

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

(Mark One)

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

For the quarterly period ended June 30, 2006

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

For the transition period from __________ to __________

Commission File Number: 0-17995

ZIX CORPORATION

(Exact Name of Registrant as Specified in its Charter)

Texas	**75-2216818**
(State of Incorporation)	**(I.R.S. Employer Identification Number)**

2711 North Haskell Avenue
Suite 2200, LB 36
Dallas, Texas 75204-2960
(Address of Principal Executive Offices)
(214) 370-2000
(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 þ No o

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-2 of the Exchange Act. (Check one):

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

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	Outstanding at August 1, 2006
Common Stock, par value $.01 per share	59,638,839

INDEX

	Page Number
PART FINANCIAL INFORMATION	
Item 1. Financial Statements (Unaudited)	
Condensed Consolidated Balance Sheets at June 30, 2006 and December 31, 2005	ii
Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2006 and 2005	iii
Condensed Consolidated Statement of Stockholders Equity for the six months ended June 30, 2006	iv
Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2006 and 2005	v
Notes to Condensed Consolidated Financial Statements	1
Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations	18
Item 3. Quantitative and Qualitative Disclosures About Market Risk	36
Item 4. Controls and Procedures	36
PART II-OTHER INFORMATION	37
Item 1. Legal Proceedings	37
Item 1A. Risk Factors	37
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	43
Item 3. Defaults Upon Senior Securities	44
Item 4. Submission of Matters to a Vote of Security Holders	44
Item 5. Other Information	45
Item 6. Exhibits	45
Certification of Pursuant to Section 302	
Certification of Pursuant to Section 302	
Certification Pursuant to Section 906	

Table of Contents

ZIX CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

	June 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 19,569,000	$ 20,240,000
Restricted cash		5,100,000
Receivables, net	509,000	149,000
Prepaid and other current assets	1,421,000	1,845,000
Total current assets	21,499,000	27,334,000
Restricted cash	35,000	35,000
Property and equipment, net	3,100,000	3,652,000
Intangible assets, net	199,000	559,000
Goodwill	2,161,000	2,161,000
Deferred financing costs and other assets	87,000	374,000
	$ 27,081,000	$ 34,115,000
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 880,000	$ 1,313,000
Accrued expenses	3,496,000	3,749,000
Deferred revenue	7,988,000	7,087,000
Customer deposit	2,000,000	1,000,000
Capital lease obligations	40,000	165,000
Promissory note payable	2,437,000	
Short-term note payable	115,000	268,000
Convertible promissory note payable		4,404,000
Total current liabilities	16,956,000	17,986,000
Long-term liabilities:		
Deferred revenue	1,509,000	1,261,000
Derivative liabilities	3,231,000	
Customer deposit		2,000,000
Promissory note payable		2,226,000
Deferred rent	349,000	245,000
Total long-term liabilities	5,089,000	5,732,000
	22,045,000	23,718,000
Contingencies (Note 15)		
Stockholders equity:		
Preferred stock, $1 par value, 10,000,000 shares authorized; none issued and outstanding		

Common stock, $0.01 par value, 175,000,000 shares authorized; 61,966,020 issued and 59,638,839 outstanding in 2006 and 51,932,561 issued and 49,605,380 outstanding in 2005	620,000	519,000
Additional paid-in capital	314,959,000	308,461,000
Treasury stock, at cost; 2,327,181 common shares in 2006 and 2005	(11,507,000)	(11,507,000)
Accumulated deficit	(299,036,000)	(287,076,000)
Total stockholders equity	5,036,000	10,397,000
	$ 27,081,000	$ 34,115,000

See notes to condensed consolidated financial statements.

ii

Table of Contents

ZIX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
Revenues:				
Services	$ 4,209,000	$ 3,199,000	$ 8,104,000	$ 6,497,000
Hardware		241,000		426,000
Software		9,000		109,000
Total revenues	4,209,000	3,449,000	8,104,000	7,032,000
Cost of revenues	3,090,000	3,508,000	6,465,000	7,399,000
Gross margin (loss)	1,119,000	(59,000)	1,639,000	(367,000)
Operating expenses:				
Research and development expenses	1,626,000	1,535,000	3,221,000	3,510,000
Selling, general and administrative expenses	6,549,000	6,559,000	13,141,000	14,061,000
Customer deposit forfeiture		(960,000)	(1,000,000)	(960,000)
Gain on sale of product lines				(950,000)
Total operating expenses	8,175,000	7,134,000	15,362,000	15,661,000
Operating loss	(7,056,000)	(7,193,000)	(13,723,000)	(16,028,000)
Other (expense) income:				
Investment and other income	294,000	143,000	511,000	286,000
Interest expense	(477,000)	(1,996,000)	(895,000)	(2,826,000)
Gain on derivative liabilities	2,930,000		2,930,000	
Loss on extinguishment of convertible debt	(871,000)		(871,000)	
Total other (expense) income	1,876,000	(1,853,000)	1,675,000	(2,540,000)
Loss before income taxes	(5,180,000)	(9,046,000)	(12,048,000)	(18,568,000)
Income tax benefit	94,000	131,000	88,000	81,000
Net loss	$ (5,086,000)	$ (8,915,000)	$ (11,960,000)	$ (18,487,000)
Basic and diluted loss per common share	$ (0.09)	$ (0.28)	$ (0.22)	$ (0.57)
Basic and diluted weighted average common shares outstanding	59,200,723	32,391,777	54,453,902	32,343,737

See notes to condensed consolidated financial statements.

Table of Contents

ZIX CORPORATION
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY
(Unaudited)

	Stockholders Equity					
	Common Stock		Additional Paid-In Capital	Treasury Stock	Accumulated Deficit	Total Stockholders Equity
	Shares	Amount				
Balance, January 1, 2006	51,932,561	$ 519,000	$ 308,461,000	$ (11,507,000)	$ (287,076,000)	$ 10,397,000
Issuance of common stock and related warrants upon private investment (net of issuance costs)	9,930,000	100,000	4,449,000			4,549,000
Valuation of warrants issued to brokers of the private placement of common stock			199,000			199,000
Common stock issued to employees for compensation in lieu of cash	82,196	1,000	156,000			157,000
Common stock issued in lieu of cash for third-party services	21,263		30,000			30,000
Employee share-based compensation costs			1,440,000			1,440,000
Valuation of additional warrants issued relating to the convertible promissory notes payable			50,000			50,000
Valuation of beneficial conversion feature in convertible promissory note resulting from the private placement of common stock			459,000			459,000
Valuation of additional			74,000			74,000

anti-dilutive warrants issued upon private placement of common stock						
Valuation of additional warrants issued upon retirement of convertible promissory note			6,000			6,000
Reversal of unamortized valuation of beneficial conversion feature upon retirement of convertible promissory note			(365,000)			(365,000)
Net loss					(11,960,000)	(11,960,000)
Balance, June 30, 2006	61,966,020	$ 620,000	$ 314,959,000	$ (11,507,000)	$ (299,036,000)	$ 5,036,000

See notes to condensed consolidated financial statements.

iv

Table of Contents

ZIX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six Months Ended June 30, 2006	2005
Operating activities:		
Net loss	$ (11,960,000)	$ (18,487,000)
Non-cash items in net loss:		
Depreciation and amortization	1,545,000	2,195,000
Amortization of debt discount / premium, financing costs and other	686,000	2,198,000
Value of additional warrants issued	10,000	
Common stock issued to employees and non-employee in lieu of cash	187,000	243,000
Loss on extinguishment of convertible debt	871,000	
Gain on derivative liabilities	(2,930,000)	
Employee share-based compensation costs	1,440,000	
Customer deposit forfeiture	(1,000,000)	(960,000)
Changes in deferred taxes	(87,000)	
Common stock issued in lieu of cash interest payments		267,000
Non-employee stock-based compensation costs		119,000
Gain on sale of product line		(950,000)
Changes in operating assets and liabilities		
Accounts receivable	(360,000)	234,000
Other assets	443,000	682,000
Accounts payable	(393,000)	(542,000)
Deferred revenue	1,149,000	1,820,000
Accrued and other liabilities	(205,000)	8,000
Net cash used by operating activities	(10,604,000)	(13,173,000)
Investing activities:		
Purchases of property and equipment	(692,000)	(1,010,000)
Sales and maturities of marketable securities		16,000,000
Purchase of restricted cash investment		(38,000)
Proceeds from restricted cash investments	5,100,000	
Proceeds from sale of product lines		2,309,000
Net cash provided by investing activities	4,408,000	17,261,000
Financing activities:		
Proceeds from private placement of common stock	11,817,000	
Payment of expenses relating to private placement of common stock	(814,000)	
Payment of convertible debt	(5,000,000)	
Payment of premium on convertible debt	(200,000)	
Payment of short-term note payable, capital leases and other	(278,000)	(274,000)
Proceeds from exercise of stock options		3,000
Net cash provided (used) by financing activities	5,525,000	(271,000)
(Decrease) increase in cash and cash equivalents	(671,000)	3,817,000
Cash and cash equivalents, beginning of period	20,240,000	3,856,000

Cash and cash equivalents, end of period	$ 19,569,000	$ 7,673,000

See notes to condensed consolidated financial statements.

v

ZIX CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The accompanying condensed consolidated financial statements of Zix Corporation (ZixCorp or the Company) should be read in conjunction with the audited consolidated financial statements included in the Company s 2005 Annual Report to Shareholders on Form 10-K. These financial statements are unaudited, but have been prepared in the ordinary course of business for the purpose of providing information with respect to the interim periods. Management of the Company believes that all adjustments necessary for a fair presentation for such periods have been included and are of a normal recurring nature. The results of operations for the three and six-month periods ended June 30, 2006, are not necessarily indicative of the results to be expected for the full year.

2. Company Overview and Liquidity

As of January 1, 2006, the Company operates two reporting segments, Email Encryption and e-Prescribing, which provide services that protect, manage and deliver sensitive electronic information and provide electronic prescribing at the point of care.

Email Encryption is a comprehensive suite of secure messaging services, which allows an enterprise to use policy driven rules to determine which emails need to be sent securely in order to comply with regulations or corporate policy. Email Encryption is commonly referred to as Secure Messaging. e-Prescribing consists of a single product line named PocketScript. PocketScript is an electronic prescribing service that allows physicians to use a handheld device to prescribe drugs and transmit the prescription electronically to any pharmacy. During the prescribing process, the physician is provided with real-time information such as insurance formulary and drug interactions that normally would not be available in a paper prescription format. This allows the physician to leverage technology for better patient care at the point of delivery. The Company s Email Encryption and e-Prescribing services are primarily offered as a hosted-service solution, whereby customers pay for annual service subscription contracts at the inception of the service period. These service solutions require a significant up-front investment to establish service and secure enough subscribers to make the business profitable.

Prior to January 1, 2006, the Company was operated and managed as a single reporting segment.

Company History

In 1999, the Company began developing and marketing Secure Messaging products and services that brought privacy, security and convenience to Internet users. ZixMail, a desktop solution for encrypting and securely delivering email, was first commercially introduced in the first quarter of 2001. In 2002, the Company began offering additional email encryption products such as:

- ZixVPM (Virtual Private Messenger): an e-messaging gateway service that provides company-wide privacy protection for inbound and outbound email communications.
- ZixAuditor: an assessment service used to analyze email traffic patterns and monitor compliance with corporate and regulatory policies.
- ZixPort: a secure Web-messaging portal.

In July 2003, the Company acquired substantially all of the operating assets and the business of PocketScript, LLC (PocketScript), a privately-held development stage enterprise that provided electronic prescription services for the healthcare industry. This acquisition enabled the Company to expand its services into healthcare delivery solutions, specifically, the e-Prescribing marketplace. PocketScript is the cornerstone offering in the current e-Prescribing product segment.

In September 2003, the Company acquired substantially all of the operating assets and the business of Elron Software, Inc. ((Elron Software or Elron), a majority-owned subsidiary of Elron Electronic Industries Ltd. and a provider of anti-spam, email content filtering and Web filtering solutions, which enhanced the Company s then-Secure Messaging product segment.

In January 2004, the Company acquired substantially all of the operating assets and the business of MyDocOnline, Inc. (MyDocOnline), a subsidiary of Aventis Pharmaceuticals, Inc., the North American pharmaceuticals business of Aventis SA.

1

MyDocOnline offered a variety of Internet-based healthcare services and was a provider of secure Web-based communications, disease management, online doctor visits, and laboratory information solutions.

Also in 2004, Secure Messaging was combined with the Message Inspector and Web Inspector products (MI/WI) and referred to as the eSecure product line and e-Prescribing was combined with the Dr. Chart product and referred to as the eHealth product line.

In late 2004, the Company made a strategic decision to focus the Company s resources and efforts towards the two core products of the then-Secure Messaging and e-Prescribing. Subsequently, on November 4, 2004, the Company announced that it was terminating the Connect service for online doctor visits, which was one of the products acquired in the MyDocOnline acquisition.

On March 11, 2005, MI/WI product lines, which were acquired in the Elron acquisition, were sold to CyberGuard (see Note 7).

On September 30, 2005, the Company sold the remaining MyDocOnline product (Dr. Chart) to MITEM (see Note 7).

In early 2006, the eSecure product line was renamed Email Encryption and the eHealth product line was renamed e-Prescribing to reflect the single product focus in these two remaining core product lines.

Due to the Company s history of operating with spending in excess of customer receipts, liquidity is of special importance. To date, the Company s cash flow from operations has not been sufficient to fund the Company s on-going operations and the Company has relied on equity and debt financings to fund its operations. Essential to liquidity is the ability of the Company to achieve and retain subscriber bases in both core product offerings to overcome the costs of offering the service and become cash flow positive.

The Company announced in the second quarter of 2006 that it was in the process of reducing its quarterly spending by a 15% reduction in workforce, principally in non-revenue-related headcount positions. Further, non-workforce costs would be reviewed and appropriate reductions in these cost areas would also be made with a 15% reduction target. On August 8, 2006, the Company announced that the targeted cost reductions would be increased from 15% to 25% by the end of 2006. As of August 1, 2006, the Company has taken actions to achieve roughly half of the planned cost reductions. The purpose of these reductions is to streamline the Company s operating costs in order to strengthen the Company s liquidity position by more closely matching its cost structure to short-term revenue opportunities.

The Company cannot estimate the total costs to be incurred for one-time termination benefits resulting from the planned reduction in force. For the three-month and six-month periods ending June 30, 2006, the Company recorded one-time termination expenses of $345,000. As of June 30, 2006, $249,000 were accrued and are expected to be paid during the remainder of 2006, primarily in the third quarter. Further, these expenses were classified in the Company s condensed consolidated statement of operations as follows: $3,000 for Cost of Revenues, $13,000 for Research & Development expenses and $329,000 for Selling, General and Administrative expenses. The impact of the severance expenses on the Company s segments is as follows: $29,000 for Email Encryption, $138,000 for e-Prescribing and $178,000 for Corporate.

Based on the Company s size after the cost reduction actions taken in 2006 and current order and deployment rates as of June 30, 2006, the operating spending plus capital asset purchases for the next twelve months is projected to be $35,500,000 to $37,000,000. Using flat year-on-year order rates for Email Encryption, consistent renewal rates for subscribers, and an expectation of cash flow only from payors with whom the Company has a current relationship, cash receipt projections for the next twelve months are projected to be $23,500,000 to $24,500,000. These cash receipt projections, when combined with $19,569,000 unrestricted cash on hand at June 30, 2006 provide for an estimated $43,069,000 to $44,069,000 in cash available to fund the expected operational spending for the next twelve months.

The Company believes it has adequate resources and liquidity to sustain operations for at least the next twelve months and is targeting cash flow improvements to augment its liquidity beyond that time, taking into account the following factors: relatively low contractual spending commitments over the next twelve months, historically high renewal rates for Email Encryption, continued growth in the Email Encryption business consistent with historical growth levels, increased mix of cash receipts attributable to the more profitable out years of contracts, the discretionary nature of the cash spend in excess of cash receipts in the emerging area of e-Prescribing and general flexibility of spending in other areas.

As contractual cash collections and expected increases in cash sources are not always certain, the Company has some ability to adjust cash spending to react to any shortfalls in actual cash collections or to adjust spending in certain investment areas should cash receipts make that possible or, if warranted and if the terms are acceptable, with additional external financing, receipts from exercised stock options and warrants of the Company s common stock or strategic partnerships. However, operating in emerging and developing markets involves risk and uncertainties, and there are no assurances that the Company will ultimately achieve or achieve in a sufficiently timely manner its targeted improvements in operating performance. Beyond the twelve months beginning July 1, 2006, and should business results not have improved sufficiently as projected, the Company could have to alter its business plan or further augment its cash flow position through cost reduction measures, sales of assets, additional financings or a combination of these actions. However, there can be no assurance that the Company would be successful in carrying out any of these measures should they become necessary. The Company has expressed a lack of willingness, relative to other alternatives, to raise capital by issuing new shares of common stock given the current price of the Company s common stock. Accordingly, the extent and timing of success, or lack thereof, in the e-Prescribing market and continued improvement in Email Encryption will ultimately be the most significant operational determinants of liquidity.

3. Revenue and Significant Customers

The Company recognizes revenue in accordance with accounting principles generally accepted in the United States of America, as promulgated by Statement of Position (SOP) 97-2, *Software Revenue Recognition,* SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With respect to Certain Transactions,* Emerging Issues Task Force (EITF) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables,* and Securities and Exchange Commission Staff Accounting Bulletin No. 104, *Revenue Recognition in Financial Statements,* and other related pronouncements.

The Company develops, markets, licenses and supports electronic information protection services and related software products. The Company s services can be placed into several key revenue categories where each category has similar revenue recognition traits; Email Encryption subscription-based services, e-Prescribing service, various transaction fees and related professional services. A majority of the revenues generated by the Company are through direct sales; however, the Company employs a network of distributors and resellers. Under all product categories and distribution models, the Company recognizes revenue after all of the following occur: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed and determinable, and collectability is reasonably assured. In the event the arrangement has multiple elements with delivered and undelivered elements, revenue for the delivered elements are recognized under the residual method only when vendor-specific objective evidence of fair value (VSOE) exists to allocate the fair value of the total fees to the undelivered elements of the arrangement. Occasionally, when ZixCorp is engaged in a complex product deployment, customer acceptance may have to occur before the transaction is considered complete. In this situation no revenue is recognized until the customer accepts the product. Discounts provided to customers are recorded as reductions in revenue.

The Email Encryption services of ZixMail, ZixVPM, ZixPort, and ZixDirect are subscription-based services. In the first six months of 2005, subscription-based services also included Dr. Chart. Providing these services includes delivering licensed software and providing secure electronic communications and customer support throughout the subscription period. In the case of ZixVPM, typically, as part of the service, an appliance with pre-installed software is installed at the customer site at the beginning of the subscription period. In a subscription service, the customer does not own a perpetual right to a software license, but is instead granted the use of that license during the period of the service subscription. Subscriptions are generally multiple-year contracts that are irrevocable and non-refundable in nature and require annual, up-front payments. The subscription period begins on the date specified by the parties or when the service is fully functional for the customer which is consequently deemed to be the date of acceptance. Revenues from subscription services are recorded as service revenue as the services are rendered from the date of acceptance over the subscription period. Subscription fees received from customers in advance are recorded as deferred revenue and recognized as revenue ratably over the subscription period.

On September 30, 2005, the Dr. Chart product line was sold to MITEM. This product line was acquired in January 2004 through the acquisition of MyDocOnline, Inc. For the three and six-month periods ended June 30, 2005, Dr. Chart product line contributed $125,000 and $195,000 in revenue, respectively (see Note 7).

e-Prescribing service arrangements contain multiple deliverables including both hardware and services. Due to the lack of VSOE, these elements are combined into a single unit of accounting and, similar to Email Encryption, recognized as service revenue ratably over the longer of the subscription term or expected renewal period. Revenue recognition begins upon installation of the required hardware and commencement of service. Prior to the third quarter 2005, the Company did maintain VSOE for certain service elements of the e-Prescribing service. Accordingly, the residual value assigned to the PocketScript handheld device was recognized as revenue upon installation. The fair value of the undelivered services are being recognized ratably over period in which those services are delivered.

In the first quarter 2005, the Company sold anti-spam filtering, email content filtering, and Web filtering solutions under the MI/WI product lines to customers under perpetual licensing arrangements. These perpetual software licenses were normally sold as part of multiple-element arrangements that included annual maintenance and/or subscription, and may have included implementation or training services. Evidence of VSOE for implementation and training services associated with the anti-spam, email content filtering and Web filtering arrangements was based upon standard billing rates and the estimated level of effort for the individuals expected to perform the related services. Installation and training revenues were recognized as the services were rendered. The Company established VSOE for maintenance based upon maintenance that was sold separately. Maintenance revenue was recognized over the term of the maintenance agreement, generally one year.

On March 11, 2005, the MI/WI product lines were sold to CyberGuard. For the three and six-month periods ended June 30, 2005, MI/WI contributed $9,000 and $646,000 in revenue, respectively (see Note 7).

Some of the Company s services incorporate a transaction fee per event occurrence or when predetermined usage levels have been reached. These fees are recognized as revenue when the transaction occurs or when the predetermined usage levels have been achieved, and when the amounts are fixed and determinable.

The Company does not offer standalone professional services. Further, the Company s services include various warranty provisions; however, warranty expense was not material to any period presented.

For the three months ended June 30, 2006 and 2005, Blue Cross and Blue Shield of Massachusetts, Inc., an e-Prescribing customer, accounted for approximately 10% ($425,000) and 21% ($711,000) of total revenues, respectively. No other single customer accounted for 10% or more of the Company s total revenues for the three months ended June 30, 2006 and 2005. For the six months ended June 30, 2006 and 2005, Blue Cross and Blue Shield of Massachusetts, Inc., an e-Prescribing customer, accounted for approximately 10% ($784,000) and 20% ($1,385,000) of total revenues, respectively. No other single customer accounted for 10% or more of the Company s total revenues for the six months ended June 30, 2006 and 2005.

4. Segment Information

As of January 1, 2006, the Company began to manage its business in two reportable segments: Email Encryption and e-Prescribing as discussed in Note 2.

The Company s Chief Executive Officer is the chief operating decisions maker (CODM) in assessing the performance of each segment and determining the related allocation of resources.

To determine the allocation of resources the CODM generally assesses the performance of each segment based on revenue, gross margin, and direct expenses which include research and development expenses and selling and marketing expenses that are directly attributable to the segments. Most assets and most corporate costs are not allocated to the segments and are not used to determine resource allocation. Any transactions that are considered a one-time occurrence or not likely to be repeated in future periods are excluded from the CODM s assessments. The accounting policies of the reportable segments are the same as those applied to the condensed consolidated financial statements.

Corporate includes charges such as corporate management, compliance and other non-operational activities that cannot be directly attributed to a reporting segment. In addition, corporate also includes the revenues and direct costs of products that have been sold or otherwise discontinued by the Company. In 2005, the Company sold two product lines: MI/WI and Dr. Chart (see Note 7). These products contributed $134,000 and $841,000 of revenue in the three and six months ended June 30, 2005, respectively.

Prior to January 1, 2006, the Company was operated and managed as a single reporting unit. Amounts shown below for any period prior to January 1, 2006, are estimations prepared for comparative purposes only.

Table of Contents

	Three Months Ended June 30, 2006				Three Months Ended June 30, 2005			
	Email Encryption	e-Prescribing	Corporate	Total	Email Encryption	e-Prescribing	Corporate	Total
Revenues	$ 3,369,000	$ 840,000	$	$ 4,209,000	$ 2,434,000	$ 881,000	$ 134,000	$ 3,449,000
Cost of revenues	1,319,000	1,771,000		3,090,000	1,350,000	1,731,000	427,000	3,508,000
Gross margin (loss)	2,050,000	(931,000)		1,119,000	1,084,000	(850,000)	(293,000)	(59,000)
Direct expenses	2,897,000	2,745,000		5,642,000	3,059,000	2,273,000	240,000	5,572,000
Segment (loss)	(847,000)	(3,676,000)		(4,523,000)	(1,975,000)	(3,123,000)	(533,000)	(5,631,000)
Unallocated (expense) / income								
Marketing, general and administrative expense			(2,533,000)	(2,533,000)			(2,522,000)	(2,522,000)
Customer deposit forfeiture							960,000	960,000
Gain on derivatives			2,930,000	2,930,000				
Loss on extinguishment of debt			(871,000)	(871,000)				
Investment and other income			294,000	294,000			143,000	143,000
Interest expense			(477,000)	(477,000)			(1,996,000)	(1,996,000)
Total			(657,000)	(657,000)			(3,415,000)	(3,415,000)
Loss before income taxes	$ (847,000)	$ (3,676,000)	$ (657,000)	$ (5,180,000)	$ (1,975,000)	$ (3,123,000)	$ (3,948,000)	$ (9,046,000)

	Six Months Ended June 30, 2006				Six Months Ended June 30, 2005			
	Email Encryption	e-Prescribing	Corporate	Total	Email Encryption	e-Prescribing	Corporate	Total
Revenues	$ 6,702,000	$ 1,402,000	$	$ 8,104,000	$ 4,477,000	$ 1,714,000	$ 841,000	$ 7,032,000
Cost of revenues	2,785,000	3,680,000		6,465,000	2,664,000	3,531,000	1,204,000	7,399,000
Gross margin (loss)	3,917,000	(2,278,000)		1,639,000	1,813,000	(1,817,000)	(363,000)	(367,000)
Direct expenses	5,723,000	5,468,000		11,191,000	6,115,000	4,932,000	950,000	11,997,000

Segment (loss)	(1,806,000)	(7,746,000)		(9,552,000)	(4,302,000)	(6,749,000)	(1,313,000)	(12,364,000)
Unallocated (expense) / income								
Marketing, general and administrative expense			(5,171,000)	(5,171,000)			(5,574,000)	(5,574,000)
Gain of sales of product line							950,000	950,000
Customer deposit forfeiture			1,000,000	1,000,000			960,000	960,000
Gain on derivatives			2,930,000	2,930,000				
Loss on extinguishment of debt			(871,000)	(871,000)				
Investment and other income			511,000	511,000			286,000	286,000
Interest expense			(895,000)	(895,000)			(2,826,000)	(2,826,000)
Total			(2,496,000)	(2,496,000)			(6,204,000)	(6,204,000)
Loss before income taxes	$ (1,806,000)	$ (7,746,000)	$ (2,496,000)	$ (12,048,000)	$ (4,302,000)	$ (6,749,000)	$ (7,517,000)	$ (18,568,000)

Revenues from international customers and long-lived assets located outside of the United States are not material to the condensed consolidated financial statements.

As mentioned above, the Company does not allocate resources based on assets; however, for disclosure purposes total assets by segment are shown below. Assets reported under each segment include only those that provide a direct and exclusive benefit to that segment. Assets assigned to each segment include accounts receivable and related allowances, prepaid and other assets, certain property and equipment and related accumulated depreciation, goodwill, and intangible assets and related accumulated amortization. All other corporate and shared assets are recorded under Corporate.

	June 30, 2006				**December 31, 2005**			
	Email Encryption	**e-Prescribing**	**Corporate**	**Total**	**Email Encryption**	**e-Prescribing**	**Corporate**	**Total**
Total assets	$ 3,315,000	$ 1,240,000	$ 22,526,000	$ 27,081,000	$ 3,969,000	$ 1,436,000	$ 28,710,000	$ 34,115,000

5

5. Stock Options and Stock-based Employee Compensation

Below is a summary of common stock options outstanding at June 30, 2006:

	Authorized Shares	Options Outstanding	Options Vested	Available for Grant
Employee and Director Stock Option Plans:				
1990 Stock Option Plan	345,045	2,500	2,500	
1992 Stock Option Plan	450,000	65,666	65,666	
1995 Long-term Incentive Plan	1,825,000	1,340,000	948,333	
1996 Director s Stock Option Plan	225,000	60,000	60,000	
1999 Director s Stock Option Plan	975,000	826,153	770,625	
2001 Stock Option Plan	2,525,000	1,751,892	878,232	307,198
2001 Employee Stock Option Plan	300,000	215,770	172,311	40,683
2003 New Employee Stock Option Plan	500,000	463,000	344,233	37,000
2004 Stock Option Plan	3,200,000	1,767,795	553,785	1,432,205
2004 Director s Stock Option Plan	300,000	270,833	160,208	29,167
2006 Director s Stock Option Plan	750,000	194,190	16,183	555,810
Cook Employee Transferred Options	807,127	18,000	18,000	
Total employee and director stock option plans	12,202,172	6,975,799	3,990,076	2,402,063
Executive Stock Option Agreements:				
John A. Ryan, former Chairman and CEO	1,000,000	1,000,000	1,000,000	
Richard D. Spurr, Chairman, President and CEO	650,000	650,000	517,045	
Other executive stock option agreements	450,000	158,665	158,665	
Total executive stock option agreements	2,100,000	1,808,665	1,675,710	
Other stock option agreements	70,000	70,000	70,000	
Total	14,372,172	8,854,464	5,735,786	2,402,063

Under all of the Company s stock option plans, new shares are issued when options are exercised.

Employee and Director Stock Option Plans

The Company has non-qualified stock options outstanding to employees, directors, and third parties under various stock option plans. The exercise price of options granted under these plans are generally not less than the fair market value at the date of grant and, subject to termination of employment, generally expire ten years from the date of grant. Employee options generally vest in installments over three years. Option grants to employees, officers and directors frequently contain accelerated vesting provisions upon the occurrence of a change of control, as defined in the applicable option agreements. At June 30, 2006, 2,402,063 shares of common stock were available for future grants under the Company s stock option plans.

Cook Employee Transferred Options - During 2000 and 2001, David Cook, founder of the Company, reallocated vested options to acquire 807,127 shares of the Company s common stock to certain of the Company s employees and a director. These reallocated options have a five-year term and are fully vested. As of June 30, 2006, 18,000 options remain outstanding with an exercise price of $7.00 per share. Non-cash compensation expense of $16,815,000 was recognized over the vesting periods from 2000 to 2002, representing the intrinsic value of the reallocated options based upon the difference between the fair market value of the Company s common stock on the dates the options were reallocated and the respective option exercise prices.

Executive Stock Option Agreements:

John A. Ryan - In November 2001, Mr. John A. Ryan was appointed chairman, president and chief executive officer of the Company. Mr. Ryan received options to acquire 1,000,000 shares of ZixCorp common stock at an exercise price of $5.24 per share that became fully vested in November 2003, and all were still outstanding on June 30, 2006. Mr. Ryan resigned as Chief Executive Officer and Chairman of the Board in February and October 2005, respectively.

Richard D. Spurr - In January 2004, Mr. Richard D. Spurr was appointed president and chief operating officer of the Company. Mr. Spurr received options to acquire 650,000 shares of ZixCorp common stock at an exercise price of $10.80 per share. These options vested 25% in April 2004 and the remaining balance vests quarterly through January 2007 on a pro rata basis. The options automatically vest 100% in the event of a change in control of the Company. At June 30, 2006, all 650,000 options were still outstanding. Mr. Spurr was appointed Chief Executive Officer in March 2005, and Chairman of the Board in February 2006.

Other Executive Stock Option Agreements - In 2001 and 2002, options to purchases 450,000 shares of common stock were granted to key company executives. The options have exercise prices ranging from $4.96 to $5.25 and became fully vested in March 2005. At June 30, 2006, 158,665 options remain outstanding.

Other Stock Option Agreements:

From time to time the Company may grant stock options to consultants, contractors and other third parties for services provided to the Company. These options are expensed based on their fair values as calculated by using the Black-Scholes Option Pricing Model (BSOPM). At June 30, 2006, options outstanding to non-employees were 310,000, of which 240,000 were granted from employee or director stock option plans and the remaining 70,000 issued under other stock option agreements.

Accounting Treatment

On January 1, 2006, the Company adopted SFAS No. 123(R), *Share-Based Payment*, and has elected to use the modified prospective method, which requires the application of the accounting standard to all share-based awards issued on or after January 1,

Table of Contents

2006 and any outstanding share-based awards that were issued but not vested as of January 1, 2006. Accordingly, the condensed consolidated financial statements as of June 30, 2005, and for the three and six months then ended have not been restated to reflect the impact of SFAS 123(R).

For the three and six months ended June 30, 2006, the adoption of FAS 123(R) resulted in incremental stock-based compensation expense of $673,000 and $1,440,000, respectively. This amount includes (i) compensation expense related to stock options granted prior to January 1, 2006, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the pro-forma provisions of SFAS 123, and (ii) compensation expense for stock options granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). The incremental stock-based compensation expense caused loss before taxes and net loss to increase by $673,000 and $1,440,000 and the basic and diluted net loss per share to increase by $0.01 and $0.03 per share for the three and six months ended June 30, 2006, respectively.

For the three and six months ended June 30, 2006, the total stock-based compensation expense was recorded to the following line items of the Company s condensed consolidated statement of operations:

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Cost of revenues	$ 30,000	$ 63,000
Research and development expenses	26,000	58,000
Selling, general and administrative expenses	617,000	1,319,000
Stock-based compensation expense	$ 673,000	$ 1,440,000

There were no stock option exercises for the six months ended June 30, 2006; therefore, no excess tax benefits were recorded. A deferred tax asset totaling $547,000, resulting from stock-based compensation expense recognized in the first six months of 2006, was recorded and $518,000 of that total, which relates to stock option compensation costs for U.S. employees, was fully reserved as of June 30, 2006, because of the Company s historical net losses for its United States operations. The difference of $29,000, which relates to stock option compensation costs for Canadian employees, was recognized as an income tax benefit on the income statement for the period.

SFAS 123(R) requires the Company to calculate the pool of excess tax benefits, or the APIC (additional paid-in capital) pool, available as of January 1, 2006, to absorb tax deficiencies recognized in subsequent periods, assuming the Company had applied the provisions of the standard in prior periods. Pursuant to the provisions of FASB Staff Position 123R-3, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards,* the Company adopted the alternative method for determining the tax effects of share-based compensation, which among other things, provides a simplified method for estimating the beginning APIC pool balance.

Prior to the adoption of SFAS 123(R), the Company applied APB 25 to account for its stock-based awards. The following table details the effect on net income and earnings per share had compensation expense for employee stock-based awards been recorded in the in the three and six-month periods ended June 30, 2005, based on the fair value method under FAS 123:

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net loss, as reported	$ (8,915,000)	$ (18,487,000)
Deduct pro forma stock compensation expense computed under the fair value method	(1,601,000)	(3,362,000)
Pro forma net loss	$ (10,516,000)	$ (21,849,000)

Basic and diluted loss per common share:				
As reported	$	(0.28)	$	(0.57)
Pro forma	$	(0.32)	$	(0.68)

During the first quarter of 2006 and with shareholder approval, the Company extended the contract life of 306,143 options held by one former director. As a result of this modification, the Company recognized an additional compensation expense of $34,000 in the period.

As of June 30, 2006, there was $2,950,000 of total unrecognized stock based compensation related to non-vested share-based compensation awards granted under the stock option plans. This cost is expected to be recognized over a weighted average period of 1.13 years.

Table of Contents

The Company used the BSOPM to determine the fair value of option grants made during the first and second quarters of 2006 and 2005. The Company estimated the average holding period of vested options to be two years from the vesting period (1.6 years) for options granted before 2006, but used the simplified method per SEC Staff Accounting Bulletin No. 107, *Share Based Payment,* to calculate the estimated life of options granted to employees subsequent to December 31, 2005. The expected stock price volatility was calculated by averaging the historical volatility of the Company s common stock over the past six years. The following weighted average assumptions were applied in determining the fair value of options granted during the respective periods:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Risk-free interest rate	4.95%	3.45%	4.62%	3.22%
Expected option life	5.5 years	3.6 years	5.8 years	3.6 years
Expected stock price volatility	92.2%	95.1%	95.6%	97.3%
Expected dividend yield				
Fair value of options granted	$ 0.68	$ 2.03	$ 1.24	$ 2.47

Stock Option Activity

The following is a summary of all stock option transactions for the six months ended June 30, 2006:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2006	7,595,415	$ 7.03		
Granted at market price	15,000	$ 1.93		
Granted above market price	2,161,373	$ 2.87		
Cancelled or expired	(917,324)	$ 6.20		
Exercised		$		
Outstanding at June 30, 2006	8,854,464	$ 6.09	6.81	$
Options exercisable at June 30, 2006	5,735,786	$ 7.27	5.98	$

At June 30, 2006, the Company had no stock options outstanding in which the exercise price was lower than the market value of the Company s common stock. Therefore, the intrinsic value is zero on all options.

The weighted average grant-date fair value of options granted during the three and six months ended June 30, 2006 was $0.68 and $1.24, respectively. The weighted average grant-date fair value of options granted during the three and six months ended June 30, 2005 was $2.03 and $2.47, respectively. A significant factor in the difference between the 2006 and 2005 valuations is the Company s 2006 practice of granting options with exercise prices in excess of the market price of the Company s common stock on the date of grant. The total intrinsic value of options exercised during the three and six months ended June 30, 2006, and 2005, was not material in either period.

Common Stock Issued in Lieu of Cash

In the third quarter of 2003, the Company implemented a program whereby non-executive employees were paid certain incentive compensation, such as commissions, with Company common stock rather than cash. This program was authorized to grant 600,000 shares in-lieu of compensation. In May 2005, shareholders approved an additional 500,000 shares for this program, which was expanded to include executive incentive pay as well. In June 2006, shareholders approved an additional 500,000 shares for this program. At June 30, 2006, a total of 980,328 shares of common stock had been granted under the program. During the three and six months ended June 30, 2006, the

Company granted unrestricted shares of common stock of 8,739, and 103,459, respectively, under this program. The common stock granted under this program had a weighted average fair value of $1.19 per share and $1.78 per share for the three and six months ended June 30, 2006, respectively. The Company valued this stock at the fair value on the date of grant. For the three and six months ended June 30, 2006 and 2005, the Company incurred non-cash expense relating to common stock issue in lieu of cash consisting of the following:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2006	**2005**	**2006**	**2005**
Common stock issued to employees for compensation in lieu of cash	$	$ 243,000	$ 157,000	$ 243,000
Stock granted to third parties	10,000		30,000	
Total	$ 10,000	$ 243,000	$ 187,000	$ 243,000

8

Table of Contents

6. Supplemental Cash Flow Information

Supplemental cash flow information relating to interest, taxes and noncash activities:

	Six Months Ended June 30, 2006	2005
Cash paid for interest	$ 259,000	$ 298,000
Cash paid for income tax	$ 42,000	$ 294,000
Noncash investing and financing activities:		
Assets acquired on capital lease	$	$ 160,000
Issuance of note receivable relating to the sale of Message Inspector and Web Inspector product lines (Note 7)	$	$ 1,435,000
Revaluation of warrants resulting from restructure of convertible promissory notes payable (Note 12)	$	$ (375,000)
Accrued expenses relating to private placement of common stock (Note 13)	$ 94,000	$
Valuation of beneficial conversion, net of subsequent reversal (Note 12)	$ 94,000	$ 2,518,000
Accrued expenses related to fixed asset purchases	$ 40,000	$
Assets sold to customers as part of their subscription service	$ 19,000	$
Value of additional warrants issued (Note 12)	$ 130,000	$
Insurance premiums financed by short-term note payable	$	$ 84,000

7. Business Sales and Acquisitions

Sale of Dr. Chart, a product of MyDocOnline

On September 30, 2005, the Company sold the remaining MyDocOnline product (Dr. Chart) to MITEM. As consideration, the Company received $150,000 in cash paid immediately after closing, a promissory note with a principal amount of $550,000 payable by mid-August 2007, and a warrant exercisable for 400,000 shares of MITEM common stock. Additionally, subject to the conditions and limitations provided in the Asset Purchase Agreement, MITEM assumed all Dr. Chart customer contracts and obligations upon close of the sale, including net deferred revenues of approximately $739,000. Subsequent to the closing of the transaction, the promissory note was adjusted to a principal amount of $540,000 pursuant to the terms of the sales agreement. The note principal is due in six equal quarterly payments of $90,000 beginning May 15, 2006, and bears interest at a rate of 10% per annum.

As of the date of filing this report on Form 10Q, MITEM had not made any payments on the promissory note. The promissory note was fully reserved at the time of the sale and no value was assigned to the warrants received. Therefore, gains could be recorded in future periods should payments on the note receivable be received. The Company is working with MITEM to agree to revised payment terms of the note receivable; however, the outcome of the discussions and the eventual resolution of the note receivable is not known at this time.

The following summarizes the carrying amount of assets and liabilities that were sold to or assumed by MITEM upon the close of the transaction, the allocation of the goodwill to the Dr. Chart product, and resulting loss from the sale:

Net assets sold (liabilities transferred):	
Accounts receivable, net	$ 34,000
Equipment, net	37,000
Intangibles, net	575,000
Deferred revenue	(739,000)
Net	(93,000)
Goodwill	4,797,000
Net proceeds:	
Cash receivable	150,000
Note receivable, net	
Service obligation	(30,000)
Transaction fees	(167,000)
Net proceeds	(47,000)
Loss on sale of product line	$ (4,751,000)

Table of Contents

Revenues for the Dr. Chart product line were $125,000 and $195,000 for the three and six months ended June 30, 2005. Dr. Chart did not represent a separate component of the Company as its operations and cash flows were not sufficiently separated from the rest of the Company; consequently, its results of operations are included in income from operations in the consolidated statements of operations.

The Company also agreed to provide customary indemnification to MITEM for breaches of representations and warranties, covenants and other specified matters. The Company has evaluated this indemnification and determined that no accrual is necessary.

Sale of Web Inspector and Message Inspector Product Lines

On March 11, 2005, the Web Inspector and Message Inspector product lines, which were acquired in the Elron acquisition, were sold to CyberGuard Corporation for $3,244,000 net of transactions fees of $317,000, consisting of $2,126,000 in cash and a $1,500,000 note receivable with no stated interest rate. The note receivable was recorded at its present value of $1,435,000 using an imputed interest rate of 9%. This is estimated to approximate the rate which would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions. The resulting discount was amortized into interest income over the term of the note. CyberGuard paid the note in full in 2005.

The following summarizes the carrying amount of assets and liabilities that were sold to or assumed by CyberGuard upon the close of the transaction, the allocation of the goodwill associated with the portion of the email encryption reporting unit being sold, and the resulting gain from the sale:

Net assets sold (liabilities transferred):	
Equipment, net	$ 15,000
Prepaid expenses	165,000
Intangibles, net	1,499,000
Initial deferred revenue	(1,546,000)
Net	133,000
Goodwill	2,161,000
Net proceeds:	
Cash	2,126,000
Note receivable, net	1,435,000
Transaction fees	(317,000)
Net proceeds	3,244,000
Gain on sale of product lines	$ 950,000

In the quarter ended September 30, 2005, the Company agreed to transfer an additional $85,000 of deferred revenue to CyberGuard resulting in a total gain on the sale of MI/WI of $1,035,000 for the year ended December 31, 2005.

Revenues for the MI/WI product lines were $9,000 and $646,000 for the three and six months ended June 30, 2005. MI/WI did not represent a separate component of the Company as its operations and cash flows were not sufficiently separated from the rest of the Company; consequently, their results of operations are included in income from operations in the consolidated statements of operations.

The Company also agreed to provide customary indemnification to CyberGuard for breaches of representations and warranties, covenants and other specified matters. The Company has evaluated this indemnification and determined that no accrual is necessary.

8. Restricted Cash

Current and noncurrent restricted cash of $5,135,000 at December 31, 2005, relates primarily to a debt covenant on the convertible promissory note payable requiring the Company to maintain a minimum of $5,000,000 on deposit.

This note was retired in June 2006 using the restricted cash balance (see Note 12). The remaining noncurrent restricted cash balance at June 30, 2006, of $35,000 relates to a Letter of Credit given as a security deposit on one of the Company s office leases.

9. Accounts Receivable

	June 30, 2006	December 31, 2005
Gross trade accounts receivable	$ 3,882,000	$ 3,136,000
Allowance for returns and doubtful accounts	(89,000)	(35,000)
Billed but unpaid portion of deferred revenue	(3,596,000)	(2,969,000)
Trade receivables, net	197,000	132,000
Taxes receivable	301,000	
Other receivable	11,000	17,000
Total receivables, net	$ 509,000	$ 149,000

The above Billed but unpaid portion of deferred revenue is a reduction for future customer service or maintenance obligations which are invoiced but unpaid as of the respective balance sheet dates. Deferred revenue in current and long-term liabilities represents future customer service or maintenance obligations which have been billed and collected as of the respective balance sheet dates.

No single customer accounted for 10% or more of gross trade accounts receivable at June 30, 2006 or December 31, 2005.

10. Intangible Assets and Goodwill

At June 30, 2006, the Company s intangible assets, all of which are subject to amortization, were comprised of developed technology, which resulted from the third quarter 2003 acquisition of PocketScript and the first quarter 2004 acquisition of MyDocOnline.

	June 30, 2006			December 31, 2005		
	Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Developed technology	$ 2,034,000	$ 1,835,000	$ 199,000	$ 2,034,000	$ 1,475,000	$ 559,000

The weighted average useful life for developed technology is three years as of June 30, 2006 and 2005. Amortization expense relating to intangible assets totaled $180,000 and $360,000 for the three and six months ended June 30, 2006, and $288,000 and $732,000 for the three and six months ended June 30, 2005, respectively.

The expected future intangible amortization expense is as follows:

Six months ended December 31, 2006	$ 176,000
2007	23,000