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IMAGE SOFTWARE INC
Form 10-K
March 30, 2004

FORM 10-K
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

- (X) ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934. For the fiscal year ended 12/31/2003
- OR
- () TRANSITION REPORT PURSUANT TO SECTION 13 OF 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934. For the transition period from _____ to _____.

IMAGE SOFTWARE, INC.

(Exact name of Registrant as specified in its charter)
0-12535
(Commission File Number)

COLORADO

(State of Incorporation)

84-0866294

(IRS Employer Identification Number)

6025 S. QUEBEC ST. #300 - ENGLEWOOD CO 80111

(Address of principal executive offices)

(303) 694-9180

(Registrant's telephone number, including area code)

Securities Registered Pursuant to Section 12(b) of the Act:

NONE

(Title of Class)

NONE

(Name of Exchange)

Securities Registered Pursuant to Section 12(g) of the Act:

COMMON STOCK - \$.004 PAR VALUE

(Title of Class)

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 X No

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes . No

State the aggregate market value of the voting and nonvoting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of March 15, 2004: \$1,698,901.

As of March 15, 2004, there were 3,287,597 shares of the Registrant's Common Stock outstanding.

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Certain information required by Part III of this report (Items 10, 11, 12, 13 and 14) is incorporated by reference from the Registrant's proxy statement relating to the Registrant's 2004 Annual Meeting of shareholders.

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PART I

ITEM 1. BUSINESS

INTRODUCTION

Image Software, Inc., (the "Company") develops and markets computer-based document imaging systems that capture, store and display electronic files and paper documents as graphical images. Document management systems like IMAGE(R) (pronounced "one image") offer organizations of every size the ability to deliver the information embedded in millions of documents to their workers across their existing computing infrastructure, as well as the tools to efficiently manage the proliferation of digital documents for eBusiness deployment. The modular IMAGE system captures entire documents from a variety of sources. Memos, letters, source documents, contracts, purchase orders, word processing files, e-mail, fax, industry and market studies, spreadsheets, databases, multimedia, maps and regulatory forms are examples of documents that are automatically converted into secure, permanent digital images that are indexed for instantaneous retrieval. Using an open, client/server architecture design, IMAGE provides a comprehensive solution for scanning, indexing, storing and retrieving document images so that they may be viewed, printed, faxed, e-mailed or made available for eBusiness or eCommerce applications. The IMAGE system is designed to integrate easily with existing IT infrastructure, using an extensive library of multi-platform APIs (Application Programming Interfaces), rather than forcing expensive investments in re-engineered or new computing hardware and software.

Today's workplace is dramatically changing with the advent of eBusiness, eCommerce, and affordable electronic document imaging. During 2003, the Company concentrated its efforts on selling document imaging software to its niche markets. This market includes users that prefer a choice of (1) operating platforms, such as RedHat Linux, Windows, and Unix, or (2) application software developers that wish to offer a document imaging solution as part of their portfolio. The Company also continued to make progress toward its goal of establishing a broad-based Value Added Reseller ("VAR") network for its imaging software. In addition to VARs, the Company seeks to partner with software developers, consultants, and other businesses, which provide software to their targeted vertical markets.

IMAGING SOFTWARE MARKET

The Company markets its products through its direct sales force and its indirect channel partners. The Company targets VARs, systems integrators, developers, consultants, and other companies that market complementary software, services, or other products. IMAGE software has an established presence in a multitude of industries, including retail, distribution, education, state and local government, healthcare, manufacturing, energy, automotive, public safety, transportation and utilities.

The Company offers a comprehensive reseller program, which provides, in the context of a cooperative marketing effort, a broad range of sales, marketing, and technical support. The program includes technical training and assistance, marketing communications, sales training and assistance, excellent support and training, lead referral services, customized product literature, and a discounted demonstration/development system.

PRODUCTS

As noted above, the Company's flagship product is IMAGE(R), its proprietary document imaging software package. The Company is continually enhancing this product in order to improve its performance and expand its

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possible uses.

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IMAGE(R) DOCUMENT MANAGEMENT - IMAGE is a powerful electronic image management system created to operate the same on Linux, Windows(TM) and Unix-based computer systems. It provides a comprehensive solution for the scanning, indexing, storage and retrieval of images and is designed to file, route, track, archive, and manage an organization's incoming and outgoing documents and electronic files.

Additional products include the following:

- o 1API for image-enabling an application using a toolkit
- o 1SCAN for scanning, pre-indexing, and bar code reading
- o 1FAX for inbound and outbound fax or e-mail and cover sheet management
- o 1COLD/ERM for storing computer-generated formatted data
- o 1FORM for business form template administration
- o 1RENDITION for merging spooled data with supporting images for billing or other needs
- o 1WORKFLOW for electronically moving a document from one task to another
- o 1OCR/OMR for automatic indexing and data capture via optical and mark character recognition
- o 1SUITE for bringing images to Windows-based PC clients
- o 1SERVER for accessing documents via the Internet
- o 1VIEW for using standard browsers to access images over the Intranet and Internet
- o 1APPROVE for electronically approving invoices and other document related business functions
- o 1ACCESS for bringing images to computers that support JAVA programming languages
- o 1SEARCH for full text/keyword retrieval of documents
- o 1PUBLISH for selecting and recording images on output media such as CD or DVD

A key element of the Company's product line is its open systems technology, namely:

- o Open Systems compliant with Linux, Unix, and Windows Operating Systems. Supports file formats in TIFF, JPEG, PCX, PCL, PDF, HTML or HPGL. The server software (1IMAGE) operates on Linux, Unix, and Windows servers. Supporting clients include Microsoft Windows, X-Windows, ASCII, JAVA and browser clients
- o Device connectivity via Ethernet or token ring networks using TCP/IP communication protocol or over the Internet
- o Compatibility with IBM AIX, HP-UX, Sun Solaris, SCO Unix, RedHat Linux and Windows
- o Recognition technology and scanning tasks run on Microsoft Windows
- o UniVerse and UniData ("U2") Relational Database software from IBM

1IMAGE includes several distinguishing features: the ability to use many different types of workstations, the ability to quickly and easily integrate with the existing business application software using application programming interfaces ("APIs"), and the scalability to handle the needs of companies of all sizes economically. Through the use of the Linux, Unix, and Windows operating systems and open systems technology, the Company seeks to offer its customers an imaging solution at a reasonable cost. Because 1IMAGE is a server-based product, the Linux operating system ("O/S") has become very popular with end users of the Company's software. In 2003, the majority of imaging systems sold through the direct sales force were installed on servers running the Linux O/S.

During 2003, sales of 1IMAGE software licenses (excluding annual license fees) accounted for \$815,000 (39% of total revenue); in 2002, revenue from sales

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of software licenses accounted for \$765,000 (34% of total revenue). IMAGE utilizes the Linux, Unix, and Windows operating systems and IBM's U2 database software. The Company's open systems technology makes its software transportable to numerous hardware products from varying manufacturers. Because of the number of hardware manufacturers using the Linux, Unix, and Windows operating systems, the Company's software customers are rarely restricted in their choice of hardware manufacturers.

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The Company also recommends hardware and related products and sells specialized complex peripheral products, such as high-end scanners, at the customer's request. Computer hardware and peripheral products are purchased only upon request to fill specific customer orders, no inventory is maintained. Hardware is generally shipped directly from the manufacturer to the customer. In 2003, revenue from hardware sales accounted for \$205,000 (10%) of the Company's total revenue, as compared to \$181,000 (7%) for 2002.

SERVICES AND ANNUAL FEES

The Company licenses its IMAGE software to its customers and charges an annual license and maintenance fee, which must be paid to continue receiving support for the use of the software. During 2003 and 2002, annual license fees accounted for \$786,000 (37%) and \$978,000 (44%), respectively, of the Company's net sales. The Company believes recurring annual license fees from new and existing customers will contribute to the long-term stability of the Company. The Company also provides professional services to its customers. These services include preparation of image management plans ("IMP"), installation, training, image enabling existing software, and consulting services for customers. For the years ended December 31, 2003 and 2002, the revenues from these services accounted for \$299,000 (14%), and \$318,000 (14%), of the Company's net sales. The Company does not provide service for hardware; rather, service for computer hardware sold by the Company is provided directly by the manufacturer or the manufacturer's authorized dealer.

MARKETING AND DISTRIBUTION

To date, the Company has signed VAR agreements for IMAGE with resellers specializing in a variety of industries, including health care, construction, collection services, and distribution/manufacturing. In addition, the Company licenses its software and certain other products and services through agreements with an Application Service Provider (ASP) in the healthcare industry. The Company sells its software to independent software integrators (resellers), who in turn market products, including or featuring IMAGE, to each of their individual markets. The Company's overall marketing objective is to support the current business partners and to continue to enroll new software integrators and consultants in the program. The Company provides training aids, an Internet demonstration site, user instruction manuals and other documentation, and a newsletter to keep its resellers, as well as prospective resellers and customers, informed of new product applications and developments.

The Company also markets IMAGE through its direct sales force. The general strategy is to (1) help customers define the goals for their system, (2) provide the means of achieving those goals through our document management software and appropriately configured computer systems, and (3) help assure the ongoing success of this collaborative process by providing continuing support, including on-site training and educational programs. The Company also markets its products and services over the Internet on its website at www.limage.com.

CUSTOMERS

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The Company sells its IMAGE software to businesses in a wide variety of industries and markets, facilitated through the use of VARs and its direct sales force.

During the years 2003 and 2002, the Company generated .1% and 20%, respectively, of its revenue from one customer, Reynolds & Reynolds ("Reynolds"). Reynolds is a Fortune 500 company headquartered in Dayton, Ohio. In May 1994, the Company signed a software license agreement with Reynolds for the exclusive right to sublicense certain modules of IMAGE (without payment of further license fees to the Company) to businesses primarily engaged in retail sales of new or used automobiles, trucks, or tractors. In 1996, the Company signed a subscription

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and maintenance agreement with Reynolds. Under that agreement, fees are to be paid to the Company for certain products, including but not limited to the Company's desktop client software.

On January 18, 2002, Reynolds notified the Company of its intent to terminate the 1996 subscription and maintenance agreement effective April 22, 2002. Reynolds had installed the IMAGE document management software in approximately 1,000 of its customer sites in the United States and Canada. As a result of various disputes arising out of the termination of the 1996 agreement, including Reynolds' decision to continue sublicensing the Company's software notwithstanding such termination, the Company and Reynolds are currently involved in litigation. (See "Legal Proceedings".) While it is conceivable that the Company could enter into new agreements with Reynolds to govern future-licensing arrangements, as of the date hereof, no such new agreement is planned or likely. The loss of Reynolds as a customer has already had a significantly adverse impact on the Company. (See "Management's Discussion and Analysis of Results of Operations and Financial Condition".) While the Company has now nearly replaced the bulk of the revenue lost as a result of the wrongful termination of the 1996 contract by Reynolds and Reynolds' subsequent actions the Company's opportunity for growth has been severely damaged. It is possible that some portion of the revenue lost by the Company will be awarded to the Company in the ongoing litigation between the Company and Reynolds. Naturally, the Company cannot predict the outcome of that litigation nor can there be any assurance that the Company will ever obtain a meaningful recovery from Reynolds.

SOURCES OF SUPPLY

The Company has an OEM Software Agreement with IBM Corp. to sublicense their UniVerse and UniData database programs. The agreement authorizes the Company to include certain IBM database programs as part of their imaging solution. This agreement currently runs until September 28, 2004 and it may be renewed for additional one (1) year terms. The Company has designed its product such that, through the use of its Application Program Interfaces ("API"s), third party software can be easily integrated into the core products with minimal difficulty and effort.

POSSIBLE FLUCTUATIONS IN OPERATING RESULTS

The Company's sales cycle, which generally commences at the time a prospective customer issues a request for proposal or otherwise demonstrates a serious interest in purchasing a system or software license and ends upon execution of a sales contract, is lengthy and not predictable with any degree of certainty. Prior sales and implementation cycles are not necessarily an indication of future cycles. Operating results could vary from period to period

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as a result of the length of the sales cycle, the timing of individual system sales, resellers' performance and conditions in the target markets and the economy in general.

It has been the Company's expectation that its recent focus on offering its proprietary imaging software to a broader range of customers, through its reseller network and its direct sales force, would lessen the historical quarterly fluctuations in the Company's operating results. Unfortunately, larger events, such as Reynolds's termination of the 1996 contract and subsequent actions, as well as the downturn in the national economy, especially in the technology sector, have continued to cause significant variations in those results. In addition, large volume sales or groups of sales of IMAGE licenses may cause significant variances in quarterly results that may be difficult to predict.

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TRADE SECRET AND COPYRIGHT LAWS

The Company regards its software as proprietary and relies for protection upon trade secret and copyright laws and non-disclosure agreements with its employees as well as restrictions on disclosure and transferability contained in its software license agreements with its customers. Despite these restrictions, it may be possible for competitors or customers to copy, or reverse compile, aspects of the Company's products or obtain information that the Company regards as proprietary. Furthermore, there can be no assurance that others will not independently develop software products similar to those developed or planned by the Company.

Although the Company believes its software does not infringe on the proprietary rights of others and has not received any notice of claimed infringement, it is possible that portions of the software marketed by the Company could be claimed to infringe on existing proprietary rights. In the unlikely event that any such infringements are found to exist, there can be no assurance that any necessary licenses or rights could be obtained, or could be obtained on terms satisfactory to the Company. Further, in such event, the Company could be required to modify the infringing software. There can be no assurance that the Company would be able to do so in a timely manner, upon acceptable terms and conditions, or at all; even though the failure to do so could have a material adverse effect on the Company.

The Company has brought suit against Reynolds & Reynolds for, among other things, copyright infringement. (See "Legal Proceedings".)

BACKLOG

As a practical matter, the Company's business has evolved to the point where the Company has minimal backlog at any given point in time. With respect to software license sales, because there is no significant time delay between receipt of an order and delivery of the software, electronically or otherwise, there is effectively no backlog. For hardware, because of direct delivery of the hardware by the manufacturer, hardware sales have such short lead times that unfilled firm orders seldom, if ever, build up to significant levels.

The Company normally receives a deposit of between 25% and 50% of the hardware and software price when an order is placed. This deposit may or may not be returned upon cancellation, depending on the circumstances of the cancellation.

COMPETITION

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The Company experiences intense competition in its business from competitors who target one or more of the same markets or market segments as the Company. Software and systems that perform many of the same functions as the Company's systems and software are also available from a number of competitors of the Company. Some of these competitors are larger and have longer operating histories, significantly greater financial, technical, marketing and other resources, significantly greater name recognition and a larger installed base than we do. As a result, these competitors may be able to respond more quickly to emerging technologies and changes in customer requirements, or to devote greater resources to the development, promotion and sale of their products than we can.

The Company believes that usage of the popular Linux and Windows operating systems and the IBM U2 databases has strengthened the Company's competitive position by making the Company's software compatible with more types of hardware and with the IBM U2 application software offered by software developers and system integrators. The Company further believes that its principal advantage over its competitors is the Company's ability

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to give its customers a choice in selecting a Linux, Unix, or Windows-based open systems architecture and the IBM U2 database that can be offered at lower prices.

LIMITED MARKETS

The Company's reseller program targets complementary markets and allows the Company to draw from a variety of industries with respect to its imaging software products. As noted above, the Company's strategy has been to expand the domestic and international markets for its imaging software by engaging resellers for various industries and markets.

The Company's experience has been that economic downturns or increased competitive pressures in its niche markets sometimes result in reduction or deferral of capital expenditures by potential customers. Certain adverse conditions can sometimes lead to opportunities as potential customers downsize to smaller, more cost-efficient computer systems or replace custom designed systems that require higher levels of support and maintenance.

PRODUCT DEVELOPMENT

The software and services market in which we compete is characterized by (1) rapid technological change, (2) frequent introduction of new products and enhancements, and (3) changing customer needs. Our future success depends on our ability to support existing products and develop new products. The Company capitalizes software development costs once technological feasibility is established. During 2003, the Company developed a new release of IMAGE(C) which employs new technologies, including Application Service Provider (ASP) requirements and two JAVA systems (i.e. IAPPROVE and IACCESS) which will operate on most platforms. In addition, improvements were made to the hardware/software compatibility offerings available for Linux users. During 2003 and 2002, the Company spent \$261,000 and \$297,000, respectively, for computer software development.

EMPLOYEES

As of February 28, 2004, the Company employed twenty-one persons, twenty of whom serve on a full-time basis and one on a part-time basis.

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Responsibilities are divided as follows: eight persons in sales and marketing, ten in technical support and programming functions, and three in administrative positions.

The Company provides incentive compensation packages to many of its employees, including its executive officers. The Company's chief executive officer, David R. DeYoung, receives a quarterly bonus equal to 5% of the Company's pretax profits. The Company's chief financial officer receives a quarterly bonus equal to 4% of the Company's pretax profits. Sales personnel receive a commission based upon sales. The Company has a policy of encouraging the effort and loyalty of all of its employees by making all employees eligible for the grant of stock options under its Equity Incentive Plan, subject to vesting schedules. The Company believes that these incentive programs are important in attracting and retaining skilled personnel. The future success of the Company will depend in large part upon the quality of its employees and the efforts they expend on behalf of the Company.

None of the Company's employees are represented by a labor union, and the Company has experienced no work stoppage. The Company believes that its employee relations are good.

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ITEM 2. PROPERTIES

The Company's executive offices consist of approximately 5,464 square feet at Plaza Quebec, 6025 South Quebec Street, Suite 300, Englewood, Colorado, 80111 and are occupied pursuant to a lease agreement between the Company and Trammel Crow, Inc. with monthly rental payments of \$5,226, initially, and scaling to \$7,741 by the end of the lease term. The term of the lease commenced May 1, 2003 and will terminate on August 31, 2008. The landlord is responsible for property taxes, utilities, janitorial services, repairs, and maintenance. The Company believes that its facilities and equipment are in good condition and are satisfactory for their present uses.

ITEM 3. LEGAL PROCEEDINGS

On June 21, 2002, the Company filed a civil action seeking monies owed by The Reynolds and Reynolds Company under its 1996 subscription and maintenance agreement with the Company in the District Court for the City and County of Denver, Colorado, IMAGE SOFTWARE, INC. V. THE REYNOLDS AND REYNOLDS CO. Case No.: 02-CV-4701 ("the "Collection Action"). In its complaint in the Collection Action, the Company demands immediate payment of \$193,611 currently due under that contract plus interest and costs. Reynolds deposited the \$193,611 with the court clerk, pending order of the court as to its disposition and has filed an answer denying liability. The Company filed a Motion for Summary Judgment to which Reynolds has responded, denying liability and stating that in all events, the amount due is \$166,741. The Court then referred the matter to arbitration which is pending (see below).

A lawsuit was filed by the Company in the United States District Court for the District of Colorado, IMAGE SOFTWARE, INC. V. THE REYNOLDS AND REYNOLDS CO., ET AL., No. 02-K-1688 (OES), (the "Infringement Action"), in which Image is seeking damages for copyright infringement resulting from continuing use of Image software without any license or authority by Reynolds and Reynolds and approximately 1,000 automobile dealers throughout the United States. The Infringement Action has now been referred to arbitration, along with the Collection Action, which arbitration is pending. In the arbitration, Reynolds has asserted a counterclaim for \$580,000, alleging that Image, without justification or privilege, advised customers and/or prospects of Reynolds that

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Reynolds no longer had a license to distribute Image software. Image does contend that Reynolds has no such rights but denies it improperly informed Reynolds' dealers. To Image's knowledge, no dealer has terminated its relationship with Reynolds because of the licensing dispute.

The arbitration is scheduled for hearing commencing on May 24, 2004 for one week in Cleveland, Ohio, at which time a determination whether Reynolds has any perpetual license will be made. In the event it is found that Reynolds has no license, Image seeks to recover as damages all profits earned by Reynolds and Reynolds as a result of infringing use of its software, as provided by the Copyright Infringement Act of 1976, which profits are believed to be substantial. In any event, Image will seek an award for amounts now due under the 1996 agreement, as described above. The damages hearing is scheduled to commence October 11, 2004.

The Company cannot predict the results of any litigation or arbitration with Reynolds but the burden imposed by these legal proceedings, including the direct and indirect costs and the diversion of the Company's other limited resources, may continue to have an adverse effect on the Company's results of operations. This burden may prove to be material to the Company's financial condition or results of operation in future reporting periods. It is also possible, however, that the litigation could result in a substantial judgment in favor of the Company, or a significant settlement, which could positively affect the Company's financial condition. (See "Management's Discussion and Analysis of Financial Condition and Results of Operations".)

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

The Company did not submit any matters to a vote of security holders through the solicitation of proxies or otherwise during the fourth quarter of the Company's calendar year ended December 31, 2003.

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PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

MARKET INFORMATION

The Company's Common Stock is quoted in the OTC Bulletin Board under the symbol ISOL. The following table sets forth, for the fiscal quarters indicated, the high and low bid prices per share for the Common Stock as reported on the OTC Bulletin Board.

| | 2003 | |
|----------------|---------|---------|
| | High | Low |
| First Quarter | \$ 0.51 | \$ 0.23 |
| Second Quarter | 0.56 | 0.21 |
| Third Quarter | 0.40 | 0.21 |

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| | | |
|----------------|---------|---------|
| Fourth Quarter | 0.55 | 0.25 |
| 2002 | | |
| | High | Low |
| First Quarter | \$ 0.80 | \$ 0.54 |
| Second Quarter | 0.66 | 0.30 |
| Third Quarter | 0.48 | 0.30 |
| Fourth Quarter | 1.00 | 0.35 |

These quotations reflect interdealer prices, without retail mark-up, mark down or commission and may not necessarily represent actual transactions.

On February 27, 2004, the closing bid price per share for the Common Stock was \$.85 as reported on OTCBB. On that same date, there were approximately 985 holders of record of the Common Stock.

DIVIDENDS

The Company has never declared or paid cash dividends on its Common Stock and has no present intention to do so. For the foreseeable future, any earnings will be retained to finance the development and expansion of the Company's business. The declaration and payment of future dividends will be determined by the Company's Board of Directors in light of conditions then existing, including the Company's earnings, financial condition and capital requirements.

ISSUER REPURCHASES OF REGISTERED EQUITY SECURITIES

There were no shares repurchased during the fourth quarter of 2003.

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ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth, for the periods indicated, selected financial data of the Company. This table should be read in conjunction with the financial statements and notes included in Item 8 of this Form 10-K and the section entitled "Management's Discussion and Analysis of Results of Operations and Financial Condition" following this section.

| Statements of Operations | Years Ended December 31, | | | | |
|--|--------------------------|---------|---------|---------|---------|
| In thousands, except for per share data: | 2003 | 2002 | 2001 | 2000 | 1999 |
| Net Sales | \$2,104 | \$2,242 | \$2,776 | \$2,163 | \$1,806 |
| Cost of Sales | 915 | 1,153 | 1,109 | 934 | 987 |
| Gross Profit | 1,189 | 1,089 | 1,667 | 1,229 | 819 |
| Gross Profit (as a % of Net Sales) | 57% | 49% | 60% | 57% | 45% |
| Selling, General & Administrative expenses | 1,215 | 1,365 | 1,500 | 1,211 | 1,163 |

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| | | | | | |
|---|-------|-------|-------|-------|-------|
| Income (Loss) before Income Taxes | 86 | (282) | 161 | 11 | (365) |
| Net Income (Loss) | 96 | (282) | 211 | 8 | (367) |
| Net Income (Loss) Per Share | .03 | (.09) | .07 | .00 | (.16) |
| Weighted Average Number of Outstanding Shares | 3,237 | 3,146 | 3,146 | 3,056 | 2,330 |

| Balance Sheets | Years Ended December 31, | | | | |
|---------------------------|--------------------------|-------|--------|--------|---------|
| In thousands: | 2003 | 2002 | 2001 | 2000 | 1999 |
| Working Capital/(Deficit) | \$ 175 | \$ 28 | \$ 140 | \$(93) | \$(186) |
| Total Assets | 1,674 | 1,562 | 1,496 | 1,428 | 1,364 |
| Long Term Obligations | 201 | 207 | 1 | 3 | 1 |
| Total Stockholders Equity | 789 | 643 | 925 | 714 | 654 |

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

CRITICAL ACCOUNTING POLICIES

In preparing financial statements, management must make estimates and judgments that effect the carrying values of the Company's assets and liabilities as well as recognition of revenue and expenses. Management's estimates and judgments are based on the Company's historical experience and management's knowledge and understanding of current facts and circumstances. The policy discussed below is considered by management to be critical to an understanding of the Company's financial statements. The application of this policy places significant demands on management's judgment, with financial reporting results relying on estimations about the effect of the matter that is inherently uncertain. For this policy, management cautions that future events rarely develop as a forecast, and estimates routinely require adjustment and may require material adjustment. There have been no significant changes in critical accounting policies in the past year.

Software Development Costs are capitalized when technological feasibility is established. Such costs are stated at the lower of unamortized cost or net realizable value. Amortization is computed using either the straight-line method based on estimated economic lives of the products (five years) or the ratio that current product revenues bear to the total of current and anticipated future product revenues, whichever is greater. It is reasonably possible that those estimates of anticipated future gross revenues, the remaining estimated economic life of the products, or both will be reduced significantly in the near term due to competitive pressure. As a result, the carrying amount of the capitalized software costs may be reduced materially in the near term. The net realizable value of such capitalized costs is reviewed by management on a periodic basis, and costs in excess of net realizable value, if any, are charged to operations.

OVERVIEW

Management believes that sales for the first three quarters of 2003 were negatively affected by the general economic slowdown in the technology sector.

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On the other hand, fourth quarter revenue increased 64% over the year earlier corresponding quarter, which may signal the beginning of a rebound for this type of business. Because our customers typically make a discretionary decision to implement our products based upon their individual resources and budget constraints, however, it is possible that the fourth quarter 2003 improvement in sales will ultimately prove to be a one-time or seasonal event that is not carried into future periods. Moreover, as a small company which receives only a few relatively large orders in a given quarter, the loss or delay of individual orders could have a significant impact on quarterly operating results and revenue. Thus, discerning trends in the Company's performance is especially difficult. While interest in the Company's products remains relatively strong, there can be no assurance that the Company's software sales for the first quarter of 2004 will keep pace with the fourth quarter of 2003. The Company believes that, with revenues from operations and its lines of credit with U.S. Bank and DEMALE, LLC, it has sufficient resources to fund its operations for the foreseeable future without a significant infusion of capital. Naturally, however, considering the Company's size and the tumultuous political and financial events of the past few years, there can be no assurance that the Company will continue to generate sufficient cash from these sources or that, if the Company does seek additional capital, any such capital will be made available to it.

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RESULTS OF OPERATIONS

YEAR ENDED DECEMBER 31, 2003 COMPARED TO YEAR ENDED DECEMBER 31, 2002

The Company's total revenue was \$2.1 million for the year ended December 31, 2003, compared to \$2.2 million for the year ended December 31, 2002, representing a decrease of \$138,000 (6%). The Company's revenue decreased \$428,000 as a result of the loss of the Company's largest customer, Reynolds and Reynolds, during the year as total revenue from Reynolds declined from \$441,000 to \$13,000. The Company does not anticipate any significant revenue from Reynolds in 2004.

The Company's revenue is derived from four sources: software licenses, annual maintenance/license fees, consulting services, and hardware sales.

In 2003, software license revenue increased 6%, or \$49,000 from 2002 levels, of which a decrease of \$121,000 was attributable to the loss of this single customer. Without the loss of this large customer, software license revenue would have increased \$170,000. Annual license fees decreased 20%, or \$192,000 of which a decrease of \$307,000 was attributable to the loss of business from this large customer. Without the loss of this large customer, annual license fees would have increased \$115,000. The professional service group's revenue decreased by \$20,000 (6%) for the year primarily due to decreased consulting programming services provided due to the timing of year-end contracts. Hardware sales of \$205,000 increased \$24,000 (13%) over \$181,000 for 2002.

Gross profit on revenue for the year ended 2003 was 57%, as compared to 49% for 2002, primarily due to the increase in software sales. In 2003, selling, general and administrative expenses decreased \$151,000 (11%) due to tight expense controls across all departments of the Company. In addition, during 2003, the Company settled a payable of \$138,000 that was due to a vendor in connection with a software purchase for an earlier period. For the year ended December 31, 2003, the Company reported net income of \$96,000 or \$.03 per share, an improvement of \$378,000 over a net loss of \$282,000 or \$(-.09) per share for the previous year.

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See the discussion of the effect of the loss of Reynolds and Reynolds in "Liquidity and Capital Resources" below.

| | Year Ended 12/31/03 | Year Ended 12/31/02 | Increase/ (Decrease) \$ | Increase/ (Decrease) % |
|----------------------------|------------------------|------------------------|-------------------------------|------------------------------|
| Revenue, as reported | \$ 2,104,367 | \$ 2,242,089 | \$ (137,722) | (6%) |
| Less: Reynolds Revenue | 13,318 | 441,152 | (427,834) | (97%) |
| Revenue excluding Reynolds | \$ 2,091,049 | \$ 1,800,937 | \$ 290,112 | 16% |

YEAR ENDED DECEMBER 31, 2002 COMPARED TO YEAR ENDED DECEMBER 31, 2001.

The Company's total revenue was \$2.2 million for the year ended December 31, 2002 compared to \$2.8 million for the year ended December 31, 2001, representing a decrease of \$534,000 (19%). The Company's revenue decreased \$547,000 as a result of the loss of the Company's largest customer, Reynolds and Reynolds, during the year as total revenue from Reynolds declined from \$988,000 to \$441,000. In addition, continued slow economic conditions worldwide, particularly in the technology sector contributed to slower than anticipated revenue growth.

The Company's revenue is derived from four sources: software licenses, annual maintenance/license fees, consulting services, and hardware sales.

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In 2002, software license revenue decreased 35%, or \$391,000, from 2001 levels, of which \$301,000 was attributable to the loss of this single customer. Annual license fees decreased 15%, or \$167,000, of which a decrease of \$223,000 was attributable to the loss of business from this large customer. Without the loss of this large customer, annual license fees would have increased \$56,000. The professional service group's revenue decreased by \$89,000 (22%) for the year primarily due to decreased consulting/programming services provided to existing customers. Hardware sales of \$181,000 increased \$113,000 (168%) over \$68,000 for 2001.

Gross profit on revenue for the year 2002 was 49%, as compared to 60% for 2001, primarily due to the decrease in software license revenue. In 2002, selling, general and administrative expenses decreased \$135,000 (9%). This decrease resulted from tight expense controls throughout the Company; offset by a \$94,000 increase in legal fees as a result of the legal proceedings with Reynolds. For the year ended December 31, 2002 the Company reported a net loss of \$282,000, or \$.09 per share, as compared to net income of \$211,000, or \$.07 per share, for the previous year.

See the discussion of the effect of the loss of Reynolds and Reynolds in "Liquidity and Capital Resources" below.

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| | Year Ended 12/31/02 | Year Ended 12/31/01 | Increase/ (Decrease) | Increase/ (Decrease) |
|----------------------------|------------------------|------------------------|-------------------------|-------------------------|
| | | | \$ | % |
| Revenue, as reported | \$ 2,242,089 | \$ 2,775,931 | \$ (533,842) | (19%) |
| Less: Reynolds Revenue | 441,152 | 988,649 | (547,497) | (55%) |
| Revenue excluding Reynolds | \$ 1,800,937 | 1,787,282 | 13,655 | (1%) |

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LIQUIDITY AND CAPITAL RESOURCES

The Company's cash and cash equivalents decreased approximately \$6,000 during the twelve months ended December 31, 2003 as compared to December 31, 2002. During 2003, the Company used cash of \$261,000 for deferred development expenses. The Company had working capital of \$175,000 as of December 31, 2003. Included in current liabilities is \$287,000 for Deferred Revenue, which will be earned throughout 2004. The Company had drawn \$139,000 on its bank line of credit at December 31, 2003, as compared to \$200,000 drawn at December 31, 2002. The line is collateralized by all accounts receivable and general intangibles of the Company. The Company's line of credit agreement with a prior bank expired on February 24, 2004. The Company changed its banking relationship and has established a similar new banking relationship with U.S. Bank, including a new \$200,000 line of credit that is secured by accounts receivable and general intangibles of the Company.

In April, 2004 the Company established an additional line of credit with DEMALE, LLC, a partnership comprised of three principal shareholders of the Company. The line provides for borrowings of up to \$300,000 and is secured by substantially all of the Company's assets and is subordinate to the bank line of credit. At December 31, 2003, DEMALE had advanced \$55,000, leaving a balance available of \$245,000.

As noted above in "Results of Operations", the termination by Reynolds and Reynolds ("Reynolds") of its 1996 Subscription and Maintenance Agreement and the resulting loss of Reynolds as a customer has already had a significantly adverse impact on the Company's revenue in 2003. The Company has nearly replaced the bulk of the revenue lost as a result of the termination of the 1996 contract by Reynolds and Reynolds' subsequent actions but it is possible that some portion of that lost revenue will be awarded to the Company in the ongoing litigation between the Company and Reynolds. Naturally, the Company cannot predict the outcome of that litigation nor can there be any assurance that the Company will ever obtain a meaningful recovery from Reynolds.

The Company made significant progress in its ongoing efforts to replace the lost revenue and cash flow previously provided by Reynolds during the year ended December 31, 2003. Nevertheless, if the Company ultimately fails to recover significant damages from its claims in the pending arbitration proceeding against Reynolds, there could still be a significantly adverse effect on the long-term cash flow and liquid resources of the Company.

The Company receives its revenues from software licenses, recurring annual maintenance/license fees, consulting services and hardware sales. The Company maintains minimal inventory balances of third party software products. Notwithstanding the burdens imposed by Reynolds' actions, the Company believes

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that its existing cash, and the cash flows generated from operations, will be sufficient however, to meet its anticipated cash needs for working capital for at least the next twelve months.

The Company has no material commitments for capital expenditures for 2004.

Contractual obligations at December 31, 2003 are as follows:

| Year | Lines of Credit (1) | Capital Lease (2) | Operating Lease | Total |
|------------|---------------------|-------------------|-----------------|-----------|
| 2004 | \$139,314 | \$5,010 | \$82,871 | \$227,195 |
| 2005 | 54,600 | 5,010 | 85,602 | 145,212 |
| 2006 | - | 4,593 | 88,335 | 92,928 |
| 2007 | - | - | 91,067 | 91,067 |
| 2008 | - | - | 61,925 | 61,925 |
| Thereafter | - | - | - | - |
| | \$193,914 | \$14,613 | \$409,800 | \$618,327 |

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- (1) Lines of credit consist of two revolving line of credit agreements expiring in 2004 and 2005 with monthly payments of interest and the outstanding principal balance due at maturity.
- (2) Amounts shown under capital lease arise under a lease for office equipment expiring in 2006 with monthly lease payments of approximately \$418.

Risks to Future Financial Performance

VARIABLE OPERATING RESULTS. Our future operating results may vary significantly and are difficult to predict due to a number of factors, of which many are beyond our control. These factors include:

- o Demand for our products;
- o The level of product and price competition;
- o The length of our sales cycle;
- o The size and timing of individual license transactions;
- o The delay or deferral of customer implementations;
- o Our success in expanding our customer support organization, direct sales force and indirect distribution channels;
- o The timing of new product introductions and product enhancements;
- o Changes in our pricing policy;
- o The mix of products and services sold;
- o Our ability to develop and market new products and control costs;
- o Current economic and political conditions; and
- o The outcome of the pending litigation against Reynolds & Reynolds

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CURRENT ECONOMIC AND POLITICAL CONDITIONS MAY AFFECT RESULTS. The general economic slowdown may persist for some time into the future. The slowdown has increased the risk to our revenue stream. Additionally, the political landscape has significantly changed and could have a material impact on results going forward. We also believe that there has been an industry-wide slowdown in spending, or at least for the imaging software and systems category. Due to the discretionary nature of our customers' budget and purchase cycles and the absence of long-term customer purchase commitments, it is expected to remain difficult to avoid significant fluctuations in quarterly operating results.

FORWARD LOOKING STATEMENTS

Some of the statements made herein are not historical facts and may be considered "forward looking statements." All forward-looking statements are, of course, subject to varying levels of uncertainty. In particular, statements which suggest or predict future events or state the Company's expectations or assumptions as to future events may prove to be partially or entirely inaccurate, depending on any of a variety of factors, such as adverse economic conditions, new technological developments, competitive developments, results of pending litigation, competitive pressures, changes in the management, personnel, financial condition or business objectives of one or more of the Company's customers, increased governmental regulation or other actions affecting the Company or its customers as well as other factors.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

IMAGE SOFTWARE, INC.

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INDEPENDENT ACCOUNTANTS' REPORT

To the Board of Directors and Stockholders of
 Image Software, Inc.
 Englewood, Colorado

We have audited the accompanying balance sheets of Image Software, Inc. as of December 31, 2003 and 2002, and the related statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Image Software, Inc. as of December 31, 2003 and 2002, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

BKD, LLP

Denver, Colorado
 January 22, 2004, except for Note 4.

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IMAGE SOFTWARE, INC.
 BALANCE SHEETS
 DECEMBER 31, 2003 AND 2002

| | 2003 | 2002 |
|--|------------|------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 143,505 | \$ 149,738 |
| Receivables: | | |
| Trade (less allowance: 2003, \$20,000; 2002, \$10,000) | 609,216 | 549,455 |
| Inventory | 11,517 | 16,500 |
| Prepaid expenses and other current assets | 55,457 | 16,374 |
| Employee advances | 19,631 | 7,029 |

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| | | |
|--|--------------|--------------|
| Deferred tax asset | 20,000 | -- |
| | ----- | ----- |
| Total current assets | 859,326 | 739,096 |
| PROPERTY AND EQUIPMENT, at cost, net | 43,465 | 48,577 |
| OTHER ASSETS: | | |
| Software development costs, net | 694,262 | 720,916 |
| Loan costs, net | 25,929 | -- |
| Deferred tax asset | 40,000 | 50,000 |
| Rent/Security deposit | 7,841 | 100 |
| Inventory | 2,958 | 2,958 |
| | ----- | ----- |
| TOTAL ASSETS | \$ 1,673,781 | \$ 1,561,647 |
| | ===== | ===== |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Current portion of capital lease obligations | \$ 3,663 | \$ 3,903 |
| Deferred revenue | 287,000 | 281,000 |
| Accounts payable | 162,255 | 278,174 |
| Accrued liabilities | 230,958 | 148,260 |
| | ----- | ----- |
| Total current liabilities | 683,876 | 711,337 |
| | ----- | ----- |
| LONG-TERM OBLIGATIONS: | | |
| Capital lease obligations | 7,105 | 7,325 |
| Line of credit - Bank | 139,314 | 200,000 |
| Line of credit - Related Parties | 54,600 | -- |
| | ----- | ----- |
| | 201,019 | 207,325 |
| | ----- | ----- |
| SHAREHOLDERS' EQUITY: | | |
| Common Stock, \$.004 par value - 10,000,000 shares authorized; shares outstanding: 2003 and 2002-3,287,597 and 3,146,554 | 13,150 | 12,586 |
| Additional paid-in capital | 7,288,455 | 7,238,658 |
| Accumulated deficit | (6,512,719) | (6,608,259) |
| | ----- | ----- |
| Total shareholders' equity | 788,886 | 642,985 |
| | ----- | ----- |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$ 1,673,781 | \$ 1,561,647 |
| | ===== | ===== |

See notes to financial statements.

IMAGE SOFTWARE, INC.
STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31, 2003, 2002, AND 2001

| | | | |
|--|-------|-------|-------|
| | 2003 | 2002 | 2001 |
| | ----- | ----- | ----- |

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| | | | |
|-------------------------------------|--------------|--------------|--------------|
| REVENUE: | | | |
| System sales and software licenses | \$ 1,019,708 | \$ 946,071 | \$ 1,224,057 |
| Services and annual fees | 1,084,659 | 1,296,018 | 1,551,874 |
| | ----- | ----- | ----- |
| Total revenue | 2,104,367 | 2,242,089 | 2,775,931 |
| | ----- | ----- | ----- |
| COST OF REVENUE: | | | |
| System sales and software licenses | 537,623 | 623,242 | 520,299 |
| Services and annual fees | 377,380 | 529,791 | 589,122 |
| | ----- | ----- | ----- |
| Total cost of revenue | 915,003 | 1,153,033 | 1,109,421 |
| | ----- | ----- | ----- |
| GROSS PROFIT | 1,189,364 | 1,089,056 | 1,666,510 |
| OPERATING EXPENSES: | | | |
| Selling, general & administrative | 1,214,577 | 1,365,214 | 1,500,038 |
| | ----- | ----- | ----- |
| INCOME/(LOSS) FROM OPERATIONS | (25,213) | (276,158) | 166,472 |
| | ----- | ----- | ----- |
| OTHER INCOME/(EXPENSE): | | | |
| Interest income | 1,701 | 3,396 | 4,891 |
| Interest expense | (29,467) | (9,595) | (10,206) |
| Other Income | 138,519 | -- | -- |
| | ----- | ----- | ----- |
| Total other income (expense) | 110,753 | (6,199) | (5,315) |
| | ----- | ----- | ----- |
| INCOME/(LOSS) BEFORE INCOME TAXES | 85,540 | (282,357) | 161,157 |
| PROVISION/(CREDIT) FOR INCOME TAXES | (10,000) | -- | (50,000) |
| | ----- | ----- | ----- |
| NET INCOME/(LOSS) | \$ 95,540 | \$ (282,357) | \$ 211,157 |
| | ===== | ===== | ===== |
| BASIC AND DILUTED INCOME | | | |
| (LOSS) PER COMMON SHARE | \$.03 | \$ (.09) | \$.07 |
| | ===== | ===== | ===== |
| WEIGHTED AVERAGE NUMBER OF | | | |
| COMMON SHARES OUTSTANDING | 3,236,610 | 3,146,554 | 3,146,554 |
| | ===== | ===== | ===== |

See notes to financial statements.

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| | Common Stock | | Addition Paid-In Capita |
|---|--------------|-----------|-------------------------------|
| | Shares | Amount | |
| Balances, January 1, 2001 | 3,146,554 | \$ 12,586 | 7,238, |
| Net income | -- | -- | |
| Balances, December 31, 2001 | 3,146,554 | \$ 12,586 | 7,238, |
| Net loss | -- | -- | |
| Balances, December 31, 2002 | 3,146,554 | \$ 12,586 | 7,238, |
| Issuance of stock for services | 38,043 | 152 | 6, |
| Issuance of stock for loan origination fee | 90,000 | 360 | 20, |
| Issuance of warrants for loan origination fee | 0 | 0 | 18, |
| Issuance of stock for exercise of stock options | 13,000 | 52 | 4, |
| Net income | | | |
| Balances, December 31, 2003 | 3,287,597 | \$ 13,150 | 7,288, |

See notes to financial statements.

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IMAGE SOFTWARE, INC.
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2003, 2002, AND 2001

| | 2003 | 2002 |
|--|-----------|-------------|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net earnings/(loss) | \$ 95,540 | \$(282,357) |
| Adjustments to reconcile earnings/(loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 319,252 | 323,096 |
| Settlement of payable | (138,375) | -- |
| Deferred revenue | 6,000 | 48,000 |
| Deferred tax asset | (10,000) | -- |
| Issuance of stock options for services | 7,000 | -- |
| Changes in assets and liabilities: | | |
| Receivables | (59,761) | (127,478) |
| Inventory | 4,983 | (7,430) |
| Prepaid expenses and other assets | (59,426) | (7,806) |
| Accounts payable | 22,456 | 90,296 |
| Accrued liabilities | 82,698 | 1,750 |
| Net cash provided by operating activities | 270,367 | 38,071 |

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CASH FLOWS FROM INVESTING ACTIVITIES:

| | | |
|--|-----------|-----------|
| Purchase of property and equipment | (13,180) | (6,103) |
| Additions to capitalized software | (261,346) | (292,015) |
| | ----- | ----- |
| Net cash used for investing activities | (274,526) | (298,118) |
| | ----- | ----- |

CASH FLOWS FROM FINANCING ACTIVITIES:

| | | |
|--|----------|---------|
| Additions to line of credit | 54,600 | 200,000 |
| Repayment of line of credit | (60,686) | -- |
| Repayment of long-term obligations | (460) | (2,636) |
| Proceeds from exercise of Common Stock options | 4,472 | -- |
| | ----- | ----- |
| Net cash provided by (used for) financing activities | (2,074) | 197,364 |
| | ----- | ----- |

INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS

| | | |
|--|------------|------------|
| | (6,233) | (62,683) |
| CASH AND CASH EQUIVALENTS, beginning of year | 149,738 | 212,421 |
| | ----- | ----- |
| CASH AND CASH EQUIVALENTS, end of year | \$ 143,505 | \$ 149,738 |
| | ===== | ===== |

SUPPLEMENTAL CASH FLOWS INFORMATION

| | | |
|--|-----------|-------|
| Issuance of stock and stock purchase warrants for deferred loan origination fees related to the DEMALE, LLC line of credit | \$ 38,889 | \$ -- |
|--|-----------|-------|

See notes to financial statements

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IMAGE SOFTWARE, INC.
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2003, 2002, AND 2001

| | | |
|--|-------|-------|
| | 2003 | 2002 |
| | ----- | ----- |

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

| | | |
|------------------------|-----------|----------|
| Cash paid for interest | \$ 14,774 | \$ 9,595 |
| | ===== | ===== |
| Income taxes paid | \$ 2,500 | \$ 2,500 |
| | ===== | ===== |

SUPPLEMENTAL SCHEDULE OF NON-CASH ACTIVITIES:

| | | |
|--|-------|-----------|
| Acquisition of property and equipment by assuming capital lease obligations | \$ -- | \$ 10,987 |
| | ===== | ===== |

IMAGE SOFTWARE, INC.
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2003, 2002, AND 2001

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ORGANIZATION
ORGANIZATION AND NATURE OF BUSINESS - Image Software, Inc. (the "Company")
was incorporated in Colorado in December 1981.

The Company develops and markets a Linux, Unix, and Windows-based electronic document image management and retrieval system. The Company earns the majority of its revenues in the United States.

CASH EQUIVALENTS - The Company considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents.

INVENTORIES consist of third party software and are stated at the lower of cost (specific identification method) or market (net realizable value). This software is ultimately integrated into the Company's products.

PROPERTY AND EQUIPMENT is stated at cost. Depreciation and amortization are computed using the straight-line method over the estimated useful lives (generally five years) of the assets or the lease term, if shorter. The Company capitalizes all expenditures for property and equipment in excess of \$500. For the years ended December 31, 2003, 2002 and 2001, depreciation expense totaled \$18,292, \$21,896 and \$27,562, respectively.

ADVERTISING COSTS are expensed as incurred. Advertising expenses totaled \$63,552, \$118,373, and \$121,718, in 2003, 2002 and 2001, respectively.

SOFTWARE DEVELOPMENT COSTS are capitalized when technological feasibility is established. Such costs are stated at the lower of unamortized cost or net realizable value. Amortization is computed using either the straight-line method based on estimated economic lives of the products (five years) or the ratio that current product revenues bear to the total of current and anticipated future product revenues, whichever is greater. It is reasonably possible that those estimates of anticipated future gross revenues, the remaining estimated economic life of the products, or both will be reduced significantly in the near term due to competitive pressure. As a result, the carrying amount of the capitalized software costs may be reduced materially in the near term. The amounts capitalized for the years ended December 31, 2003, 2002, and 2001 were \$261,346, \$296,510, and \$270,973, respectively. Amortization of these costs totaled \$288,000, \$301,200, and \$300,101, respectively. The net realizable value of such capitalized costs is reviewed by management on a periodic basis, and costs in excess of net realizable value, if any, are charged to operations.

LOAN COSTS are amortized using the effective interest method over the term of the debt agreement.

REVENUE RECOGNITION - Revenue from the sale of software licenses, computer equipment, and existing application software packages is recognized when the software and computer equipment are shipped to the customer, remaining vendor obligations are insignificant, there are no significant uncertainties about customer acceptance and collectibility is probable. Revenue from related services, including installation and software

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modifications, is recognized upon performance of services. Maintenance revenue is recognized ratably over the maintenance period.

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A single customer, Reynolds and Reynolds, accounted for .1%, 20%, and 36% of revenues in 2003, 2002, and 2001, respectively. No other customer accounted for more than 10% of revenue for 2003, 2002 or 2001.

ACCOUNTS RECEIVABLE - Accounts receivable are stated at the amount billed to customers. The Company provides an allowance for doubtful accounts, which is based upon a review of outstanding accounts receivable, historical collection information and existing economic conditions. The Company performs credit evaluations of its customers' financial condition and generally does not require collateral. The Company retains a security interest in the equipment and software sold until they are paid in full. Accounts receivable are ordinarily due 30 days after the issuance of the invoice, with those customers not meeting those requirements being subject to stricter credit policies. Delinquent receivables are written off based on individual credit evaluation and specific circumstances of the customer.

One customer accounted for 31% of accounts receivable at December 31, 2003. Three different customers accounted for 32%, 12% and 11% of accounts receivable at December 31, 2002. Two different customers accounted for 18% and 10% of accounts receivable at December 31, 2001.

EARNINGS (LOSS) PER SHARE is computed by dividing net income (loss) by the weighted average number of common and equivalent shares outstanding during the year. The potential dilution from Common Stock equivalents is not material. Fully diluted earnings per share are either anti-dilutive or not materially different from basic earnings per share.

INCOME TAXES The Company follows the liability method of accounting for income taxes in accordance with Statement of Financial Accounting Standards (SFAS) No. 109. Under this method, deferred income taxes are recorded based upon differences between the financial reporting and tax bases of assets and liabilities and are measured using enacted tax rates and laws that will be in effect when the underlying assets or liabilities are received or settled.

The Company has recorded a valuation allowance against the deferred tax assets due to the uncertainty of ultimate realizability.

STOCK-BASED COMPENSATION At December 31, 2003, the Company has three stock-based employee compensation plans, which are described more fully in Note 5. The Company accounts for these plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the grant date. The following table illustrates the effect on net income and earnings per share if the company had applied the fair value provisions of FASB Statement No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

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| | Year Ended December 31 | | |
|---|------------------------|--------------|------------|
| | 2003 | 2002 | 2001 |
| | ---- | ---- | ---- |
| Net income (loss), as reported | \$ 95,540 | \$ (282,357) | \$ 211,157 |
| Less: Total stock-based employee compensation cost determined under the fair value based method, net of income taxes | (105,885) | (97,166) | (98,808) |
| | ----- | ----- | ----- |
| Pro forma net income (loss) | \$ 10,345 | \$ (379,523) | \$ 112,349 |
| | ===== | ===== | ===== |
| Earnings per share: | | | |
| Basic and Diluted - as reported | \$ 0.03 | \$ (0.09) | \$ 0.07 |
| | ===== | ===== | ===== |
| Basic and Diluted - pro forma | \$ -- | \$ (0.12) | \$ 0.04 |
| | ===== | ===== | ===== |

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

RECLASSIFICATION -The Company has reclassified certain amounts from prior years to conform to the current year presentation. These reclassifications had no effect on net income.

2. PROPERTY AND EQUIPMENT

Property and equipment at December 31 consists of the following:

| | 2003 | 2002 |
|--------------------------------|------------|------------|
| | ---- | ---- |
| Equipment | \$ 666,277 | \$ 656,748 |
| Furniture | 57,088 | 56,078 |
| Leasehold improvements | 10,903 | 8,262 |
| | ----- | ----- |
| | 734,268 | 721,088 |
| Less: accumulated depreciation | (690,803) | (672,511) |
| | ----- | ----- |
| | \$ 43,465 | \$ 48,577 |
| | ===== | ===== |

3. ACCRUED LIABILITIES

Accrued liabilities at December 31 consists of the following:

| | 2003 | 2002 |
|---------------------------|------------|------------|
| | ---- | ---- |
| Sales tax payable | \$ 73,770 | \$ 40,458 |
| Accounting and audit fees | 9,521 | 10,575 |
| Accrued compensation | 80,873 | 37,695 |
| Other | 66,794 | 59,532 |
| | ----- | ----- |
| | \$ 230,958 | \$ 148,260 |
| | ===== | ===== |

4. LINES OF CREDIT

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BANKS

The Company has a \$200,000 annual revolving bank line of credit which expires on February 24, 2004 and bears interest at the greater of 7% or prime plus 1.5% (total rate of 7.0% at December 31, 2003) not to

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exceed 18%, and is collateralized by all accounts receivable and general intangibles of the Company. Total borrowings outstanding under the line of credit were \$139,314 and \$200,000 at December 31, 2003 and 2002, respectively.

The bank line of credit expired on February 24, 2004 and was not renewed. On February 24, 2004, the Company entered into a \$200,000 annual revolving line-of-credit agreement with U.S. Bank, which expires February 24, 2005 and bears interest at prime plus 1.75% not to exceed 18%, and is collateralized by all accounts receivable and general intangibles of the Company. The proceeds from the new line of credit were used to pay-off the line of credit existing at December 31, 2003.

RELATED PARTIES

On April 1, 2003, the Company entered into a \$300,000 revolving line-of-credit agreement (the Agreement) which expires June 30, 2005, with DEMALE, LLC, an entity owned by certain stockholders of the Company. In connection with the Agreement, the Company issued 90,000 shares of restricted common stock and stock purchase warrants to purchase an additional 90,000 shares of restricted common stock as payment for loan origination costs. The line expires on June 30, 2005 and requires the Company, among other things, to maintain certain financial conditions. At December 31, 2003, there was \$54,600 borrowed against this line. The line is secured by substantially all of the Company's assets and is subordinate to the bank line of credit. Interest is accrued and payable quarterly at the greater of 7% or prime plus 1.5% (total interest rate of 7.0% at December 31, 2003).

5. SHAREHOLDERS' EQUITY

STOCK COMPENSATION PLANS

At December 31, 2003, the Company has three stock-based compensation plans, which are described below. The Company applies Accounting Principles Board (APB) Opinion 25 and related interpretations in accounting for its plans. Accordingly, no compensation cost has been recognized. Had compensation cost for the Company's three stock-based compensation plans been determined based on the fair value at the dates of awards under those plans consistent with the method of FASB Statement 123, the Company's net income (loss) and earnings (loss) per share would have been as indicated below:

| Net Income (Loss): | 2003 | 2002 | 2001 |
|-----------------------------------|-------------|--------------|------------|
| | ---- | ---- | ---- |
| As Reported | \$ 95,540 | \$ (282,357) | \$ 211,157 |
| Pro Forma | \$ (10,345) | \$ (379,523) | \$ 112,349 |
| Earnings (Loss) Per Common Share: | | | |
| As Reported | \$ 0.03 | \$ (0.09) | \$ 0.07 |
| Pro Forma | \$ -- | \$ (0.12) | \$ 0.04 |

The fair value of each option grant is estimated on the date of grant

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using the Black-Scholes option-pricing model with the following weighted-average assumptions for grants in 2003, 2002, and 2001:

| | 2003 ---- | 2002 ---- | 2001 ---- |
|-------------------------|--------------|--------------|--------------|
| Dividend Yield | 0% | 0% | 0% |
| Expected Volatility | 132% | 128% | 124% |
| Risk-Free Interest Rate | 4.25% | 4.25% | 4.75% |
| Expected Lives | 9.0 years | 8.8 years | 8.4 years |

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The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are freely transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

1996 EQUITY INCENTIVE PLAN

In September 1996, the Board of Directors authorized 1,000,000 shares of Common Stock for issuance under its 1996 Equity Incentive Plan ("1996 Plan") as incentive stock options ("ISOs") or non-qualified stock options ("NQSOs"). The Company grants ISOs only to employees. The Company grants NQSOs and restricted stock to persons who are employees of the Company and to non-employee directors under the 1996 Plan.

The options are granted to purchase Common Stock at the fair market value on the grant date or at other prices as determined by the Board of Directors. The option-vesting period is determined at the time of each grant, and all options expire five to ten years from the grant date.

A summary of the 1996 Plan stock option activity follows:

| | Outstanding Shares | Exercise Price | Weighted Avg. Exercise Price |
|-----------------------------|-----------------------|-------------------|---------------------------------|
| Balances, January 1, 2001 | 633,500 | | .59 |
| Granted | 145,000 | \$.56 - \$.75 | .60 |
| Canceled | (8,500) | \$.63 - \$.66 | (.65) |
| | | | |
| Balances, December 31, 2001 | 770,000 | | .59 |
| Granted | 8,000 | \$.51 | .51 |
| Canceled | (13,500) | \$.56 - \$.70 | (.66) |
| | | | |
| Balances, December 31, 2002 | 764,500 | | .59 |
| Granted | 112,000 | \$.31-\$.39 | .34 |
| Canceled | (74,500) | \$.51-\$1.43 | (.67) |

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Balances, December 31, 2003 802,000 .55
=====

The following table summarizes information about stock options under the plan at December 31, 2003:

| Range of Exercise Prices | Outstanding | | | Exercisable | |
|--------------------------------|-----------------------|---|--|-----------------------|--|
| | Number Outstanding | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| 0.31 to 0.44 | 347,000 | 5.3 years | 0.41 | 321,500 | 0.41 |
| 0.51 to 0.84 | 443,000 | 6.1 years | 0.64 | 421,165 | 0.64 |
| 1.29 to 1.44 | 12,000 | 5.8 years | 1.34 | 12,000 | 1.34 |

At December 31, 2003, options for 754,665 shares were exercisable under the 1996 Plan. There were no shares available for future grant.

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The weighted-average grant-date fair value of options granted during 2003, 2002, and 2001 were \$.34, \$.51, and \$.60, respectively.

In addition, options for 20,000 shares exercisable at \$.34 per share were granted outside of the 1996 Plan by the Board of Directors on December 31, 2003. Those options are treated in all respects as to terms and conditions as if they were granted under the 1996 Plan.

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1994 STOCK OPTION AND GRANT PLAN

In April 1994, the Company authorized 700,000 shares of Common Stock for issuance under its 1994 Stock Option and Grant Plan ("1994 Plan") to employees, consultants and contractors of the Company. The Plan was amended in 2002 to permit grants to employees who were also members of the board of directors.

The options are granted to purchase Common Stock at the fair market value on the date of grant or at other prices as determined by the Board of Directors ("the Board"). Options issued under the 1994 Plan become exercisable in one or more installments during its term and the right to exercise may be cumulative, as determined by the Board. Options expire as determined by the Board, but not more than 10 years after the date of grant.

Details of activity under the 1994 Plan are as follows:

| Stock Options | Outstanding | Exercise Price | Weighted Average Exercise Price |
|---------------|-------------|----------------|------------------------------------|
|---------------|-------------|----------------|------------------------------------|

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| | | | |
|-----------------------------|----------|-------------|--------|
| Balances, January 1, 2001 | 317,250 | | \$.52 |
| Granted | 4,500 | \$.56 | .56 |
| Canceled | (1,000) | \$.63 | (.63) |
| ----- | | | |
| Balances, December 31, 2001 | 320,750 | | .52 |
| Granted | 34,000 | \$.35 | .35 |
| Canceled | (96,500) | \$.63 | (.63) |
| ----- | | | |
| Balances, December 31, 2002 | 258,250 | | .46 |
| Granted | 78,849 | \$.31-\$.35 | .34 |
| Exercised | (13,000) | \$.34 | (.34) |
| Canceled | (34,250) | \$.34-\$.66 | (.51) |
| ----- | | | |
| Balances, December 31, 2003 | 289,849 | | .43 |
| ===== | | | |

| Stock Grants | | Grant Price | Weighted Average Exercise Price |
|-----------------------------|--------|-----------------|---------------------------------|
| Balances, January 1, 2001 | 83,166 | \$.84 - \$1.13 | \$1.66 |
| Granted/Canceled | -- | -- | -- |
| ----- | | | |
| Balances, December 31, 2001 | 83,166 | | 1.66 |
| Granted/Canceled | -- | -- | -- |
| ----- | | | |
| Balances, December 31, 2002 | 83,166 | | 1.66 |
| Granted/Canceled | -- | -- | -- |
| ----- | | | |
| Balances, December 31, 2003 | 83,166 | | 1.66 |
| ===== | | | |

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The following table summarizes information about stock options under the 1994 Plan at December 31, 2003:

| Range of Exercise Prices | Outstanding | | | Exercisable | |
|--------------------------|--------------------|---|---------------------------------|--------------------|---------------------------------|
| | Number Outstanding | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| 0.31 to 0.35 | 211,349 | 5.6 years | 0.34 | 115,960 | 0.34 |
| 0.56 to 0.66 | 78,500 | 4.3 years | 0.65 | 75,750 | 0.65 |

The weighted-average grant-date fair value of options granted during

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2003, 2002, and 2001 were \$.34, \$.35, and \$.56, respectively.

At December 31, 2003, options to purchase 191,710 shares of Common Stock were exercisable and no shares were available for future grant under the 1994 Plan.

1993 STOCK OPTION PLAN

In May 1994, the Company authorized 235,000 shares of Common Stock for issuance under its 1993 Stock Option Plan ("1993 Plan") as incentive or non-qualified stock options. The Company grants nonqualified stock options to officers, directors and employees and incentive stock options may be granted to employees under the 1993 Plan.

The options are granted to purchase Common Stock at the fair market value on the grant date or at other prices as determined by the Board of Directors. The option-vesting period is determined at the time of each grant, and all options expire two to ten years from the grant date.

A summary of the 1993 Plan stock option activity follows:

| | Outstanding Shares | Exercise Price | Weighted Avg. Exercise Price |
|-----------------------------|-----------------------|----------------|---------------------------------|
| Balances, January 1, 2001 | 76,300 | | .47 |
| Granted | 3,500 | \$.56 | .56 |
| Balances, December 31, 2001 | 79,800 | | .47 |
| Granted/Canceled/Exercised | 0 | \$ - | -- |
| Balances, December 31, 2002 | 79,800 | | .47 |
| Granted | 11,675 | \$.31 | .31 |
| Canceled | (11,675) | \$.44-\$2.06 | (.52) |
| Balances, December 31, 2003 | 79,800 | | \$.44 |

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The following table summarizes information about stock options under the plan at December 31, 2003.

| Range of Exercise Prices | Outstanding | | | Exercisable | |
|--------------------------------|-----------------------|---|--|-----------------------|--|
| | Number Outstanding | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| 0.31 to 0.44 | 74,800 | 3.2 years | 0.41 | 63,125 | 0.43 |
| 0.56 to 0.75 | 4,500 | 3.6 years | 0.73 | 4,500 | 0.73 |

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1.38 to 2.06 500 2.0 years 1.72 500 1.72

There were 11,675 options granted during 2003. At December 31, 2003, options for 68,125 shares were exercisable under the 1993 Plan. There are no shares available for future grant under the 1993 Plan.

COMMON STOCK WARRANTS

On April 1, 2003, in connection with obtaining the line of credit - related party, the Company issued warrants to the owners of the lender to purchase 90,000 shares of Common Stock at an exercise price of \$0.18 per share, that price being equal to 80% of the fair market value of the Common Stock on March 31, 2003. These warrants expire on April 1, 2008.

COMMON STOCK RESERVED

Common Stock reserved at December 31, 2003 was as follows:

| | |
|----------------------------------|-----------|
| 1996 Equity Incentive Plan | 822,000 |
| 1994 Stock Option and Grant Plan | 289,849 |
| 1993 Stock Option Plan | 79,800 |
| | ===== |
| | 1,191,649 |
| | ===== |

6. INCOME TAXES

The provisions (credit) for income taxes for the years ended December 31, consists of:

| Current: | 2003 | 2002 | 2001 |
|----------------|-------------|-------|-------------|
| | ---- | ---- | ---- |
| Federal | \$ -- | \$ -- | \$ -- |
| State | -- | -- | -- |
| | ----- | ----- | ----- |
| Total current | -- | -- | -- |
| | ----- | ----- | ----- |
| Deferred: | | | |
| Federal | (10,000) | -- | (50,000) |
| State | -- | -- | -- |
| | ----- | ----- | ----- |
| Total deferred | (10,000) | -- | (50,000) |
| | ----- | ----- | ----- |
| | \$ (10,000) | \$ -- | \$ (50,000) |
| | ===== | ===== | ===== |

The following is a reconciliation of statutory federal income taxes to the actual provision (credit) for income taxes:

| | | | |
|--|------|------|------|
| | 2003 | 2002 | 2001 |
|--|------|------|------|

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| | ----- | ----- | ----- |
|--|----------|-------------|-------------|
| Federal income taxes at statutory rate | 29,000 | \$ (96,000) | \$ 65,000 |
| Non-deductible expenses | 7,000 | 7,000 | -- |
| Increase (decrease) in taxes resulting from state income taxes | 3,000 | (9,000) | 6,300 |
| Increase (decrease) in deferred tax asset valuation allowance | (52,000) | 101,000 | (141,000) |
| Expiration of business tax credits | -- | -- | 14,000 |
| Other, net | 3,000 | (3,000) | 5,700 |
| | ----- | ----- | ----- |
| Provision/(credit) for income taxes | (10,000) | \$ -- | \$ (50,000) |
| | ===== | ===== | ===== |

The components of the net deferred tax (liability) asset recognized in the accompanying balance sheets are as follows:

| | 2003 | 2002 |
|------------------------|-------------|-------------|
| | ----- | ----- |
| Deferred tax liability | \$ (12,000) | \$ (2,000) |
| Deferred tax asset | 2,156,000 | 2,188,000 |
| Valuation allowanc | (2,084,000) | (2,136,000) |
| | ----- | ----- |
| | \$ 60,000 | \$ 50,000 |
| | ===== | ===== |

The types of temporary differences between the tax bases of assets and liabilities and their financial reporting amounts that give rise to a significant portion of the deferred tax asset and their approximate tax effects are as follows:

| | 2003 | 2002 |
|---------------------------------|--------------|--------------|
| | ----- | ----- |
| Future income (deductions): | | |
| Net operating loss | \$ 2,147,000 | \$ 2,174,000 |
| Allowance for doubtful accounts | 8,000 | 4,000 |
| Depreciation | 1,000 | 10,000 |
| Other, net | (12,000) | (2,000) |
| | ----- | ----- |
| | \$ 2,144,000 | \$ 2,186,000 |
| | ===== | ===== |

The Company has net operating loss carry forwards for federal income tax purposes of approximately \$5,540,000. These carry forwards expire on varying dates from 2006 through 2022.

7. EMPLOYEE BENEFIT PLAN

The Company has a Cash or Deferred Profit Sharing Plan ("the 401(k) Plan"). The 401(k) Plan is designed to qualify under Section 401(k) of the Internal Revenue Code and allows the Company to make discretionary contributions as determined by the Company's Board of Directors. For the years ended December 31, 2003, 2002, and 2001, the Company contributed \$3,225, \$4,923, and \$4,650 to the 401(k) Plan.

8. COMMITMENTS AND CONTINGENCIES

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At December 31, 2003 and 2002, equipment with a net book value of \$7,436 and \$9,072, net of accumulated amortization of \$19,827 and \$18,191, respectively, has been leased under capital leases.

The Company leases its executive offices under a noncancelable-operating lease, which expires in August 2008. Total rent expense for the years ended December 31, 2003, 2002 and 2001 was \$76,352, \$89,306 and \$89,306, respectively.

Future minimum payments for lease obligations are as follows:

| | Capital | Operating |
|--------------------------------------|----------|------------|
| 2004 | \$ 5,010 | \$ 82,871 |
| 2005 | 5,010 | 85,602 |
| 2006 | 4,593 | 88,335 |
| 2007 | -- | 91,067 |
| 2008 | -- | 61,925 |
| | ----- | ----- |
| Total minimum lease payments | 14,613 | \$ 409,800 |
| | | ----- |
| Amount representing interest | (3,845) | |
| | ----- | |
| Present value of min. lease payments | 10,768 | |
| Current portion | (3,663) | |
| | ----- | |
| Long-term portion | \$ 7,105 | |
| | ===== | |

The Company has bonus agreements with two officers that provide for quarterly bonuses of 5% and 4%, respectively, of the Company's pre-tax profits. The Company expensed bonuses of \$9,449, \$0, and \$33,352, under these agreements for the years ended December 31, 2003, 2002, and 2001, respectively.

The Company is currently engaged in various legal proceedings involving one of its former customers. Included in the legal proceedings is litigation pertaining to accounts receivable owed to the Company, of which, approximately \$194,000 is held in escrow by the court and is included in accounts receivable at December 31, 2003.

9. FINANCIAL INSTRUMENTS

All financial instruments are held for purposes other than trading. The following methods and assumptions were used to estimate the fair value of each financial instrument for which it is practicable to estimate that value:

CASH AND CASH EQUIVALENTS

The carrying amount approximates fair value because of the short maturity of those instruments.

DEBT

The fair value of the Company's debt is estimated based on borrowing rates

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currently available to the Company for bank loans with similar terms and maturities.

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The estimated fair values of the Company's financial instruments at December 31, 2003 are as follows:

| | Carrying Amount | Fair Value |
|--------------------------------|-----------------|------------|
| Assets: | | |
| Cash and cash equivalents | \$ 143,505 | \$ 143,505 |
| Receivables | \$ 628,848 | \$ 628,848 |
| Liabilities: | | |
| Accounts Payable | \$ 162,255 | \$ 162,255 |
| Line of Credit-bank | \$ 139,314 | \$ 139,314 |
| Line of Credit-related parties | \$ 54,600 | \$ 54,600 |

The estimated fair values of the Company's financial instruments at December 31, 2002 are as follows:

| | Carrying Amount | Fair Value |
|---------------------------|-----------------|------------|
| Assets: | | |
| Cash and cash equivalents | \$ 149,738 | \$ 149,738 |
| Receivables | \$ 556,484 | \$ 556,484 |
| Liabilities: | | |
| Accounts Payable | \$ 278,174 | \$ 278,174 |
| Line of Credit | \$ 200,000 | \$ 200,000 |

10. SEGMENT INFORMATION

The Company operates in one industry segment consisting of the development and marketing of electronic document image management and retrieval systems. The Company's technologies are managed as one segment because it offers similar products in similar markets and the factors determining strategic decisions are comparable for all products and markets.

Sales to foreign markets totaled \$35,556, \$38,197, and \$67,846 for the years ending December 31, 2003, 2002, and 2001, respectively.

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11. LIQUIDITY

The Company's cash and cash equivalents decreased \$6,233 during the year ended December 31, 2003 to approximately \$144,000 at December 31, 2003.

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During 2003, the Company incurred cash expenditures for deferred development costs of approximately \$261,000. As of December 31, 2003, the Company had working capital of approximately \$175,000. At December 31, 2003, current liabilities included deferred revenue of approximately \$287,000, which will be earned throughout calendar year 2004 and does not require additional direct cash flow needs to be earned.

At December 31, 2003, the Company's line of credit with a bank had a balance of \$139,314 and the Company's line of credit with a related party had a balance of \$54,600. Subsequent to December 31, 2003, the bank notified the Company that it would not be renewing the line of credit in February, 2004. The line is collateralized by accounts receivable and general intangibles of the Company. Subsequent to December 31, 2003, the Company obtained a \$200,000 annual revolving line of credit from a new bank, which expires on February 24, 2005 and bears interest at prime plus 1.75% not to exceed 18%, and is collateralized by all accounts receivable and general intangibles of the Company. As of December 31, 2003, the Company had no material commitments for capital expenditures to be made during calendar 2004.

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INDEPENDENT ACCOUNTANTS' REPORT ON FINANCIAL STATEMENT SCHEDULES

To the Board of Directors and Shareholders of
Image Software, Inc.
Englewood, Colorado

In connection with our audit of the financial statements of Image Software, Inc. for each of the three years in the period ended December 31, 2003, we have also audited the following financial statement schedule. This financial statement schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement schedule based on our audits of the basic financial statements. The schedule is presented for purposes of complying with the Securities and Exchange Commission's rules and regulations and is not a required part of the financial statements.

In our opinion, the financial statement schedule referred to above, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information required to be included herein.

BKD, LLP

Denver, Colorado
January 22, 2004

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IMAGE SOFTWARE, INC.

SCHEDULE VIII
VALUATION AND QUALIFYING ACCOUNTS

| | Balance at beginning of period | Additions charged to: Costs and expenses | Deductions Accounts charged to: Allowance | Balance at end of period |
|--|---|--|---|--------------------------------|
| For the Year Ended December 31, 2003: Allowance for Doubtful Accounts | \$ 10,000 | \$ 43,450 | \$ 33,450 | \$ 20,000 |
| For the Year Ended December 31, 2002: Allowance for Doubtful Accounts | \$ 10,000 | \$ 34,850 | \$ 34,850 | \$ 10,000 |
| For the Year Ended December 31, 2001: Allowance for Doubtful Accounts | \$ 10,000 | \$ 62,888 | \$ 62,888 | \$ 10,000 |

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

There were no disagreements with accountants on accounting and financial disclosure.

ITEM 9A. CONTROLS AND PROCEDURES

As of the end of the period reported on in this report, the Company has undertaken an evaluation under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rule 13a-15 of the Securities Exchange Act of 1934. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective, in all material respects, with respect to the recording, processing, summarizing and reporting, within the time periods specified in the SEC's rules and forms, of information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act.

There have been no significant changes in the Company's internal controls during the quarter ended December 31, 2003, or in other factors that could significantly affect internal controls subsequent to the date of the evaluation described above.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required herein is incorporated by reference from the Company's definitive proxy statement for the 2004 annual meeting of

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shareholders.

ITEM 11. EXECUTIVE COMPENSATION

The information required herein is incorporated by reference from the Company's definitive proxy statement for the 2004 annual meeting of shareholders.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required herein is incorporated by reference from the Company's definitive proxy statement for the 2004 annual meeting of shareholders.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required herein is incorporated by reference from the Company's definitive proxy statement for the 2004 annual meeting of shareholders.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required herein is incorporated by reference from the Company's definitive proxy statement for the 2004 annual meeting of shareholders.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

- (a) 1. Financial Statements
See Financial Statement Index on Page 13
- 2. Financial Statement Schedules
See Financial Statement Index on Page 13
- 3. List of Exhibits

| Exhibit Number | Description and Incorporation by Reference |
|----------------|---|
| 3.1* | - Restated Articles of Incorporation of the Company, as amended. |
| 3.2* | - Bylaws of the Company, as amended. |
| 3.3* | - Articles of Amendment to the Articles of Incorporation of the Company dated April 18, 1991 |
| 3.4** | - Articles of Amendment to the Articles of Incorporation dated May 21, 1993. |
| 3.4** | - Articles of Amendment to the Articles of Incorporation dated June 28, 1994. |
| 10.5* | - UniVerse(TM) Distributor Agreement between INFORMIX SOFTWARE, INC. and the Company dated May 15, 1991 |
| 10.14***** | - President Employment Agreement between David R. DeYoung and the Company dated November 1, 1999. |
| 10.15***** | - Chief Financial Officer Employment Agreement between Mary Anne DeYoung and the Company dated September 1, 1999. |
| 10.21**** | - Software License Agreement between Reynolds+Reynolds and the Company. The grant of confidential treatment for this exhibit filed separately with the Securities and Exchange Commission has been agreed to. |

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- 10.22*** - 1994 Stock Option and Grant Plan.
- 10.23** - 1993 Stock Option Plan.
- 10.24***** - Equity Incentive Plan
- 10.25 - Revolving Credit

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- 10.25A. Revolving Credit Note and Business Security and Corporate Resolution for Borrowing with U.S. Bank, N.A. dated February 24, 2004
- 23 - Consent of BKD, LLP
- 31.1 - Certificate of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 - Certificate of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32 - Certificate of CEO and CFO pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

See Index to Financial Statements on Page 13

- * Filed as an Exhibit to Form S-1 Registration Statement No. 33-44717, on December 23, 1991.
- ** Filed as an Exhibit to Form S-8 Registration Statement No. 33-86760, on November 29, 1994
- *** Filed as an Exhibit to Form S-8 Registration Statement No. 33-78096, on April 22, 1994.
- **** Filed as an Exhibit to Form 10-K for the period ended December 31, 1994.
- ***** Filed as an Exhibit to Form S-3 Registration Statement No. 333-35265, on September 10, 1997.
- ***** Filed as an Exhibit to Form 10-K for the period ended December 31, 2001
- (b) There were no reports filed on Form 8-K for the quarter ended December 31, 2003.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

IMAGE SOFTWARE, INC.

By: /s/ DAVID R. DEYOUNG

Date: MARCH 29, 2004

David R. DeYoung
President

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the date indicated.

By: /s/ DAVID R. DEYOUNG

Date: MARCH 29 2004

David R. DeYoung, President
and Principal Chief Executive Officer

By: /s/ MARY ANNE DEYOUNG

Date: March 29, 2004

Mary Anne DeYoung
Vice President, Finance

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Principal and Accounting Officer

By: /s/ ROBERT WIEGAND, II

Robert Wiegand, II
Director and Secretary

Date: March 29, 2004

By: /s/ JOHN G. MAZZA

John G. Mazza
Director

Date: March 29, 2004

By: /s/ SPENCER D. LEHMAN

Spencer D. Lehman
Director

Date: March 29, 2004
