

SPESCOM SOFTWARE INC  
Form 10-Q  
August 12, 2004

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the Quarterly Period Ended June 30, 2004.

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

For the transition period from

to .

Commission File Number 0-15935

**SPESCOM SOFTWARE INC.**

(Exact name of registrant as specified in its charter)

**CALIFORNIA**  
(State or other jurisdiction of  
incorporation or organization)

**95-3634089**  
(I.R.S. Employer  
Identification No.)

**10052 MESA RIDGE COURT, SUITE 100, SAN DIEGO, CA 92121**  
(Address of principal executive offices and zip code)

**(858) 625-3000**  
(Registrant's telephone number, including area code)

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

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YES  NO

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

YES  NO

Number of shares of Common Stock outstanding at August 11, 2004: 34,068,278

Number of Sequentially Numbered Pages: 27

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SPESCOM SOFTWARE INC.

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**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA****SPESCOM SOFTWARE INC.****CONSOLIDATED BALANCE SHEETS**

	June 30, 2004 (Unaudited)	September 30, 2003
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 1,033,000	\$ 333,000
Receivables, net of allowance for doubtful accounts of \$83,000 and \$78,000 respectively	342,000	423,000
Other current assets	200,000	169,000
Total current assets	1,575,000	925,000
Property and equipment, net		
Property and equipment, net	119,000	213,000
Computer software, net	22,000	63,000
Other assets	28,000	29,000
Total assets	\$ 1,744,000	\$ 1,230,000
<b>LIABILITIES AND SHAREHOLDERS DEFICIT</b>		
Current liabilities:		
Accounts payable	\$ 458,000	\$ 405,000
Payable to Spescom Ltd.	49,000	46,000
Preferred stock dividend payable to Spescom Ltd.	202,000	
Accrued liabilities	1,496,000	1,080,000
Note and accrued interest payable to Spescom Ltd.	505,000	
Lease obligations - current portion	21,000	23,000
Deferred revenue	2,228,000	2,018,000
Fair value of equity instruments redeemable for common stock		1,233,000
Total current liabilities	4,959,000	4,805,000
Notes and accrued interest payable to Spescom Ltd.		
Notes and accrued interest payable to Spescom Ltd.		504,000
Lease obligations	48,000	62,000
Total liabilities	5,007,000	5,371,000
Shareholders' deficit:		
Convertible preferred stock, \$1,000 stated value per share, 1,000,000 shares authorized; 5,291 shares issued and outstanding in 2004 and 2003	6,790,000	6,790,000
Common stock, no par value, 100,000,000 shares authorized; 34,068,278 and 33,929,278 issued and outstanding in 2004 and 2003	74,764,000	73,676,000
Common stock warrants	278,000	278,000
Accumulated other comprehensive loss	(385,000)	(294,000)
Accumulated deficit	(84,710,000)	(84,591,000)
Total shareholders' deficit	(3,263,000)	(4,141,000)
Total liabilities and shareholders' deficit	\$ 1,744,000	\$ 1,230,000

The accompanying notes are an integral part of these consolidated financial statements.

## SPESCOM SOFTWARE INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	For the three months ended June 30,		For the nine months ended June 30,	
	2004	2003	2004	2003
<b>Revenues:</b>				
Licenses	\$ 1,559,000	\$ 485,000	\$ 3,037,000	\$ 1,773,000
Services and other	1,341,000	1,417,000	3,589,000	4,233,000
Total revenues	2,900,000	1,902,000	6,626,000	6,006,000
<b>Cost of revenues:</b>				
Licenses	37,000	189,000	178,000	589,000
Services and other	586,000	655,000	1,693,000	1,749,000
Total cost of revenues	623,000	844,000	1,871,000	2,338,000
Gross profit	2,277,000	1,058,000	4,755,000	3,668,000
<b>Operating expenses:</b>				
Research and development	341,000	364,000	1,008,000	1,101,000
Marketing and sales	871,000	635,000	2,201,000	1,918,000
General and administrative	585,000	319,000	1,574,000	1,090,000
	1,797,000	1,318,000	4,783,000	4,109,000
Income (loss) from operations	480,000	(260,000)	(28,000)	(441,000)
Interest and other income		4,000	5,000	4,000
Interest and other expense	(37,000)	(134,000)	(96,000)	(393,000)
Net income (loss)	443,000	(390,000)	(119,000)	(830,000)
Cumulative preferred dividends	(66,000)		(198,000)	
Net income (loss) available to common shareholders	\$ 377,000	\$ (390,000)	\$ (317,000)	\$ (830,000)
<b>Earnings per share:</b>				
Basic	\$ 0.01	\$ (0.01)	\$ (0.01)	\$ (0.03)
Diluted	\$ 0.01	\$ (0.01)	\$ (0.01)	\$ (0.03)
<b>Weighted average shares outstanding:</b>				
Basic	34,068,000	30,890,000	33,992,000	30,850,000
Diluted	35,452,000	30,890,000	33,992,000	30,850,000
<b>Statement of Comprehensive Income</b>				
Net income (loss)	\$ 443,000	\$ (390,000)	\$ (119,000)	\$ (830,000)
<b>Other Comprehensive income (loss):</b>				
Foreign currency translation adjustment	80,000	(81,000)	(119,000)	(99,000)
Comprehensive Income	\$ 523,000	\$ (471,000)	\$ (238,000)	\$ (929,000)

The accompanying condensed notes are an integral part of these consolidated financial statements.



**SPESCOM SOFTWARE INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**

	For the nine months ended June 30,	
	2004	2003
<b>Cash flows from operating activities:</b>		
Net loss	\$ (119,000)	\$ (830,000)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	154,000	381,000
Unpaid interest on notes payable	22,000	277,000
Gain on derivative revaluation	(6,000)	
Value of stock issued to consultant	46,000	
Changes in assets and liabilities, net :		
Receivables, net	95,000	1,018,000
Other assets	2,000	518,000
Accounts payable	48,000	(301,000)
Accrued liabilities	343,000	(681,000)
Deferred revenue	145,000	112,000
Net cash provided by operating activities	730,000	494,000
<b>Cash flows from investing activities:</b>		
Purchases of property and equipment	(5,000)	(28,000)
Purchases of software	(10,000)	(6,000)
Net cash used in investing activities	(15,000)	(34,000)
<b>Cash flows from financing activities:</b>		
Proceeds from shareholder loan	600,000	
Payments on shareholder loan	(600,000)	
Proceeds from exercise of stock options	13,000	5,000
Payments on capital lease obligations	(16,000)	(12,000)
Net cash used in financing activities	(3,000)	(7,000)
Effect of exchange rate changes on cash	(12,000)	(6,000)
Net increase in cash and cash equivalents	700,000	447,000
Cash and cash equivalents at beginning of period	333,000	87,000
Cash and cash equivalents at end of period	\$ 1,033,000	\$ 534,000

\*See Note 2 for supplemental cash flow information.

The accompanying condensed notes are an integral part of these consolidated financial statements.





SPESCOM SOFTWARE INC.

**CONDENSED NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note 1 - Basis of Presentation**

The accompanying consolidated financial statements as of June 30, 2004 and for the three and nine months ended June 30, 2004 and 2003 are unaudited. The consolidated financial statements and related notes have been prepared in accordance with generally accepted accounting principles applicable to interim periods. In the opinion of management, the consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the consolidated financial position, operating results and cash flows for the periods presented.

The information contained in the following Condensed Notes to the Consolidated Financial Statements is condensed from that which would appear in the annual consolidated financial statements; accordingly, the consolidated financial statements included herein should be reviewed in conjunction with the consolidated financial statements and related notes thereto contained in Spescom Software Inc.'s (the Company) Annual Report on Form 10-K for the year ended September 30, 2003. It should be understood that the accounting measurements at an interim date inherently involve greater reliance on estimates than at year-end. The results of operations for the interim periods presented are not necessarily indicative of the results expected for the entire year.

The Company's future liquidity depends on its ability to generate new system sales of its eB product suite in the near term, which cannot be assured. Failure to generate sufficient system sales to meet the Company's cash flow needs can be expected to have a material adverse effect on the Company's business, results of operations, and financial condition. The Company's financial position can be a factor in attracting new customers. In an effort to strengthen the Company's financial condition and provide capital for expanding marketing and sales capabilities, the Company will continue to explore additional equity or debt financing from third parties. There can be no assurance that additional financing will be available or that the terms of such financing will be acceptable to the Company. The Company believes that its current cash and receivables, as well as additional cash that may be generated from operations, will be sufficient to meet its short-term needs for working capital. However, the Company may not be able to obtain sufficient orders to enable the Company to continue on a cash flow break-even level, which would be necessary to continue operations in the absence of further financing.

**Note 2 Summary of Significant Accounting Policies**

*Principles of Consolidation*

The consolidated financial statements are prepared using accounting principles generally accepted in the United States of America and include the accounts of the Company and its wholly-owned United Kingdom subsidiary, Spescom Software, Ltd. All significant intercompany balances and transactions have been eliminated.

*Foreign Currency*

The functional currency of the Company's United Kingdom subsidiary is the pound sterling. Assets and liabilities are translated into U.S. dollars at end-of-period exchange rates. Revenues and expenses are translated at average exchange rates in effect for the period. Net currency exchange gains or losses resulting from such translations are excluded from net income and are accumulated in a separate component of shareholders deficit as accumulated other comprehensive income (loss). Gains and losses resulting from foreign currency transactions, which are not significant, are included in the consolidated statements of operations.

*Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and also requires disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. Significant estimates made by management include revenue recognition estimates, the viability of recognizing deferred income tax assets, capitalized software costs and the valuation of equity instruments, and the allowance for doubtful accounts. Significant changes in these estimates may have a material impact on the financial statements.

*Revenue Recognition*

The Company's revenues are derived from sales of its document and configuration management systems that are primarily composed of software and services, including maintenance, training and consulting services, and third party software and hardware. The Company recognizes revenue in accordance with Statement of Position ( SOP ) 97-2 Software Revenue Recognition and SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions and Staff Accounting Bulletin ( SAB ) No. 101, updated by SAB's 103 and 104 Update of Codification of Staff Accounting Bulletins.

Software license and third party product revenues are recognized upon shipment of the product if no significant vendor obligations remain and collection is probable. In cases where a significant vendor obligation exists, revenue recognition is delayed until such obligation has been satisfied. For new software products where a historical record has not yet been demonstrated that acceptance is perfunctory, the Company defers recognition of revenue until acceptance has occurred. If an undelivered element of the arrangement exists under the license arrangement, a portion of revenue is deferred based on vendor-specific objective evidence (VSOE) of the fair value of the undelivered element until delivery occurs. If VSOE does not exist for all undelivered elements, all revenue is deferred until sufficient evidence exists or all elements have been delivered. Annual maintenance revenues, which consist of ongoing support and product updates, are recognized on a straight-line basis over the term of the contract. Payments received in advance of performance of the related service for maintenance contracts are recorded as deferred revenue. Revenues from training and consulting services are recognized when the services are performed and adequate evidence of providing such services is available. Contract revenues for long-term contracts or programs requiring specialized systems are recognized using the percentage-of-completion method of accounting, primarily based on contract labor hours incurred to date compared with total estimated labor hours at completion. Provisions for anticipated contract losses are recognized at the time they become known.

Contracts are billed based on the terms of the contract. There are no retentions in billed contract receivables. Unbilled contract receivables relate to revenues earned but not billed at the end of the period.

The Company considers many factors when applying accounting principles generally accepted in the United States of America related to revenue recognition. These factors include, but are not limited to:

The actual contractual terms, such as payment terms, delivery dates, and pricing of the various product and service elements of a contract

Availability of products to be delivered

Time period over which services are to be performed

Creditworthiness of the customer

The complexity of customizations to the Company's software required by service contracts

The sales channel through which the sale is made (direct, VAR, distributor, etc.)

Discounts given for each element of a contract

Any commitments made as to installation or implementation of go live dates

Each of the relevant factors is analyzed to determine its impact, individually and collectively with other factors, on the revenue to be recognized for any particular contract with a customer. Management is required to make judgments regarding the significance of each factor in applying the revenue recognition standards, as well as whether or not each factor complies with such standards. Any misjudgment or error by management in its evaluation of the factors and the application of the standards, especially with respect to complex or new types of transactions, could have a material adverse effect on the Company's future operating results.

*Fair Value of Financial Instruments*

Statement of Financial Accounting Standards (SFAS) No. 107, "Disclosures About Fair Value of Financial Instruments", requires management to disclose the estimated fair value of certain assets and liabilities defined by SFAS No. 107 as cash or a contractual obligation that both conveys to one entity a right to receive cash or other financial instruments from another entity, and imposes on the other entity the obligation to deliver cash or other financial instruments to the first entity. At June 30, 2004 and September 30, 2003, management believes that the carrying amounts of cash and cash equivalents, short-term investments, accounts receivable and accounts payable, and accrued expenses approximate fair value because of the short maturity of these financial instruments. The Company believes that the carrying value of its loans approximate their fair values based on current market rates of interest.

*Concentration of Credit Risk*

The Company provides products and services to customers in a variety of industries worldwide, including local governments, petrochemicals, utilities, manufacturing and transportation. Concentration of credit risk with respect to trade receivables is limited due to the geographic and industry dispersion of the Company's customer base. The Company has not experienced significant credit losses on its customer accounts. Constellation Energy Group and Network Rail accounted for 31% and 25%, respectively, of trade accounts receivable at June 30, 2004 and there were no customers that accounted for more than 10% of trade accounts receivable at September 30, 2003.

A small number of customers have typically accounted for a large percentage of the Company's annual revenues. Network Rail and Constellation Energy Group accounted for 27% and 17%, respectively of revenue for the nine months ended June 30, 2004, while Network Rail accounted for 21% of revenue for nine months ended June 30, 2003. The Company's reliance on relatively few customers could have a material adverse effect on the results of its operations on a quarterly basis.

*Property and Equipment*

Property and equipment is recorded at cost and depreciated using the straight-line method over useful lives of two to seven years. Leasehold improvements are amortized on a straight-line basis over the shorter of their useful life or the term of the related lease. Expenditures for ordinary repairs and maintenance are expensed as incurred while major additions and improvements are capitalized.

*Software Development Costs and Purchased Software*

Software development costs and purchased software are capitalized under FAS 86, Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed, when technological feasibility and marketability of the related product have been established. Software development costs incurred solely in connection with a specific contract are charged to cost of revenues. Capitalized software costs are amortized on a product-by-product basis, beginning when the product is available for general release to customers. Annual amortization expense is calculated using the greater of the ratio of each product's current gross revenues to the total of current and expected gross revenues or the straight-line method over the estimated useful life of three to four years. Accumulated amortization of capitalized software costs was \$266,000 and \$215,000 at June 30, 2004 and September 30, 2003, respectively. The related amortization expense was \$51,000 and \$193,000 for the nine months ended June 30, 2004 and 2003, respectively.

*Long-lived Assets*

The Company assesses potential impairments to its long-lived assets when there is evidence that events or changes in circumstances have made recovery of the asset's carrying value unlikely. An impairment loss would be recognized when the sum of the expected future net cash flows is less than the carrying amount of the asset. The Company concluded in fiscal 2004 that there were no events or changes in circumstances that would indicate that the carrying amounts of long-lived assets were impaired.

*Derivatives*

Under Emerging Issues Task Force (EITF) Issue No. 00-19, *Accounting for Derivative Financial Instruments Index to, and Potentially Settle in, a Company's Own Stock*, the initial balance sheet classification of contracts that require net cash settlement are recorded as assets or liabilities and contracts that require settlement in shares are recorded as equity instruments. At each balance sheet date, the Company reviews contracts and equity instruments that are to be settled in common stock to determine if sufficient common shares are available to satisfy the maximum number of shares that could be required to net-share settle the contracts, among other conditions. If sufficient common shares do not exist, then certain contracts are reclassified as a liability based on their fair value. Changes in fair value are accounted for in the consolidated statements of operations.

*Stock-Based Compensation*

The Company measures compensation expense for its stock-based employee compensation plans using the intrinsic value method and provides pro forma disclosures of net loss and basic and diluted net loss per share as if the fair value-based method had been applied in measuring compensation expense. The Company applies SFAS No. 123, *Accounting for Stock-Based Compensation* and Accounting Principles Board Opinion No. 25 and related Interpretations in accounting for its employee stock-based compensation plan.

No compensation cost was recognized for employee stock option grants during 2004 and 2003 based upon the intrinsic value method, which were fixed in nature, as the options were granted at exercise prices equal to fair market value on the date of grant. Had compensation cost for the Company's employee stock-based compensation plan been determined based on the fair value at the grant dates the disclosure requirements of SFAS No. 148, which amends the disclosure requirements of FAS 123, would have been as follows:

	For the three months ended June 30,		For the nine months ended June 30,	
	2004	2003	2004	2003
Net income (loss) used in computing net loss per share				
As reported	\$ 443,000	\$ (390,000)	\$ (119,000)	\$ (830,000)
Deduct:				
Stock-based employee compensation expense determined under the fair value method	(112,000)	(14,000)	(259,000)	(66,000)
Pro forma	\$ 331,000	\$ (404,000)	\$ (378,000)	\$ (896,000)

Under FAS 123, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants:

	For the three months ended June 30,		For the nine months ended June 30,	
	2004	2003	2004	2003
Dividend Yield	0%	0%	0%	0%
Expected Volatility	253%	285%	261%	303%
Risk free interest rate	4.73	3.33	3.83	3.33
Expected lives (years)	5	5	5	5

#### *Income Taxes*

Current income tax expense is the amount of income taxes expected to be payable for the current year. A deferred income tax asset or liability is established for the expected future consequences resulting from the differences in the financial reporting and tax bases of assets and liabilities. Deferred income tax expense (benefit) is the change during the year in the deferred income tax asset or liability. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be more likely than not realized in the future based on the Company's current and expected operating results.

#### *Net Income (Loss) per Common Share*

Basic net income (loss) per common share is computed as net income (loss) divided by the weighted average number of common shares outstanding during the year. Diluted net income (loss) per common share is computed as net loss divided by the weighted average number of common shares and potential common shares, using the treasury stock method, outstanding during the year and assumes conversion into common stock at the beginning of each period of all outstanding shares of convertible preferred stock, stock options, warrants and other potential common stock. Computations of diluted net income (loss) per share do not give effect to individual potential common stock for any period in which their inclusion would be anti-dilutive.



*Statements of Cash Flows*

The following table provides supplemental cash flow information:

	For the three months ended June 30,		For the nine months ended June 30,	
	2004	2003	2004	2003
Supplemental cash flow information:				
Interest paid	\$ 3,000	\$ 1,000	\$ 9,000	\$ 3,000
Non-cash financing and investing activities:				
Accrued preferred stock dividends	\$ 66,000	\$	\$ 198,000	\$
Fair value of equity instruments redeemable for common stock converted to common stock	\$	\$	\$ 1,159,000	\$

**Note 3 Related Party Transactions**

In September 2003 \$5,291,000 of debt owed to Spescom Ltd., the Company's principal shareholder, and its subsidiary Spescom, Ltd. UK (Spescom UK) was converted into preferred stock. The debt converted was comprised of the outstanding principal balance of promissory notes plus accrued but unpaid interest as well as accounts payable due to Spescom UK in the amount of \$492,000. On September 30, 2003, the Company issued 5,291 Series F Convertible Preferred Stock to Spescom Ltd. with a stated value of \$1,000 per share. The Series F preferred stock are convertible into common stock, beginning 45 days from the issuance date subject to availability of sufficient common shares at a stated conversion price of \$0.45 per share subject to certain adjustments. The conversion is at the option of Spescom Ltd. through September 30, 2008.

Related party liabilities consist of the following:

	June 30, 2004 (Unaudited)	September 30, 2003
<b>Related party liabilities:</b>		
Notes and accrued interest payable on demand - Spescom	\$ 505,000	\$ 504,000
<b>Total liabilities</b>	<b>\$ 505,000</b>	<b>\$ 504,000</b>

On November 18, 2003 the Company issued a note payable to Spescom UK with a principal balance of \$600,000 bearing an interest rate of 5% per annum, with principal payable in two installments of approximately \$300,000 plus interest at January 31, 2004 and March 31, 2004. The first payment of \$305,000 was made on January 29, 2004 to Spescom UK and the remaining balance of \$304,000 was paid on May 18, 2004. The due date for the second payment had been extended from March 31, 2004 to May 31, 2004. Interest expense on the note for the three and nine months ended June 30, 2004 amounted to \$2,000 and \$9,000, respectively.

In addition, the Company has two existing demand notes payable to Spescom UK for \$400,000 and \$100,000, each bearing an interest rate of 10% per annum. Spescom Ltd. has agreed that it will not cause Spescom UK to demand repayment under the two notes prior to October 1, 2004. Interest expense on the notes was \$13,000 and \$38,000 for the three and nine months ended June 30, 2004, respectively compared to \$25,000 and \$73,000 for the same period in 2003, respectively. These notes are collateralized by a security interest in favor of Spescom UK in respect of all the Company's assets.

Spescom UK provides certain administrative and accounting functions for the Company's United Kingdom subsidiary. The Company is billed a monthly fee by Spescom UK for reimbursement of certain costs in the United Kingdom including the office facilities, all accounting and human resources services, and certain corporate marketing activities. For the three and nine months ended June 30, 2004 the administrative fees totaled \$148,000 and \$439,000, respectively, compared to \$155,000 and \$460,000 for the three and nine month period ended June 30, 2003. The office rent for the Company's United Kingdom operations included in the administrative fee totaled \$86,000 and \$257,000, respectively for the three and nine months ended June 30, 2004 compared to \$69,000 and \$205,000, respectively for the three and nine months ended June 30, 2003. At June 30, 2004 and September 30, 2003 the Company had a payable to Spescom UK of \$49,000 and \$46,000, respectively. In 1999, as part of an agreement to sell the 60% interest in its United Kingdom subsidiary to Spescom Ltd., the lease for the United Kingdom office facility was to be assigned to Spescom Ltd.; however, the landlord did not grant its consent to the assignment. Since 1999, Spescom UK has paid the lease for the entire office directly to the landlord. The lease expires in March 2006 and has an annual rent of \$618,000. A portion of the office has been subleased to third party tenants for an annual rent of \$284,000. The sublease also expires March 2006.

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Spescom Ltd. and the Company have entered into a license agreement pursuant to which Spescom Ltd. has licensed to the Company the right to use the name "Spescom" and to use a trademark owned by Spescom Ltd. related to certain computer software. The Company will not pay any royalties to Spescom Ltd. in connection with this license. The license is for an indefinite term, but is terminable by either party upon 60 days prior written notice. Under the license agreement, Spescom Ltd. has agreed to indemnify and hold harmless the Company and its directors, officers, employees and agents against liabilities arising from any claim brought against the Company that alleges that Spescom Ltd.'s or the Company's use of the licensed trademark infringes the rights of any third party, provided that the Company is in material compliance with the provisions of the license agreement.

**Note 4 Receivables**

	June 30, 2004 (Unaudited)	September 30, 2003
Receivables consist of:		
Receivables	\$ 426,000	\$ 501,000
Less: allowance for doubtful accounts	(84,000)	(78,000)
	\$ 342,000	\$ 423,000

**Note 5 Reconciliation of Net Income (Loss) and Shares Used in Per Share Computations:**

Basic earnings per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options, stock awards and shared performance stock awards using the treasury stock method. The components of basic and diluted earnings per share were as follows:

	For the three months ended June 30,		For the nine months ended June 30,	
	2004	2003	2004	2003
Net income (loss) available for common shareholders(A)	\$ 377,000	\$ (390,000)	\$ (317,000)	\$ (830,000)
Weighted average outstanding shares of common stock (B)	34,068,000	30,890,000	33,992,000	30,850,000
Dilutive effect of employee stock based compensation	1,384,000			
Common stock and common stock equivalents(C)	35,452,000	30,890,000	33,992,000	30,850,000
Earnings per share:				
Basic (A/B)	\$ 0.01	\$ (0.01)	\$ (0.01)	\$ (0.03)
Diluted (A/C)	\$ 0.01	\$ (0.01)	\$ (0.01)	\$ (0.03)

For the three months ended June 30, 2003 and 2004, 4,080,000 and 2,047,332 shares attributable to outstanding stock options were excluded from the calculation of diluted earnings per share because the effect was antidilutive. For the nine months ended June 30, 2003 and 2004, 3,912,964 and 1,295,659 shares attributable to outstanding stock options were excluded from the calculation of diluted earnings per share because the effect was antidilutive.

In September 2003, the Company issued an option to purchase 2,500,000 shares of common stock to an investment consulting firm involved in a private placement and the Company issued 5,291 shares of Series F Preferred Stock to Spescom Ltd. and Spescom UK with a stated value of \$1,000 per share which are convertible into the Company's common stock at a stated conversion price of \$0.45 per share representing a total of 11,757,778 shares of common stock. In addition in September 2003, the Company issued warrants to investors who participated in the private placement to purchase 1,008,335 shares of the Company's common stock. The stock options, warrants and convertible preferred stock were excluded from calculations of per share amounts, because their effect would be antidilutive.

**Note 6 Segment and Geographic Information**

The Company has one business segment, which consists of the development and sale of a suite of integrated document, configuration and records management software products.

Revenues for the three and nine month periods ended June 30, 2004 and 2003 by customer location were as follows:

	For the three months ended June 30,		For the nine months ended June 30,	
	2004	2003	2004	2003
Net sales:				
United States	\$ 753,000	\$ 1,083,000	\$ 3,165,000	\$ 3,388,000
Europe, primarily United Kingdom	2,120,000	816,000	3,326,000	2,583,000
Other International	27,000	3,000	135,000	35,000
	\$ 2,900,000	\$ 1,902,000	\$ 6,626,000	\$ 6,006,000

	June 30, 2004 (Unaudited)	September 30, 2003
Identifiable assets from continuing operations:		
United States	\$ 833,000	\$ 941,000
Europe, United Kingdom	911,000	289,000
	\$ 1,744,000	\$ 1,230,000

**Note 7 Equity**

In January 2004 the Company reclassified 5,291 shares of preferred stock valued at \$6,790,000 related to the conversion of debt owed to Spescom Ltd. and Spescom UK to equity from mezzanine equity (see Note 8). For the three and nine months ended June 30, 2004, the Company recorded accrued dividends on the preferred stock of \$66,000 and \$198,000, respectively. In addition interest on unpaid accrued dividends of \$3,000 and \$4,000 was recorded for the three and nine months ended June 30, 2004. Finally, the Company issued 90,000 shares of common stock valued at \$46,000 to the Company's investor relations firm for services rendered.

**Note 8 Derivatives**

At September 30, 2003, the Company did not have a sufficient number of authorized shares of its common stock to satisfy potential exercises of 1,108,335 warrants held by investors and 1,150,000 options held by non-employees. As a result, the fair value of such equity instruments was reclassified from shareholders' deficit to current liabilities. The fair value of the warrants and options was determined using the Black-Scholes model at the date of reclassification and totaled \$1,233,000. As of December 31, 2003 the total options held by non-employees was reduced by 130,000 options from 1,150,000 to 1,020,000 due to the exercise of 50,000 options and the expiration of 80,000 options. The Company recognized a gain of \$5,000 on the revaluation of the remaining warrants and options as of December 31, 2003. The Annual Meeting of Shareholders was held on January 30, 2004. At the meeting, the shareholders approved a proposal to amend the Company's Articles of Incorporation to increase the number of shares of authorized common stock from 40,000,000 to 100,000,000 shares. As a result, the Company has sufficient number of shares of common stock authorized to satisfy potential exercises of 1,108,335 warrants held by investors and 1,150,000 options held by non-employees. The fair value of such equity instruments of \$1,159,000 was reclassified from current liabilities to equity and a gain of \$1,000 was recognized on the revaluation of the warrants and options to equity during the quarter ended March 31, 2004. In addition the preferred stock of \$6,790,000 was reclassified to equity from mezzanine equity.

**Note 9 Recent Accounting Pronouncements**

In November 2002, the FASB issued FASB Interpretation No. 45 (FIN No. 45), *Guarantors' Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. FIN No. 45 expands on the accounting guidance of FASB Statements No. 5, 57, and 107 and incorporates without change the provisions of FASB Interpretation No. 34, which is being superseded. FIN No. 45 will affect leasing transactions involving residual guarantees, vendor and manufacturer guarantees, and tax and environmental indemnities. All such guarantees will need to be disclosed in the notes to the financial statements starting with the period ending after December 15, 2002. Existing guarantees will be grandfathered and will not be recognized on the balance sheet. The provisions related to recognizing a liability at inception of the guarantee do not apply to product warranties, indemnification provisions in our software license arrangements or to guarantees accounted for as derivatives. The initial recognition and measurement provision are effective prospectively for guarantees issued or modified on or after December 31, 2002 and the disclosure requirements apply to guarantees outstanding as of December 31, 2002. This interpretation did not have a material effect on our consolidated financial position or results of operations as we currently do not have any guarantees or obligations falling under the scope of Interpretation No. 45.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure*, an amendment of SFAS No. 123. SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation. This statement is effective for financial statements for fiscal years ending after December 15, 2002. We are currently evaluating which method of transition to fair value accounting we will elect.

In January 2003, the Emerging Issues Task Force (EITF) issued No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*. This EITF establishes the criteria for recognizing revenue in arrangements when several items are bundled into one agreement. EITF 00-21 does not allow revenue recognition unless the fair value of the undelivered element(s) is available and the element has stand-alone value to the customer. EITF 00-21 also provides guidance on allocating the total contract revenue to the individual elements based upon the available fair value of each deliverable. This interpretation is not expected to have a material effect on our consolidated financial position or consolidated results of operations.

In January 2003, the FASB issued Interpretation 46, *Consolidation of Variable Interest Entities*. In general, a variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) do not have equity investors with voting rights or (b) have equity investors that do not provide sufficient financial resources for the entity to support its activities. Interpretation 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. The consolidation requirements of Interpretation 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after June 15, 2003. Certain of the disclosure requirements apply in all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established. This interpretation is not expected to have a material effect on our consolidated financial position or consolidated results of operations as we currently do not have any variable interest entities falling within the scope of Interpretation 46.

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*.

SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS 133, effective for reporting periods ending after June 30, 2003. In particular, SFAS No. 149 clarifies under what circumstances a contract within an initial net investment meets the characteristic of a derivative and when a derivative contains a financing component that warrants special reporting in the statement of cash flows. SFAS No. 149 is generally effective for contracts entered into or modified after June 30, 2003. The adoption of SFAS 149 had a material effect on our consolidated financial position or consolidated results of operations. See Note 8 Derivatives.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS No. 150 did not have a material effect on our consolidated financial position or consolidated results of operations as we currently do not have any financial instruments falling within the scope of SFAS No. 150.

In December 2003, the FASB issued Interpretation 46R (FIN 46R), a revision to Interpretation 46 (FIN 46), *Consolidation of Variable Interest Entities*. FIN 46R clarifies some of the provisions of FIN 46 and exempts certain entities from its requirements. FIN 46R is effective at the end of the first interim period ending after March 15, 2004. Entities that have adopted FIN 46 prior to this effective date can continue to apply the provisions of FIN 46 until the effective date of FIN 46R or elect early adoption of FIN46R. This interpretation is not expected to have a material effect on our consolidated financial position or consolidated results of operations.

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

### **Forward Looking Statements**

*This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from historical results or anticipated results, including those set forth under *Certain Factors That May Affect Future Results* below and elsewhere in, or incorporated by reference into, this report.*

*When used in the following discussion, the words *believes, anticipates, expects* and similar expressions are intended to identify forward-looking statements. Such statements are subject to certain risks and uncertainties, which could cause actual results to differ materially from those projected. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to publicly release the result of any revisions to these forward-looking statements, which may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.*

*The following discussion should be read in conjunction with the Selected Consolidated Financial Data and the Consolidated Financial Statements, including the Notes thereto.*



**CRITICAL ACCOUNTING POLICIES**

The consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America. As such, management is required to make judgments, estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. The significant accounting policies which are most critical to aid in fully understanding and evaluating reported financial results include the following:

*Revenue Recognition*

The Company enters into contractual arrangements with end-users that may include licensing of the Company's software products, product support and maintenance services, consulting services or various combinations thereof, including the sale of such products or services separately. The Company recognizes revenue in accordance with Statement of Position ( SOP ) 97-2 Software Revenue Recognition and SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions and Staff Accounting Bulletin ( SAB ) No. 101, updated by SAB's 103 and 104 Update of Codification of Staff Accounting Bulletins.

Software license and third party product revenues are recognized upon shipment of the product if no significant vendor obligations remain and collection is probable. In cases where a significant vendor obligation exists, revenue recognition is delayed until such obligation has been satisfied. For new software products where a historical record has not yet been demonstrated that acceptance is perfunctory, the Company defers recognition of revenue until acceptance has occurred. If an undelivered element of the arrangement exists under the license arrangement, a portion of revenue is deferred based on vendor-specific objective evidence (VSOE) of the fair

value of the undelivered element until delivery occurs. If VSOE does not exist for all undelivered elements, all revenue is deferred until sufficient evidence exists or all elements have been delivered. Annual maintenance revenues, which consist of ongoing support and product updates, are recognized on a straight-line basis over the term of the contract. Payments received in advance of performance of the related service for maintenance contracts are recorded as deferred revenue. Revenues from training and consulting services are recognized when the services are performed and adequate evidence of providing such services is available. Contract revenues for long-term contracts or programs requiring specialized systems are recognized using the percentage-of-completion method of accounting, primarily based on contract labor hours incurred to date compared with total estimated labor hours at completion. Provisions for anticipated contract losses are recognized at the time they become known.

Contracts are billed based on the terms of the contract. There are no retentions in billed contract receivables. Unbilled contract receivables relate to revenues earned but not billed at the end of the period.

The Company considers many factors when applying accounting principles generally accepted in the United States of America related to revenue recognition. These factors include, but are not limited to:

The actual contractual terms, such as payment terms, delivery dates, and pricing of the various product and service elements of a contract

Availability of products to be delivered

Time period over which services are to be performed

Creditworthiness of the customer

The complexity of customizations to the Company's software required by service contracts

The sales channel through which the sale is made (direct, VAR, distributor, etc.)

Discounts given for each element of a contract

Any commitments made as to installation or implementation of go live dates

Each of the relevant factors is analyzed to determine its impact, individually and collectively with other factors, on the revenue to be recognized for any particular contract with a customer. Management is required to make judgments regarding the significance of each factor in applying the revenue recognition standards, as well as whether or not each factor complies with such standards. Any misjudgment or error by management in its evaluation of the factors and the application of the standards, especially with respect to complex or new types of transactions, could have a material adverse effect on the Company's future operating results.

*Allowance for Doubtful Accounts*

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The Company sells its products directly to end-users, generally requiring a significant up-front payment and remaining terms appropriate for the creditworthiness of the customer. The Company also sells its products to VARs and other software distributors generally under terms appropriate for the creditworthiness of the VAR or distributor. The Company retains no continuing obligations on sales to VARs. Receivables from customers are generally unsecured. The Company continuously monitors its customer account balances and actively pursues collections on past due balances. The Company maintains an allowance for doubtful accounts which is comprised of a general reserve based on historical collections performance plus a specific reserve for certain known customer collections issues. If actual bad debts are greater than the reserves calculated based on historical trends and known customer issues, the Company may be required to book additional bad debt expense which could have a material adverse effect on our business, results of operations and financial condition for the periods in which such additional expense occurs.

**RESULTS OF OPERATIONS**

The following table sets forth the condensed consolidated statement of operations expressed as a percentage of total revenue for the periods indicated:

	For the three months ended June 30,		For the nine months ended June 30,	
	2004	2003	2004	2003
<b>Revenues</b>				
Licenses	54%	25%	46%	30%
Services and other	46%	75%	54%	70%
Total revenues	100%	100%	100%	100%
<b>Cost of revenues</b>				
Licenses	1%	10%	3%	10%
Services and other	20%	34%	26%	29%
	21%	44%	29%	39%
Gross profit	79%	56%	71%	61%
<b>Operating expenses:</b>				
Research and development	12%	19%	15%	18%
Marketing and sales	30%	33%	33%	32%
General and administrative	20%	17%	24%	18%
	62%	69%	72%	68%
Income (loss) from operations	17%	(13)%	(1)%	(7)%
Interest income and other income			1%	
Interest expense and other expense	(2)%	(7)%	(2)%	(7)%
Net Income (loss)	15%	(20)%	(2)%	(14)%

**Revenues**License Revenues

(in thousands)

	Three Months Ended June 30,			Percent Change	Nine Months Ended June 30,			Percent Change
	2004	2003			2004	2003		
License Revenue	\$ 1,559	\$ 485		221%	\$ 3,037	\$ 1,773		71%
Percentage of total revenue	54%	25%			46%	30%		

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License revenues increased by \$1.1 million, or 221%, to \$1.6 million from \$485,000 for the three months ended June 30, 2004 as compared to the same period in 2003. The increase for the quarter was due primarily to a sale to an existing customer, Network Rail, of \$1.5 million as compared to various smaller sales to new and existing customers totaling \$400,000 in the prior year. License revenues increased by \$1.3 million, or 71%, to \$3.0 million from \$1.8 million for the nine months ended June 30, 2004 as compared to the same period in 2003. The increase was due primarily to sales to Network Rail and Constellation Energy Group of \$1.5 million and \$750,000, respectively, compared to sales of \$369,000 and \$250,000 to Network Rail and Bechtel, respectively, during the corresponding period in the prior year. The Company has continued to experience higher sales of the eB product suite as a result of customers expanding their existing software systems and an increase in software orders from new and existing customers in response to a higher demand for a comprehensive content management solution needed for business process compliance, corporate record keeping and enterprise collaboration.

We anticipate that the demand for enterprise document, configuration and records management software solutions will continue to increase if overall economic conditions continue to strengthen. The Company's license revenues fluctuate from quarter to quarter, but we have experienced and expect to continue to see increased license revenue opportunities as more users are deployed throughout existing customer enterprises and as we make additional sales to new customers.

Although the Company has historically generated the majority of its revenues from its direct sales force, the Company has also established a network of third-party VARs, system integrators and OEMs who build and sell systems (with components or complete systems provided by the Company) that address specific customer needs within various industries, including those targeted directly by the Company. Sales through indirect channels for the three months ended June 30, 2004 amounted to \$71,000, or 3% of total revenue compared to \$83,000 or 4% of total revenue for the same period in 2003. Sales through indirect channels for the nine months ended June 30, 2004 amounted to \$371,000, or 6% of total revenue compared to \$131,000 or 2% of total revenue for the same period in 2003. The increase in indirect sales of \$240,000 nine months ended June 30, 2004 is due primarily to increased sales from one distributor in the United Kingdom.

A small number of customers have typically accounted for a large percentage of the Company's annual revenues. Network Rail accounted for 61% of revenue for the three months ended June 30, 2004, compared to 15% of revenue for three months ended June 30, 2003. Network Rail and Constellation Energy Group accounted for 27% and 17% of revenue for the nine months ended June 30, 2004, while Network Rail accounted for 21% of revenue for nine months ended June 30, 2003. The Company's reliance on relatively few customers could have a material adverse effect on its results of operations on a quarterly basis.

#### Service and Other Revenues

(in thousands)

	Three Months Ended June 30,			Percent Change	Nine Months Ended June 30,			Percent Change		
	2004		2003		2004		2003			
Service Revenue	\$	1,341	\$	1,417	-5%	\$	3,589	\$	4,233	-15%
Percentage of total revenue		46%		75%		54%		70%		

Services and other revenues are comprised of maintenance and non-maintenance services. Non-maintenance services typically relate to business process studies, implementation of systems and training which vary with the level of license revenues while maintenance revenue is primarily dependent on customers renewing their annual maintenance support contracts.

Services and other revenue decreased in absolute dollars and as a percentage of total revenue for the three and nine months ended June 30, 2004, as compared to the corresponding prior year periods. The \$76,000, or 5%, decrease in the three months ended June 30, 2004 as compared to the same periods in 2003 was comprised of a \$218,000, or 32%, reduction in non-maintenance service revenue which was partially offset by an increase of \$142,000, or 20%, in maintenance revenue. The \$644,000, or 15%, decrease in the nine months ended June 30, 2004 as compared to the same period in 2003 consisted of a \$757,000, or 38% reduction in non-maintenance service revenue which was partially offset by an increase of \$118,000, or 5% in maintenance revenue. The decrease in non-maintenance service revenue in the three and nine months ended June 30, 2004 resulted from the fact that the Company had one large implementation service contract as compared to two large implementation service contracts for the same period in 2003. The increase in maintenance revenue in the three and nine months ended June 30, 2004 compared to the comparable periods of 2003 resulted from increased license sales and maintenance requirements.

We anticipate that service and other revenue will fluctuate primarily due to fluctuations in sales to new customers, which require more services that typically include a business process study, integration with other business systems and training. In addition, we expect that service and other revenues will continue to fluctuate from quarter to quarter based on the timing of customer orders.

**Cost of Revenues**Cost of License Revenues

(in thousands)

	Three Months Ended			Percent Change	Nine Months Ended			Percent Change		
	2004	June 30, 2004	2003		2004	June 30, 2004	2003			
Cost of License Revenue	\$	37	\$	189	-80%	\$	178	\$	589	-70%
Percentage of license revenue		2%		39%		6%		33%		

Cost of licenses revenues consists of costs associated with reselling third-party products and amortization of internal software development costs.

Cost of license revenue decreased in absolute dollars and as a percentage of associated license revenue in both the three and nine months ended June 30, 2004, as compared to the same periods in 2003. The costs of licensed revenues in the three months ended June 30, 2004 decreased \$152,000, or 80% as compared to the same period in 2003. The decrease was related to a reduction in third-party software costs of \$79,000 due to fewer sales of third-party products as a percentage of total sales. In addition, amortization expense of capitalized software costs decreased \$73,000 as a result of a majority of such costs being fully amortized in fiscal 2003. The overall decrease in costs of license revenues and increase in license revenue resulted in an improvement in gross profit margin to 98% for the three months ended June 30, 2004 as compared to 61% for the same period a year ago.

The costs of licensed revenues in the nine months ended June 30, 2004 decreased \$411,000, or 70% as compared to the same period in

2003. Approximately \$230,000 of this decrease was related to reduced amortization expense of capitalized software as mentioned above. The remaining decrease of \$181,000, was due to decreased third-party costs due to lower sales of third-party products as a percentage of total sales. The overall decrease in cost of license revenues resulted in an improvement in gross profit percentage of license revenues to 94% for the nine months ended June 30, 2004 as compared to 67% for the same period a year ago.

We expect the cost of license revenues to fluctuate based on customer requirements for third-party software products since these costs have the largest impact on cost of license revenues.

### Cost of Services and Other Revenues

(in thousands)

	Three Months Ended June 30,			Percent Change	Nine Months Ended June 30,			Percent Change
	2004	2003			2004	2003		
Cost of service and other revenue	\$ 586	\$ 655	-11%	\$ 1,693	\$ 1,749	-3%		
Percentage of service and other revenue	44%	46%		47%	41%			

Cost of services and other revenues consists primarily of personnel-related costs in providing consulting services, training to customers and support. It also includes costs associated with reselling third-party hardware and maintenance, which includes telephone support costs.

Cost of services and other revenue decreased in absolute dollars in the three and nine months ended June 30, 2004 as compared to the same periods in 2003. The \$69,000, or 11% and \$56,000, or 3%, decrease in the three and nine months ended June 30, 2004, respectively, as compared to the same periods in 2003, was due primarily to decreased third party service costs of \$64,000 associated with a customer contract for conversion of data in the prior year. The decrease in cost of services and other revenue resulted in a slight increase in gross profit to 56% from services and other revenue for the three month period ended June 30, 2004 as compared to 54% for the same period a year ago. The gross profit from services and other revenue as a percentage of services and other revenues decreased to 53% for the nine months ended June 30, 2004 from 59% for the same period a year ago. The lower gross profit percentage is due to a 15% decrease in service and other revenues while cost of revenues decreased only 3% as third party costs decreased \$75,000 and personnel and related costs remained relatively unchanged.

We expect the cost of service and other revenues to fluctuate in absolute dollar amounts and as a percentage of total revenues as the related service revenue fluctuates.

### **Operating Expenses**

#### Research and Development



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(in thousands)

	Three Months Ended			Percent Change	Nine Months Ended			Percent Change
	2004	June 30, 2004	2003		2004	June 30, 2004	2003	
Research and development expenses	\$	341	\$ 364	-6%	\$	1,008	\$ 1,101	-8%
Percentage of total revenue		12%	19%			15%	18%	

Research and development expenses consist of salaries and benefits for software developers as well as an allocation of corporate expenses, calculated on the basis of headcount, such as corporate insurance, facilities, telephone and other.

Research and development expenses decreased in absolute dollars and as a percentage of total revenue in the three and nine months ended June 30, 2004, as compared to the same periods in 2003. The \$23,000, or 6%, decrease for the three months ended June 30, 2004 was due primarily to a reduction in facility costs of \$10,000 associated with the Company moving to a smaller facility in June of fiscal year 2003 and reduced labor and related costs of \$8,000.

The \$93,000, or 8% decrease for the nine months ended June 30, 2004 was due primarily to a reduction in facility costs of \$118,000 associated with the Company moving to a smaller facility in June of fiscal year 2003. The decrease was partially offset by an increase of \$25,000 in labor and related costs associated with the Company adding additional personnel dedicated to quality assurance.

We believe that continued investment in research and development is a critical factor in maintaining our competitive position and we expect research and development costs to remain at the current levels in absolute dollar amounts in the next several quarters.

Marketing and Sales

(in thousands)

	Three Months Ended June 30,			Percent Change	Nine Months Ended June 30,			Percent Change
	2004	2003			2004	2003		
Marketing and sales expenses	\$ 871	\$ 635		37%	\$ 2,201	\$ 1,918		15%
Percentage of total revenue	30%	33%			33%	32%		

Marketing and sales expenses consist of salaries, cost of benefits, sales commissions and other expenses related to the direct sales force, as well as allocation of overall corporate expenses, calculated on the basis of headcount, related to items such as corporate insurance, facilities, telephone and other.

Marketing and sales expenses increased in absolute dollars for the three and nine months ended June 30, 2004, as compared to the same periods in 2003. The increase of \$236,000, or 37%, for the three months ended June 30, 2004 as compared to the same period in 2003 was due primarily to an increase of \$92,000 in marketing labor and related costs associated with additional marketing and sales personnel, \$68,000 in commission expenses related to higher revenues, \$65,000 in marketing costs primarily related to user conferences and travel and \$50,000 in trade shows. The increase in marketing costs was partially offset by reduced facility costs of \$34,000 associated with the Company moving into a smaller facility in June of fiscal year 2003.

Marketing and sales expenses increased \$283,000, or 15%, for the nine months ended June 30, 2004 as compared to the same period in 2003 due primarily to an increase of \$127,000 in marketing labor and related costs associated with additional marketing and sales personnel, \$129,000 in commission expenses related to higher revenues, \$74,000 in marketing costs primarily related to user conferences and travel and \$53,000 in trade shows. The increase in marketing costs was partially offset by reduced facility costs of \$66,000 associated with the Company moving into a smaller facility in June of fiscal year 2003 and a reduction of \$45,000 in consultants expenses due to the Company performing certain marketing and sales services in-house which were previously performed by outside consultants.

We expect marketing and sales expense to increase in absolute dollar amounts and as a percentage of total revenue as a result of the planned expansion of our sales and marketing efforts in the next several quarters.

General and Administrative

(in thousands)

	Three Months Ended June 30,			Percent Change	Nine Months Ended June 30,			Percent Change
	2004	2003			2004	2003		
General and administrative expenses	\$ 585	\$ 319		83%	\$ 1,574	\$ 1,090		44%
Percentage of total revenue	20%	17%			24%	18%		

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General and administrative expenses consist primarily of personnel costs for finance, information technology, human resources and general management, as well as outside professional services and an allocation of overall corporate expenses, calculated on the basis of headcount, such as corporate insurance, facilities, telephone and other.

General and administrative expenses increased in absolute dollars and as a percentage of total revenue for the three and nine months ended June 30, 2004, as compared to the same period in 2003. The 83%, or \$266,000 increase in the three months ended June 30, 2004 as compared to the same period in 2003, was primarily due to increased accounting and legal fees of \$142,000 relating to several registration statement filings and increased investor relations costs of \$44,000 relating to a new public relations firm engaged in September 2003.

The \$484,000 increase in the nine months ended June 30, 2004 as compared to the same period in 2003 was due primarily to an increase in accounting and legal fees of \$273,000 relating to routine SEC review of the Company's Annual Report on Form 10-K for the year ended September 30, 2002 and several registration filings. In addition, the Company incurred additional expenses of \$109,000 relating to a new public relations firm engaged in September, 2003, and increased costs of \$30,000 associated with the annual shareholder meeting held in January, 2004.

We expect that general and administrative expenses will fluctuate in absolute dollars based on the timing of accounting and legal matters such as the Company's recent registration statement filings.

### **INTEREST EXPENSE**

Interest expense consists primarily of fixed interest obligations on our outstanding debt to Spescom Ltd. as well as interest paid on capital lease obligations. Interest expense was \$37,000 and \$96,000 for the three and nine months ended June 30, 2004, respectively, as compared to \$134,000 and \$393,000 for the comparable periods in 2003. The decrease is due to decreased debt balances owed to

Spescom UK due to the conversion of debt to convertible preferred stock in September 2003.

### **LIQUIDITY AND CAPITAL RESOURCES**

At June 30, 2004, the Company's cash and cash equivalents totaled \$1,033,000 as compared to \$333,000 at June 30, 2003. Its current ratio (current assets divided by current liabilities) was .32 at June 30, 2004.

For the nine months ended June 30, 2004, cash used by financing activities totaled \$3,000, primarily due to payments on capital leases of \$16,000 which was partially offset by cash received of \$13,000 from the exercise of stock options. Cash provided by operating activities totaled \$730,000 and primarily relates to the sale and collection of a large software license fee during the quarter.

The Company has received loans from Spescom Ltd. in the past to meet its obligations. The outstanding balance of its loans from Spescom was relatively unchanged at \$505,000 at June 30, 2004 as compared to \$504,000 at September 30, 2003. These notes are due in October 2004. In November 2003, the Company issued a short-term note payable to Spescom UK of \$600,000 which was repaid prior to June 30, 2004. The first payment of \$305,000 was made on January 29, 2004 and the second payment of \$304,000 was made on May 18, 2004.

In fiscal year 2003, Spescom Ltd. supported the Company's operations by extending the due dates of notes payable and by converting \$5.3 million in debt and other obligations owed to Spescom Ltd. to preferred stock. The preferred stock is entitled to receive dividends of 5% of the stated value per share per annum, payable on a quarterly basis in cash or common stock. Unpaid dividends accrue at 8% per annum compounded annually from the date of accrual until paid. The Company has recorded accrued dividends on the preferred stock of \$198,000 and interest of \$4,000 as of June 30, 2004. Spescom Ltd. has stated that it has the ability and will continue to fund the Company's operations through October 1, 2004, if necessary.

However, the funding of such loans may be delayed or prevented as a result of, among other factors, currency exchange regulations of the Republic of South Africa, under which Spescom is required to apply for and obtain the approval of the South African Reserve Bank before providing any funds to the Company. Spescom Ltd. is presently unaware of any reason why such Reserve Bank approval should not be given.

The Company's future liquidity depends on its ability to generate new system sales of its eB product suite in the near term, which cannot be assured. Failure to generate sufficient system sales to meet the Company's cash flow needs can be expected to have a material adverse effect on the Company's business, results of operations, and financial condition. The Company's financial position can be a factor in attracting new customers. In an effort to strengthen the Company's financial condition and provide capital for expanding marketing and sales capabilities, the Company will continue to explore additional equity or debt financing from third parties. There can be no assurance that additional financing will be available or that the terms of such financing will be acceptable to the Company. The Company believes that its current cash and receivables, as well as additional cash that may be generated from operations, will be sufficient to meet its short-term needs for working capital. However, the Company may not be able to obtain sufficient orders to enable the Company to continue on a cash flow break-even level, which would be necessary to continue operations in the absence of further financing.

### **CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS**

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The following summarizes our contractual obligations and other commitments at June 30, 2004, and the effect such obligations could have on our liquidity and cash flow in future periods:

	Amount of Commitment Expiring by Period				Total
	Less Than 1 Year	1-3 Years	4-5 Years	Over 5 Years	
Notes and Accounts Payable to Spescom	\$ 554,000	\$	\$	\$	\$ 554,000
Capital Lease Obligations	21,000	48,000			69,000
Operating Lease Obligations	237,000	749,000	371,000		1,357,000
Total	\$ 812,000	\$ 797,000	\$ 371,000	\$	\$ 1,980,000

**OFF-BALANCE SHEET ARRANGEMENTS**

At June 30, 2004 and September 30, 2003, we did not have any other relationships with unconsolidated entities or financial partnerships, including entities often referred to as structured finance or special purpose entities that would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Therefore, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we were engaged in such relationships.

**CERTAIN FACTORS THAT MAY AFFECT FUTURE RESULTS**

*Foreign Currency*

The Company's geographic markets are primarily in the United States and Europe, with some sales in other parts of the world. For the nine months ended June 30, 2004, revenues from the United States were 48% of total revenues, and revenues from Europe and other locations were 52% of total revenues. This compares to 56% and 44% respectively for the same period a year ago. Revenues from our United Kingdom subsidiary can fluctuate from quarter to quarter based on the timing of customer orders. The increased revenue in the current quarter was improved by a foreign currency gain of \$309,000 due to a weakened dollar value compared to the pound sterling. Changes in foreign currency rates, the condition of local economies, and the general volatility of software markets may result in a higher or lower proportion of foreign revenues in the future. Although the Company's operating and pricing strategies take into account changes in exchange rates over time, future fluctuations in the value of foreign currencies may have a material adverse effect on the Company's business, operating results and financial condition.

*Inflation*

The Company believes that inflation has not had a material effect on its operations to date. Although the Company enters into fixed-price contracts, management does not believe that inflation will have an adverse material impact on its operations for the foreseeable future, as the Company takes into account expected inflation in its contract proposals and is generally able to project its costs based on forecasted contract requirements.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK****Interest Rate Risk**

The Company's exposure to market rate risk for changes in interest rates relates primarily to the Company's investment portfolio. As of June 30, 2004 the Company had investments in money market accounts totaling \$1 million. The Company does not use derivative financial instruments in its investment portfolio. The Company places its investment with high quality issuers and follows internally developed guidelines to limit the amount of credit exposure to any one issuer. Additionally, in an attempt to limit interest rate risk, the Company follows guidelines to limit the average and longest single maturity dates. The Company is adverse to principal loss and ensures the safety and preservation of its invested funds by limiting default, market and reinvestment risk. The following table summarizes our securities and weighted average yields, as of June 30, 2004:

	Expected Maturity Date				Total
	2004	2005	2006	2007	
Certificates of Deposit	\$ 642,000	\$	\$		\$ 642,000
Weighted Average Yield	2.63%				
Money Market	376,000				376,000
Weighted Average Yield	0.50%				
Total	\$ 1,018,000	\$	\$		\$ 1,018,000

**ITEM 4. CONTROLS AND PROCEDURES**

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, we have concluded that, as of June 30, 2004, the Company's disclosure controls and procedures are effective in recording, processing, summarizing and reporting within the time periods specified in the SEC's rules and forms material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic SEC filings.

During the last fiscal quarter, there were no significant changes in the Company's internal control over financial reporting or in other factors that materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

**PART II. OTHER INFORMATION**

**ITEM 1 LEGAL PROCEEDINGS**

The Company is involved from time to time in litigation arising in the normal course of business. Management believes that any liability with respect to such routine litigation, individually or in the aggregate, is not likely to be material to the Company's consolidated financial position or results of operations.

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

None.

**ITEM 6 EXHIBITS AND REPORTS ON FORM 8-K:**

(a) Exhibits

3.1\* Registrant's Articles of Incorporation, as amended.

3.2\* Registrant's Bylaws, as amended.

10.1 (1) Lease between The Irvine Company and Spescom Software Inc., dated February 25, 2001.

10.2 (2) 10.0% promissory note due October 15, 2003 in principal amount of \$1,235,076 issued by Spescom Software Inc. to Spescom Ltd. South Africa on February 15, 2002.

10.3 (3) 10.0% promissory note due October 15, 2003 in principal amount of \$1,810,383 issued by Spescom Software Inc. to Spescom Ltd., a United Kingdom corporation, on February 15, 2002.

10.4 (4) Security agreement between Spescom Software Inc. and Spescom Limited, a United Kingdom corporation and Spescom Limited, a South African corporation and collectively with Spescom UK dated February 15, 2002.

10.5 (5) 10% promissory note due upon demand in principal amount of \$400,000 issued by Spescom Software Inc. to Spescom Ltd., a United Kingdom corporation, on March 15, 2002.

10.6 (6) Security agreement dated March 15, 2002 between Spescom Software Inc., a California corporation and Spescom Ltd., a United Kingdom corporation.

10.7 (7) Pledge agreement executed March 15, 2002 by and between Spescom Software Inc., a California corporation, Spescom Ltd., a United Kingdom corporation, and Solomon Ward Seidenwurm & Smith, LLP.

10.8 (8) 10.0% promissory note due upon demand in principal amount of \$500,000 issued by Spescom Software Inc. to Spescom Ltd., a United Kingdom corporation, on April 19, 2002.





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- 10.9 (9) 10.0% promissory note due upon demand in principal amount of \$700,000 issued by Spescom Software Inc. to Spescom Ltd., a United Kingdom corporation, on May 31, 2002.
- 10.10 (10) 5.0% promissory note due in two payments of \$300,000 in principal and accrued interest on January 31, 2004 and March 31, 2004, respectively issued by Spescom Software Inc. to Spescom Ltd., a United Kingdom corporation, on November 18, 2003.
- 31.1 Section 302 Certification by Carl Mostert, Chief Executive Officer.
- 31.2 Section 302 Certification by John W. Low, Chief Financial Officer.
- 32.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- (b) Reports on Form 8-K.

We furnished the SEC a report on Form 8-K dated February 2, 2004 that announced the approval from the Company's shareholders an amendment to the Articles of Incorporation to change the name from Altris Software Inc. to Spescom Software Inc.

We furnished to the SEC two reports on Form 8-K dated April 21, 2004. The first 8-K announced the dismissal of Grant Thornton, LLP as the principal independent accountants of the Company. In addition, the Company announced the appointment of Singer, Lewak, Greenbaum and Goldstein, LLP as the new principal independent accountants.

The second April 21, 2004 8-K announced the appointment of Michael Silverman to the Board of Directors of the Company.

We furnished the SEC a report on Form 8-K dated April 26, 2004 that announced preliminary results for the Company's second fiscal quarter ended March 31, 2004. Revenues were approximately \$1.6 million with an estimated loss of approximately \$573,000 or \$0.02 per share.

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- (1) Incorporated by reference to Exhibit 10.27 to the Form 10-K filed on November 23, 2001.
- (2) Incorporated by reference to Exhibit 10.28 to the Form 10-Q filed on May 15, 2002.
- (3) Incorporated by reference to Exhibit 10.29 to the Form 10-Q filed on May 15, 2002.
- (4) Incorporated by reference to Exhibit 10.30 to the Form 10-Q filed on May 15, 2002.
- (5) Incorporated by reference to Exhibit 10.31 to the Form 10-Q filed on May 15, 2002.
- (6) Incorporated by reference to Exhibit 10.32 to the Form 10-Q filed on May 15, 2002.
- (7) Incorporated by reference to Exhibit 10.33 to the Form 10-Q filed on May 15, 2002.
- (8) Incorporated by reference to Exhibit 10.34 to the Form 10-Q filed on August 14, 2002.
- (9) Incorporated by reference to Exhibit 10.35 to the Form 10-Q filed on August 14, 2002.
- (10) Incorporated by reference to Exhibit 10.10 to the Form 10-Q filed on February 13, 2004.
- \* Incorporated herein by this reference from previous filings with the Securities and Exchange Commission.

**SIGNATURES**

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

SPESCOM SOFTWARE INC.

<b>Signature</b>	<b>Title</b>	<b>Date</b>
/s/ Carl Mostert Carl Mostert	Director and Chief Executive Officer (Principal Executive Officer)	August 12, 2004
/s/ John W. Low John W. Low	Chief Financial Officer and Secretary (Principal Financial and Accounting Officer)	August 12, 2004