SOCKET COMMUNICATIONS INC
Form 10-Q
August 14, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2006

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period ____________ to ____________

Commission file number 1-13810

SOCKET COMMUNICATIONS, INC.
(Exact Name of Registrant as Specified in its Charter)

Delaware	**94-3155066**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

37400 Central Court, Newark, CA 94560
(Address of principal executive offices including zip code)

(510) 744-2700
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES [X] NO[ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act. Large accelerated filer [ ] Accelerated filer [ ] Non-accelerated filer [X]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
YES [ ] NO [X]

Number of shares of common stock ($0.001 par value) outstanding as of July 31, 2006 was 31,847,472 shares.

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Item 1. Financial Statements (Unaudited)

SOCKET COMMUNICATIONS, INC. CONDENSED CONSOLIDATED BALANCE SHEETS		
	June 30, 2006 (Unaudited)	December 31, 2005*
ASSETS		

Current assets:		
Cash and cash equivalents	$ 7,254,040	$ 6,833,193
Accounts receivable, net	3,063,690	2,952,429
Inventories	2,486,620	2,195,394
Prepaid expenses and other current assets	268,846	315,287
Total current assets	13,073,196	12,296,303
Property and equipment:		
Machinery and office equipment	1,949,105	1,821,367
Computer equipment	972,145	913,389
	2,921,250	2,734,756
Accumulated depreciation	(2,011,098)	(2,106,914)
Property and equipment, net	910,152	627,842
Intangible technology, net	676,852	748,937
Goodwill	9,797,946	9,797,946
Other assets	170,696	163,754
Total assets	$ 24,628,842	$ 23,634,782
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 3,173,399	$ 2,616,421
Accrued payroll and related expenses	817,391	729,768
Bank line of credit	2,226,208	2,308,771
Deferred income on shipments to distributors	1,127,115	1,114,450
Current portion of deferred rent and capital leases	26,360	42,639
Total current liabilities	7,370,473	6,812,049
Long term portion of deferred rent and capital leases	3,389	8,372
Commitments and contingencies		
Stockholders' equity:		
Series F Convertible Preferred Stock, $0.001 par value: Authorized shares - 276,269, Issued and outstanding shares - none at June 30, 2006 and 82,330 at December 31, 2005	--	82
Common stock, $0.001 par value: Authorized shares - 100,000,000, Issued and outstanding shares - 31,836,133 at June 30, 2006 and 30,223,709 at December 31, 2005	31,836	30,224
Additional paid-in capital	51,940,579	50,673,487
Accumulated deficit	(34,717,435)	(33,889,432)
Total stockholders' equity	17,254,980	16,814,361
Total liabilities and stockholders' equity	$ 24,628,842	$ 23,634,782

*Derived from audited consolidated financial statements

See accompanying notes.

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SOCKET COMMUNICATIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenues	$ 6,855,028	$ 6,580,414	$ 13,613,719	$ 12,562,610
Cost of revenue	3,453,923	3,268,756	6,839,067	6,203,060
Gross profit	3,401,105	3,311,658	6,774,652	6,359,550
Operating expenses:				
Research and development	1,378,791	897,882	2,515,348	1,787,010
Sales and marketing	1,840,713	1,557,704	3,603,137	3,192,210
General and administrative	641,633	579,059	1,483,743	1,411,880
Amortization of intangible technology	36,043	36,042	72,086	130,955
Total operating expenses	3,897,180	3,070,687	7,674,314	6,522,055
Operating income (loss)	(496,075)	240,971	(899,662)	(162,505)
Interest income and other	49,915	17,968	86,593	31,475
Interest expense	(2,077)	(857)	(4,281)	(2,596)
Net income (loss)	(448,237)	258,082	(817,350)	(133,626)
Preferred stock dividends	--	(12,174)	(10,653)	(24,374)
Net income (loss) applicable to common stockholders	$ (448,237)	$ 245,908	$ (828,003)	$ (158,000)
Net income (loss) per share applicable to common stockholders:				
Basic	$ (0.01)	$ 0.01	$ (0.03)	$ (0.01)
Diluted	$ (0.01)	$ 0.01	$ (0.03)	$ (0.01)
Weighted average shares outstanding:				
Basic	31,695,832	30,160,994	31,045,664	30,157,993
Diluted	31,695,832	32,301,424	31,045,664	30,157,993

See accompanying notes.

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SOCKET COMMUNICATIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six Months Ended June 30,	
	2006	2005
Operating activities		
Net loss	$ (817,350)	$ (133,626)
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock-based compensation	636,444	--
Depreciation and amortization	317,922	221,801
Amortization of intangibles	72,085	130,956
(Gain) loss on foreign currency translations	(54,118)	115,419
(Gain) loss on forward exchange contracts	17,793	(65,264)
Change in deferred rent	(16,512)	(16,510)
Changes in operating assets and liabilities:		
Accounts receivable	(73,695)	632,898
Inventories	(291,226)	392,675
Prepaid expenses and other current assets	46,441	10,481
Other assets	(6,942)	(35,844)
Accounts payable and accrued expenses	567,366	174,714
Accrued payroll and related expenses	87,623	37,118
Deferred income on shipments to distributors	12,665	120,757
Net cash provided by operating activities	498,496	1,585,575
Investing activities		
Purchase of equipment and tooling	(600,232)	(266,216)
Net cash used in investing activities	(600,232)	(266,216)
Financing activities		
Payments on capital leases and equipment financing notes	(4,750)	(4,533)
Gross proceeds from bank line of credit	4,973,534	5,509,300
Gross payments on bank line of credit	(5,056,097)	(6,162,572)
Proceeds from stock options exercised	48,076	23,415
Proceeds from warrants exercised	584,102	--
Dividends paid	(22,682)	(24,400)
Net cash provided by financing activities	522,183	(658,790)
Effect of exchange rate changes on cash and cash equivalents	400	(45,357)
Net increase in cash and cash equivalents	420,847	615,212
Cash and cash equivalents at beginning of period	6,833,193	5,931,752
Cash and cash equivalents at end of period	$ 7,254,040	$ 6,546,964

Supplemental cash flow information		
Cash paid for interest	$ 4,281	$ 2,595

See accompanying notes.

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SOCKET COMMUNICATIONS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 - Basis of Presentation

The accompanying unaudited consolidated financial statements of Socket Communications, Inc. and its wholly owned subsidiaries (the "Company") have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals) considered necessary for fair presentation have been included. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

NOTE 2 - Summary of Significant Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expense during the reporting period. Actual results could differ from those estimates, and such differences may be material to the financial statements.

The Company makes adjustments to the value of inventory based on estimates of potentially excess and obsolete inventory after considering forecasted demand and forecasted average selling prices. However, forecasts are subject to revisions, cancellations, and rescheduling. Actual demand will inevitably differ from anticipated demand, and such differences may have a material effect on the financial statements.

On January 1, 2006, the Company adopted Financial Accounting Standard SFAS 123R, "Share-Based Payment," for the fiscal year ended December 31, 2006. SFAS 123R requires all share-based awards to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Adoption of SFAS had a material impact on the Company's consolidated financial position, results of operations and cash flows. See Note 3 for additional information regarding the Company's stock-based compensation assumptions and expenses, including pro forma disclosures for prior periods.

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NOTE 3 - Stock-Based Compensation

On January 1, 2006, the Company adopted SFAS 123R for the fiscal year ended December 31, 2006. SFAS 123R requires all share-based awards to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The valuation provisions of SFAS 123R apply to new grants and to grants that were outstanding as of the effective date. Under SFAS 123R, the Company uses a binomial lattice valuation model to estimate fair value of stock option grants made on or after January 1, 2006. The binomial lattice model incorporates estimates for expected volatility, risk-free interest rates, employee exercise patterns and post-vesting employment termination behavior, and these estimates will affect the calculation of the fair value of the Company's stock option grants. The fair value of stock option grants outstanding as of the effective date is estimated using the Black-Scholes option pricing model used under SFAS 123. The Company adopted the modified prospective recognition method and implemented the provisions of SFAS 123R beginning with the first quarter of 2006.

At June 30, 2006, options issued to employees for 9,020,755 shares were outstanding, of which 6,431,681 were exercisable. The weighted average fair value of the individual options issued and outstanding during the three and six months ended June 30, 2006 was estimated at $1.69 and $1.72, respectively. The fair values were determined using a binomial lattice valuation model for options granted during the first six months of 2006, and a Black-Scholes valuation model for options granted prior to the first quarter of 2006. Weighted average assumptions for options issued and outstanding during the three and six months ended June 30, 2006 are shown below:

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Risk-free interest rate (%)	3.51%	3.49%
Dividend yield	--	--
Volatility factor	1.2	1.2
Expected option life (years)	4.8	4.9

Total stock-based compensation expense recognized in our consolidated statement of income for the three and six months ended June 30, 2006 are as follows:

Income Statement Classification	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Cost of revenue	$ 23,295	$ 47,691
Research and development	87,729	182,696
Sales and marketing	107,311	240,567
General and administrative	92,296	165,490
Total	$ 310,631	$ 636,444

Prior to January 1, 2006 the Company accounted for employee stock options in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 25), and the Company adopted the disclosure-only alternative described in Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS 123). Under APB 25, the Company generally did not record compensation expense, because the exercise price of the Company's employee stock options equaled the market price of the underlying stock on the date of grant. Pro forma information regarding net loss and loss per share available to common stockholders was required by SFAS 123, and such information has been determined as if the Company had accounted for its employee stock options under the fair value method.

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Had compensation cost for the Company's stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS 123, the Company's per share results for the three and six months ended June 30, 2005 would have changed to the pro forma net loss amounts indicated below:

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income (loss) applicable to common stockholders, as reported	$ 245,908	$ (158,000)
Stock-based employee compensation expense determined under fair value based method	(384,671)	(1,562,451)
Pro forma net loss applicable to common stockholders	$ (138,763)	$ (1,720,451)
Basic net income (loss) per share, as reported	$ 0.01	$ (0.01)
Diluted net income (loss) per share, as reported	$ 0.01	$ (0.01)
Pro forma basic and diluted net loss per share	$ (0.00)	$ (0.06)

The fair value of these options was estimated at the date of grant using the Black-Scholes option pricing model. Weighted average assumptions for the three and six months ended June 30, 2005 is presented below:

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Risk-free interest rate (%)	3.85%	3.78%
Dividend yield	--	--
Volatility factor	1.0	1.0
Expected option life (years)	4.5	4.5

NOTE 4 - Inventories

Inventories consist principally of raw materials and sub-assemblies, which are stated at the lower of cost (first-in, first-out) or market.

	June 30, 2006	December 31, 2005
Raw materials and subassemblies	$ 2,207,265	$ 1,910,653
Finished goods	279,355	284,741
	$ 2,486,620	$ 2,195,394

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NOTE 5 - Bank Financing Arrangements

On March 3, 2006, the Company agreed with its bank to extend the term of the existing credit facility by an additional year, which will now expire on March 3, 2008. The credit facility under the credit agreement allows the Company to borrow up to $4,000,000 based on the level of qualified domestic and international receivables, up to a maximum of $2,500,000 and $1,500,000, respectively, at the lender's index rate based on prime plus 0.5%. The rates in effect at June 30, 2006 were 8.75% on both the domestic and international lines. At June 30, 2006, outstanding amounts borrowed under the lines were $1,515,794 and $710,414, respectively, which were the approximate amounts available on the lines. These amounts outstanding at June 30, 2006 were repaid in July 2006. At December 31, 2005, outstanding amounts borrowed under the lines were $1,358,984 and $949,787, respectively, which were the approximate amounts available on the lines. These amounts outstanding at December 31, 2005 were repaid in January 2006. The Company used the credit facility only at the end of the first and second quarters in 2006, and the end of each quarter in fiscal year 2005. Under the credit agreement, the Company must maintain quarterly minimum tangible net worth equal to $5,400,000, plus 50% of quarterly net profits and 50% of net proceeds from equity and subordinated debt financing transactions beginning with the quarter ending March 31, 2006. The Company was in compliance with the quarterly tangible net worth requirement at the end of the first and second quarters of 2006.

NOTE 6 - Series F Convertible Preferred Stock Financing

On March 21, 2003, the Company sold 276,269 units of securities at a price of $7.22 per unit (total of $2,000,000 gross cash proceeds) in a private equity placement. Each unit consisted of one share of the Company's Series F convertible preferred stock (the "Series F Preferred Stock") and a three-year warrant to purchase three shares of the Company's common stock. Two directors of the Company invested an aggregate of $115,000 in the financing. Each share of Series F Preferred Stock was convertible, in whole or in part, into 10 shares of common stock at the option of the holder at any time for a period of three years following the date of sale, with a mandatory conversion date on March 21, 2006. The holders of Series F Preferred Stock had voting rights equal to the number of shares of common stock issuable upon conversion. The originally issued Series F Preferred Stock was convertible into a total of 2,762,690 shares of common stock at a conversion price of $0.722 per share, subject to certain adjustments. An additional 828,807 shares of common stock were issuable upon exercise of the originally issued warrants at an exercise price of $0.722 per share. In addition, the Company issued five-year warrants to the placement agent to acquire up to 718,300 shares of common stock at $0.722 per share.

On March 21, 2006, the remaining outstanding shares of Series F Preferred Stock automatically converted into common stock, resulting in the issuance of 823,300 shares of common stock. During the first quarter of 2006, holders elected to exercise the remaining outstanding three-year warrants resulting in the issuance of 461,022 shares of common stock.

Dividends accrued on the Series F Preferred Stock at the rate of 8% per annum and were payable quarterly in cash or in common stock, at the option of the Company. Final dividends on the Series F Preferred Stock up through the date of mandatory conversion in the first quarter 2006 were $10,653, and were paid in cash prior to the end of the first quarter. Dividends for the three and six months ended June 30, 2005 were $12,174 and $24,374, respectively, which were paid in cash subsequent to the end of each of the respective quarters.

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NOTE 7 - Intangible Assets

Intangible assets at June 30, 2006 consist of a patent purchased in 2004 for $600,000 covering the design and functioning of plug-in bar code scanners, bar code imagers and RFID products, which is being amortized on a straight line basis over its estimated life of ten years; intangible assets of $570,750 remaining from a prior acquisition in 2000 consisting of developed software and technology with estimated lives at the time of acquisition of 8.5 years; and a licensing agreement with a book value of $38,000, which was reclassified as an intangible asset at December 31, 2004 and is being amortized over its remaining life of three years.

Amortization of all intangible assets for the three and six months ended June 30, 2006 was $36,043 and $72,086, respectively, compared to $36,042 and $130,955, respectively, for the same periods in 2005. Intangible assets as of June 30, 2006 consisted of the following:

	Gross Assets	Accumulated Amortization	Net
Patent	$ 600,000	$ (120,000)	$ 480,000
Project management tools	570,750	(386,095)	184,655
Licensing agreement	114,342	(102,145)	12,197
Intangible technology	$1,285,092	$ (608,240)	$ 676,852

Based on definite lived intangible assets recorded at June 30, 2006, and assuming no subsequent impairment of the underlying assets, the annual amortization expense is expected to be as follows:

Year	Amount
2006 (six months remaining)	$ 68,361
2007	134,557
2008	127,147
2009	76,787
2010	60,000
2011 and beyond	210,000
	$ 676,852

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NOTE 8 - Net Income (Loss) Per Share Applicable to Common Stockholders

The Company calculates earnings per share in accordance with Financial Accounting Standards Board Statement No. 128, *Earnings per Share*.

The following table sets forth the computation of basic and diluted net income (loss) per share:

	Three Months Ended June 30,	Six Months Ended June 30,

	2006	2005	2006	2005
Numerator:				
 Net income (loss)	$ (448,237)	$ 258,082	$ (817,350)	$ (133,626)
 Preferred stock dividends	--	(12,174)	(10,653)	(24,374)
 Net income (loss) applicable to common stockholders	$ (448,237)	$ 245,908	$ (828,003)	$ (158,000)
Denominator:				
 Weighted average common shares outstanding used in computing net income (loss) per share				
 Basic	31,695,832	30,160,994	31,045,664	30,157,993
 Diluted	31,695,832	32,301,424	31,045,664	30,157,993
Basic net income (loss) per share	$ (0.01)	$ 0.01	$ (0.03)	$ (0.01)
Diluted net income (loss) per share	$ (0.01)	$ 0.01	$ (0.03)	$ (0.01)

For the three and six months ended June 30, 2006, and the six months ended June 30, 2005, the diluted net loss per share is equivalent to the basic net loss per share, because the Company experienced losses in these periods and thus no potential common shares underlying stock options, warrants, or convertible preferred stock have been included in the net loss per share calculation as their effect is anti-dilutive. Therefore, options and warrants to purchase 10,137,677 and 9,573,019 shares of common stock at June 30, 2006 and 2005, from the exercise of stock options, warrants, and conversion of preferred stock have been omitted from the net loss per share calculation.

NOTE 9 - Income Taxes

There were no provisions for income taxes for the three and six months ended June 30, 2006 due to the year to date net losses. The Company was not profitable in fiscal 2005, was profitable in 2004, and was not profitable in 2003 and all prior periods. The Company has maintained a full valuation allowance for all deferred tax assets.

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NOTE 10 - Segment Information

The Company operates in one segment - data collection and connection solutions for mobile electronic devices. The Company markets its products in the United States and foreign countries through its sales personnel and distributors. Information regarding geographic areas for the three and six months ended March 31, 2006 and 2005 are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
Revenues:	2006	2005	2006	2005
United States	$ 4,973,927	$ 4,013,266	$9,714,050	$ 8,048,808
Europe	1,460,363	1,994,414	2,844,686	3,359,893
Asia and rest of world	420,738	572,734	1,054,983	1,153,909
Total revenues	$ 6,855,028	$ 6,580,414	$ 13,613,719	$ 12,562,610

Export revenues are attributable to countries based on the location of the customers. The Company does not hold long-lived assets in foreign locations.

Major customers who accounted for at least 10% of the Company's total revenues during the three and six months ended June 30, 2006 and 2005 were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Tech Data	32%	32%	29%	31%
Ingram Micro	13%	13%	14%	12%
Intermec Technologies Corp.	11%	*	*	*

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

This Quarterly 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 statements include statements forecasting future financial results and operating activities, market acceptance of our products, expectations for general market growth of handheld computers and other mobile computing devices, growth in demand for our products, expansion of the markets that we serve, expansion of the distribution channels for our products, adoption of our embedded products by third-party manufacturers of electronic devices, and the timing of the introduction and availability of new products, as well as other forecasts discussed under "Management's Discussion and Analysis of Financial Condition and Results of Operations." Words such as "may," "will," "predicts," "anticipates," "expects," "intends," "plans," believes," "seeks," "estimates," variations of such words, and similar expressions are intended to identify such forward-looking statements. Such forward-looking statements are based on current expectations, estimates, and projections about our industry, management's beliefs, and assumptions made by management. These forward