INTERVOICE INC
Form 10-Q
January 09, 2006

Table of Contents

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

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED
November 30, 2005
OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
Commission file number: 1-15045
INTERVOICE, INC.
(Exact name of registrant as specified in its charter)

TEXAS	**75-1927578**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

17811 WATERVIEW PARKWAY, DALLAS, TX 75252
(Address of principal executive offices)
972-454-8000
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ **No** o
Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes þ **No** o
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o **No** þ
The Registrant had 38,289,513 shares of common stock, no par value per share, outstanding as of December 20, 2005.

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION
Item 1 Financial Statements
Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations
Item 4 Controls and Procedures
PART II. OTHER INFORMATION
Item 1 Legal Proceedings
Item 1A Risk Factors
Item 6 Exhibits
SIGNATURES
Index to Exhibits
Statement of Terms and Conditions of Employment
Certification of Chief Executive Officer
Certification of Chief Financial Officer
Certification of Chief Executive Officer
Certification of Chief Financial Officer

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1 Financial Statements

INTERVOICE, INC.
CONSOLIDATED BALANCE SHEETS

	(In Thousands, Except Share and Per Share Data)	
	November 30, 2005 (Unaudited)	February 28, 2005
ASSETS		
Current Assets		
Cash and cash equivalents	$ 70,258	$ 60,242
Trade accounts receivable, net of allowance for doubtful accounts of $1,129 in fiscal 2006 and $799 in fiscal 2005	25,211	32,605
Inventory	8,836	7,642
Prepaid expenses and other current assets	4,620	4,339
	108,925	104,828
Property and Equipment, net of accumulated depreciation of $56,676 in fiscal 2006 and $54,303 in fiscal 2005	27,151	21,755
Other Assets		
Intangible assets, net of accumulated amortization of $16,803 in fiscal 2006 and $15,840 in fiscal 2005	4,044	4,707
Goodwill	3,401	3,401
Other assets	64	168
	$ 143,585	$ 134,859
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts payable	$ 9,499	$ 11,485
Accrued expenses	9,479	13,745
Customer deposits	6,815	6,871
Deferred income	25,056	24,448
Current portion of long-term borrowings		400
Income taxes payable	5,515	4,129
	56,364	61,078
Long-Term Borrowings		1,333
Stockholders Equity		
Preferred stock, $100 par value 2,000,000 shares authorized: none issued		

Common stock, no par value, at nominal assigned value 62,000,000 shares authorized: 38,286,179 issued and outstanding in fiscal 2006 and 37,196,216 issued and outstanding in fiscal 2005	19	19
Additional capital	90,313	85,421
Accumulated deficit	(786)	(12,931)
Accumulated other comprehensive loss	(2,325)	(61)
Stockholders equity	87,221	72,448
	$ 143,585	$ 134,859

See notes to consolidated financial statements.

Table of Contents

INTERVOICE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	(In Thousands, Except Per Share Data)			
	Three Months Ended		Nine Months Ended	
	November 30, 2005	November 30, 2004	November 30, 2005	November 30, 2004
Sales				
Solutions	$ 19,328	$ 27,638	$ 62,720	$ 74,027
Recurring services	21,683	20,723	64,844	60,510
	41,011	48,361	127,564	134,537
Cost of goods sold				
Solutions	11,474	13,741	37,328	38,997
Recurring services	6,409	6,997	18,794	20,973
	17,883	20,738	56,122	59,970
Gross margin				
Solutions	7,854	13,897	25,392	35,030
Recurring services	15,274	13,726	46,050	39,537
	23,128	27,623	71,442	74,567
Research and development expenses	4,226	4,119	12,305	11,282
Selling, general and administrative expenses	15,801	16,380	46,601	44,469
Amortization of acquisition related intangible assets	252	252	756	1,209
Income from operations	2,849	6,872	11,780	17,607
Interest income	685	275	1,781	542
Interest expense		(129)	(31)	(513)
Other income (expense)	212	(89)	379	109
Income before taxes	3,746	6,929	13,909	17,745
Income taxes (benefit)	121	(104)	1,764	2,453
Net income	$ 3,625	$ 7,033	$ 12,145	$ 15,292

Net income per share basic	$ 0.09	$ 0.20	$ 0.32	$ 0.43
Shares used in basic per share computation	38,251	36,060	37,970	35,965
Net income per share diluted	$ 0.09	$ 0.18	$ 0.31	$ 0.40
Shares used in diluted per share computation	39,080	38,295	39,046	38,260

See notes to consolidated financial statements.

Table of Contents

INTERVOICE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	(In Thousands)			
	Three Months Ended		Nine Months Ended	
	November 30, 2005	November 30, 2004	November 30, 2005	November 30, 2004
Operating activities				
Net income	$ 3,625	$ 7,033	$ 12,145	$ 15,292
Adjustments to reconcile net income to net cash provided by operating activities- depreciation and amortization	2,324	1,980	5,916	6,047
Other changes in operating activities	(1,616)	(6,621)	702	(10,276)
Net cash provided by operating activities	4,333	2,392	18,763	11,063
Investing activities				
Purchases of property and equipment	(3,055)	(1,371)	(10,099)	(4,835)
Other			(300)	
Net cash used in investing activities	(3,055)	(1,371)	(10,399)	(4,835)
Financing activities				
Paydown of debt		(1,100)	(1,733)	(10,666)
Borrowings				8,000
Premium on early extinguishment of debt				(5)
Release of restricted cash				2,750
Exercise of stock options	314	915	2,392	2,618
Exercise of warrants			2,500	
Net cash provided by (used in) financing activities	314	(185)	3,159	2,697
Effect of exchange rates on cash	(726)	804	(1,507)	811
Increase in cash and cash equivalents	866	1,640	10,016	9,736
Cash and cash equivalents, beginning of period	69,392	48,955	60,242	40,859
Cash and cash equivalents, end of period	$ 70,258	$ 50,595	$ 70,258	$ 50,595

See notes to consolidated financial statements.

Table of Contents

INTERVOICE, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY
(Unaudited)
(In Thousands, Except Share Data)

	Common Stock Shares	Common Stock Amount	Additional Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total
Balance at February 28, 2005	37,196,216	$19	$85,421	$(12,931)	$ (61)	$72,448
Net income				12,145		12,145
Foreign currency translation adjustment					(2,264)	(2,264)
Comprehensive income						9,881
Exercise of stock options	468,659		2,392			2,392
Exercise of warrants	621,304		2,500			2,500
Balance at November 30, 2005	38,286,179	$19	$90,313	$ (786)	$ (2,325)	$87,221

See notes to consolidated financial statements.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
THREE AND NINE MONTHS ENDED NOVEMBER 30, 2005

Note A Basis of Presentation

We have prepared the accompanying consolidated financial statements in accordance with generally accepted accounting principles for interim financial information. We derived the consolidated balance sheet at February 28, 2005 from the audited consolidated balance sheet at that date. We believe we have included all adjustments necessary for a fair presentation of the unaudited November 30, 2005 and 2004 consolidated financial statements. Such adjustments are of a normal recurring nature. These financial statements should be read in conjunction with our audited financial statements and related notes for the three years ended February 28, 2005 included in our Annual Report on Form 10-K. Our Annual Report is available on our website at www.intervoice.com. Our operating results for the three and nine month periods ended November 30, 2005 are not necessarily indicative of the results that may be expected for our fiscal year ending February 28, 2006, as our results may be affected by a number of factors including the timing and ultimate receipt of orders from significant customers which continue to constitute a large portion of our sales, the sales channel mix of products sold, our ability to integrate the operations, products and customers of Edify Corporation (Edify) which we acquired on December 30, 2005 (See Note I), and changes in general economic conditions, any of which could have an adverse effect on our operations.

Our consolidated financial statements include the accounts of Intervoice, Inc. and our subsidiaries, all of which are directly or indirectly 100% owned by Intervoice, Inc. All significant intercompany transactions and accounts have been eliminated in consolidation. Financial statements of our foreign subsidiaries have been translated into U.S. dollars at current and average exchange rates. Resulting translation adjustments are recorded in stockholders equity as a part of accumulated other comprehensive loss. Any foreign currency transaction gains and losses are included in the accompanying consolidated statements of operations. Our total comprehensive income for the third quarter of fiscal 2006 and 2005 was $2.7 million and $8.1 million, respectively. For the nine month periods ended November 30, 2005 and 2004, total comprehensive income was $9.9 million and $15.7 million, respectively. Total comprehensive income is comprised of net income and foreign currency translation adjustments.

Note B Inventory

Our inventory consisted of the following (in thousands):

	November 30, 2005	February 28, 2005
Purchased parts	$ 3,067	$ 3,815
Work in progress	5,769	3,827
	$ 8,836	$ 7,642

Note C Property and Equipment

Our property and equipment consisted of the following (in thousands):

	November 30, 2005	February 28, 2005
Land and buildings	$ 16,901	$ 16,932
Computer equipment and software	39,791	34,004
Furniture and fixtures	2,744	3,345
Managed services equipment	15,977	12,510
Maintenance services equipment	8,414	9,267
	83,827	76,058
Less allowance for accumulated depreciation	(56,676)	(54,303)

Property and equipment, net	$	27,151	$	21,755

At November 30, 2005, the balance in our computer equipment and software account included approximately $6.0 million in capitalized costs associated with our SAP implementation. Such costs will be depreciated over a five year estimated life. Depreciation on approximately $2.6 million of the total began during the third quarter of fiscal 2006 as certain elements of the SAP project were placed into service. Depreciation on the remaining balance will begin in fiscal 2007 as additional components of the system are placed in service.

Table of Contents

Note D Long-Term Borrowings

We had no debt outstanding as of November 30, 2005. At February 28, 2005 our long-term debt was comprised of the following (in thousands):

	February 28, 2005
Term loan, bearing interest, payable monthly, accruing at a rate equal to the prime rate plus 0.50% or the London Inter-Bank Offering Rate plus 2.25%, principal repaid in full during March 2005	$ 1,733
Less: current portion	(400)
Long-term debt, net of current portion	$ 1,333

We have a $5.5 million revolving line of credit agreement with a bank. The credit agreement contains terms, conditions and representations that are generally customary for asset-based credit facilities including requirements that we comply with certain financial and operating covenants. As of November 30, 2005, we were in compliance with all such covenants. Any borrowings under the credit agreement would be secured by first liens on our accounts receivable, general intangibles, equipment, inventory and the real property and fixtures comprising our Dallas headquarters. We may borrow, partially or wholly repay our outstanding borrowings without penalty, and reborrow under the agreement so long as the total outstanding borrowings do not exceed $5.5 million. We had no amounts drawn under this line at November 30, 2005. The revolving line of credit agreement expires on January 31, 2007.

Note E Income Taxes

We recorded income tax expense of $0.1 million and $1.8 million, respectively, for the three and nine month periods ended November 30, 2005. These amounts resulted from a combination of tax expense provided at an estimated annual tax rate of 27%, a reduction in tax expense during the third quarter of fiscal 2006 of $0.7 million in connection with the completion and filing of our fiscal 2005 federal and state income tax returns and the favorable settlement of certain foreign tax liabilities, and a reduction in tax expense during the first half of fiscal 2006 of $1.0 million as a result of the favorable settlement of additional foreign tax contingencies. The 27% annual rate differs from the 35% U.S. federal statutory rate primarily because of expected benefits to be realized from the use of previously reserved net operating losses and from the effect of non-U.S. tax rates.

We recorded an income tax benefit of $0.1 million and income tax expense of $2.5 million, respectively, for the three and nine month periods ended November 30, 2004. These amounts resulted from a combination of tax expense provided at an estimated annual tax rate of 24%, a reduction in tax expense during the third quarter of fiscal 2005 totaling $0.9 million as a result of adjustments to domestic tax liabilities made in connection with the completion of our fiscal 2004 tax returns, and a reduction in tax expense during the third quarter of fiscal 2005 of $0.9 million as a result of a favorable tax settlement with a foreign government. As in fiscal 2006, the annual rate differed from the 35% U.S. federal statutory rate because of benefits realized from the use of previously reserved net operating losses and from the effect of non-U.S. tax rates.

On October 22, 2004, the American Jobs Creation Act (AJCA) was signed into law. The AJCA provides for a deduction of 85% of certain foreign earnings that are repatriated, as defined in the AJCA. We may elect to apply this provision to qualifying earnings repatriations in fiscal 2006. We have begun an evaluation of the effects of the repatriation provision; however, we have not reached a decision on whether or not the election will be beneficial to us. The range of possible amounts we are considering for repatriation under the AJCA is from $0 to $13.0 million. The related potential range of income tax expense associated with the repatriation is from $0 to $0.7 million. We expect to complete our evaluation of the effects of the repatriation provision during the fourth quarter of fiscal 2006.

Table of Contents

Note F Earnings Per Share

(in thousands, except per share data)	Three Months Ended November 30, 2005	Three Months Ended November 30, 2004	Nine Months Ended November 30, 2005	Nine Months Ended November 30, 2004
Numerator:				
Net income	$ 3,625	$ 7,033	$ 12,145	$ 15,292
Denominator:				
Denominator for basic earnings per share	38,251	36,060	37,970	35,965
Dilutive potential common shares				
Employee stock options	829	1,835	1,005	1,883
Outstanding warrants		400	71	412
Denominator for diluted earnings per share	39,080	38,295	39,046	38,260
Net income per share:				
Basic	$ 0.09	$ 0.20	$ 0.32	$ 0.43
Diluted	$ 0.09	$ 0.18	$ 0.31	$ 0.40

Options to purchase 4,718,494 and 876,000 shares of our common stock at average exercise prices of $10.51 and $14.43 per share were outstanding during the three month periods ended November 30, 2005 and 2004, respectively, but were not included in the computation of diluted earnings per share because the options exercise prices were greater than the average market prices of our common shares during the applicable periods and, therefore, the effect would have been anti-dilutive. Options to purchase 1,479,644 and 941,500 shares of our common stock at average exercise prices of $13.09 and $13.65 were outstanding during the nine month periods ended November 30, 2005 and 2004, respectively, but were not included in the computation of diluted earnings per share because the options exercise prices were greater than the average market prices of our shares for the nine month periods.

We account for our stock-based employee compensation using the intrinsic value method as defined in Accounting Principles Board Statement No. 25. Under this approach, we recognize expense at the grant date of an option only to the extent that the fair value of the related common stock at the grant date exceeds the exercise price of the option. In practice, we typically grant options at an exercise price equal to the fair value of the stock on the grant date, and, accordingly, we typically do not recognize any expense upon the granting of an option.

Because we have elected this treatment, Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS No. 123) and Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation Transition and Disclosure require disclosure of pro forma information which provides the effects on net income and net income per share as if we had accounted for our employee stock awards under the fair value method prescribed by SFAS No. 123. The Financial Accounting Standards Board has issued a revision to SFAS No. 123 (SFAS No. 123R) that requires companies to include a compensation expense in their statements of operations relating to the issuance of employee stock options and other equity awards based on the grant date fair value of the equity instrument. This change in accounting for stock options will become effective for our fiscal year beginning March 1, 2006. We are still assessing the transition method we will use to implement SFAS No. 123R as well as the impact of the new statement on our Consolidated Statements of Operations.

Table of Contents

The following table illustrates the effect on net income and net income per share amounts for the three and nine month periods ended November 30, 2005 and 2004 if we had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation (in thousands, except per share amounts):

	Three Months Ended		Nine Months Ended	
	November 30, 2005	November 30, 2004	November 30, 2005	November 30, 2004
Net income, as reported	$ 3,625	$ 7,033	$ 12,145	$ 15,292
Less: Total stock-based employee compensation expense determined under fair value based methods for all awards, net of tax	(2,615)	(1,598)	(5,854)	(3,996)
Pro forma net income	$ 1,010	$ 5,435	$ 6,291	$ 11,296
Net income per share:				
Basic as reported	$ 0.09	$ 0.20	$ 0.32	$ 0.43
Basic pro forma	$ 0.03	$ 0.15	$ 0.17	$ 0.31
Diluted as reported	$ 0.09	$ 0.18	$ 0.31	$ 0.40
Diluted pro forma	$ 0.03	$ 0.14	$ 0.16	$ 0.30

Note G Operating Segment Information and Major Customers

We operate as a single, integrated business unit. Our chief operating decision maker assesses performance and allocates resources on an enterprise wide basis. Our product line includes voice automation/IVR solutions, network portal solutions, messaging solutions, payment solutions, maintenance and support services, and managed services provided for customers on an outsourced or managed service provider basis. We believe that product line distinction provides the most meaningful breakdown of quarterly and annual sales activity. Our net sales by product line for the three and nine month periods ended November 30, 2005 and 2004 were as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	November 30, 2005	November 30, 2004	November 30, 2005	November 30, 2004
Voice automation/IVR solution sales	$ 9,749	$ 15,152	$ 30,954	$ 48,990
Network portal solution sales	689	2,244	7,417	4,442
Messaging solution sales	5,877	2,321	16,743	6,951
Payment solution sales	3,013	7,921	7,606	13,644
Total solution sales	19,328	27,638	62,720	74,027
Maintenance and support services revenues	15,589	15,298	45,964	44,293
Managed services revenues	6,094	5,425	18,880	16,217
Total recurring services revenues	21,683	20,723	64,844	60,510
Total sales	$ 41,011	$ 48,361	$ 127,564	$ 134,537

9

Table of Contents

Geographic Operations

We assign revenues to geographic areas based on the locations of our customers. Our net sales by geographic area for the three and nine month periods ended November 30, 2005 and 2004 were as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	November 30, 2005	November 30, 2004	November 30, 2005	November 30, 2004
North America	$ 22,105	$ 27,071	$ 67,508	$ 80,441
Europe	7,233	11,166	28,938	30,000
Middle East and Africa	5,201	6,055	17,146	15,562
Central and South America	4,831	2,520	10,207	4,883
Pacific Rim	1,641	1,549	3,765	3,651
Total	$ 41,011	$ 48,361	$ 127,564	$ 134,537

Concentration of Revenue

No customer accounted for 10% or more of our revenue for the quarter ended November 30, 2005. One customer, O2, accounted for approximately 11% of the Company s total revenue during the quarter ended November 30, 2004. No customer accounted for 10% or more of our total revenue during the nine month period ended November 30, 2005. Revenue from O2 accounted for approximately 10% of the Company s total revenue during the nine month period ended November 30, 2004.

Note H Contingencies

Intellectual Property Matters

We provide our customers a qualified indemnity against the infringement of third party intellectual property rights. From time to time various owners of patents and copyrighted works send us or our customers letters alleging that our products do or might infringe upon the owners intellectual property rights, and/or suggesting that we or our customers should negotiate a license or cross-license agreement with the owner. Our policy is to never knowingly infringe upon any third party s intellectual property rights. Accordingly, we forward any such allegation or licensing request to our outside legal counsel for their review and opinion. We generally attempt to resolve any such matter by informing the owner of our position concerning non-infringement or invalidity, and/or, if appropriate, negotiating a license or cross-license agreement. Even though we attempt to resolve these matters without litigation, it is always possible that the owner of a patent or copyrighted works will sue us. Although no such litigation is currently pending against us, owners of patents and/or copyrighted works have previously sued us alleging infringement of their intellectual property rights. We currently have a portfolio of 73 patents, and we have applied for and will continue to apply for and receive a number of additional patents to reflect our technological innovations. We believe our patent portfolio could allow us to assert counterclaims for infringement against certain owners of intellectual property rights if those owners were to sue us for infringement.

From time to time Ronald A. Katz Technology Licensing L.P. (RAKTL) has sent letters to certain of our customers suggesting that the customer should negotiate a license agreement to cover the practice of certain patents owned by RAKTL. In the letters, RAKTL has alleged that certain of its patents pertain to certain enhanced services offered by network providers, including prepaid card and wireless services and postpaid card services. RAKTL has further alleged that certain of its patents pertain to certain call processing applications, including applications for call centers that route calls using a called party s DNIS identification number. As a result of the correspondence, many of Intervoice s customers have had discussions, or are in discussions, with RAKTL.

We offer certain products that can be programmed and configured to provide enhanced services to network providers and call processing applications for call centers. Our contracts with customers usually include a qualified obligation to indemnify and defend customers against claims that products as delivered by Intervoice infringe a third

party s patent. None of our customers have notified us that RAKTL has claimed that

Table of Contents

any product provided by us infringes any claims of any RAKTL patent. Accordingly, we have not been required to defend any customers against a claim of infringement under a RAKTL patent. We have, however, received letters from customers notifying us of the efforts by RAKTL to license its patent portfolio and reminding us of our potential obligations under the indemnification provisions of our agreements in the event that a claim is asserted. In response to correspondence from RAKTL, a few customers have attempted to tender to us the defense of our products under contractual indemnity provisions. We have informed these customers that while we fully intend to honor any contractual indemnity provisions, we do not believe we currently have any obligation to provide such a defense because RAKTL does not appear to have made a claim that an Intervoice product infringes a patent. Some of these customers have disagreed with us and believe that the correspondence from RAKTL can be construed as claims against Intervoice products.

Some of our customers have licensed certain rights under the RAKTL patent portfolio. Two such customers who had previously attempted to tender the defense of their products to us informed us that they have entered into agreements to license certain rights under the RAKTL patents and demanded we indemnify them for unspecified amounts, including attorney s fees, paid in connection with the license agreements. We notified these customers that we believe we do not have any indemnity obligation in connection with the license agreements. We have received no further response from either customer.

A customer of ours is one of several companies recently sued by RAKTL in the case of *Ronald A. Katz Technology Licensing, L.P. v. Citibank, et al.; No. 505CV 142*, pending in the United States District Court for the Eastern District of Texas, Texarkana Division. The customer has not asserted that we are obligated to indemnify and defend the customer in the lawsuit, but the customer has notified us under the indemnity paragraph of their sales agreement with us that the lawsuit could potentially impact one or more of their agreements with us. A customer of our recently acquired subsidiary, Edify, is also a defendant in the lawsuit and has asserted that Edify is obligated to indemnify the customer under the indemnity paragraph of its sales agreement. Edify told the customer that it does not believe it has an obligation to indemnify the customer in connection with the lawsuit.

Even though no claims have been made that a specific product offered by Intervoice infringes any claim under the RAKTL patent portfolio, we have received opinions from our outside patent counsel that certain products and applications we offer do not infringe certain claims of the RAKTL patents. We have also received opinions from our outside counsel that certain claims under the RAKTL patent portfolio are invalid or unenforceable. Furthermore, based on the reviews by outside counsel, we are not aware of any valid and enforceable claims under the RAKTL portfolio that are infringed by our products. If we do become involved in litigation in connection with the RAKTL patent portfolio, under a contractual indemnity or any other legal theory, we intend to vigorously contest the claims and to assert appropriate defenses.

We have received letters from Webley Systems (Webley), a division of Parus Holdings, Inc. (Parus), and its counsel alleging that certain Webley patents cover one or more of our products and services. In the letters, Parus offers a license to the Webley patents. As a result of the correspondence, we conducted discussions with Parus. Based on reviews by our outside counsel, we are not aware of any valid and enforceable claims under the Webley patents that are infringed by our products or services.

Pending Litigation

David Barrie, et al., on Behalf of Themselves and All Others Similarly Situated v. InterVoice-Brite, Inc., et al. ; No. 3-01CV1071-D, pending in the United States District Court, Northern District of Texas, Dallas Division:

Several related class action lawsuits were filed in the United States District Court for the Northern District of Texas on behalf of purchasers of common stock of Intervoice during the period from October 12, 1999 through June 6, 2000 (the Class Period). Plaintiffs have filed claims, which were consolidated into one proceeding, under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 against us as well as certain named current and former officers and directors of Intervoice on behalf of the alleged class members. In the complaint, Plaintiffs claim that we and the named current and former officers and directors issued false and misleading statements during the Class Period concerning the financial condition of Intervoice, the results of the merger with Brite Voice Systems, Inc. and the alleged future business projections of Intervoice. Plaintiffs have asserted that these alleged statements resulted in artificially inflated stock prices.

11

Table of Contents

We responded to this complaint by filing a motion to dismiss the complaint in the consolidated proceeding. We asserted that the complaint lacked the degree of specificity and factual support to meet the pleading standards applicable to federal securities litigation. On this basis, we requested that the United States District Court for the Northern District of Texas dismiss the complaint in its entirety. On August 8, 2002, the Court entered an order granting our motion to dismiss the class action lawsuit. In the order dismissing the lawsuit, the Court granted Plaintiffs an opportunity to reinstate the lawsuit by filing an amended complaint.

Plaintiffs filed an amended complaint which the Court dismissed on September 15, 2003. Plaintiffs appealed the District Court decision to the Fifth Circuit Court of Appeals. On January 12, 2005, the Fifth Circuit Court of Appeals issued an opinion in which it affirmed, in part, the District Court s order of dismissal. The Court of Appeals opinion also reversed a limited number of issues in the District Court s proceedings. On February 25, 2005, Intervoice filed a motion for rehearing with the Fifth Circuit Court of Appeals requesting the Court to modify its opinion. On May 12, 2005, the Fifth Circuit Court of Appeals denied our petition for rehearing but modified its opinion to clarify the Court s decision. The case has been remanded to the District Court for further proceedings consistent with the Fifth Circuit s opinion. We believe that we and our officers and directors complied with the securities laws and will continue to vigorously defend the portions of the case that have been remanded to the District Court.

Daniel Wardiman, derivatively on behalf of Nominal Defendant, Intervoice-Brite, Inc. v. Daniel D. Hammond et. al., pending in federal district court in Dallas, Texas (case no. 3-05CV2114-N):

One of our shareholders recently filed a shareholder derivative suit against certain current and former directors and officers. The suit alleges that these individuals breached their fiduciary duties to Intervoice during the fiscal year ended February 29, 2000 and during the first quarter of the fiscal year ended February 28, 2001. The alleged conduct is largely the same conduct that is the subject of the Barrie class action lawsuit discussed above. The shareholder filed the derivative suit after sending a letter, previously disclosed by us, demanding that Intervoice file suit against the defendants. We and the individual defendants believe there are meritorious defenses to this suit.

Audit Committee Investigation

In December 2004, our Audit Committee completed an investigation it had begun in August 2004 of certain transactions occurring during our fiscal years 2000 through 2002. The Audit Committee was assisted in its investigation by separate independent legal counsel and a national accounting firm. The Audit Committee has reported the results of the investigation to, and we are cooperating with, the SEC. We are currently providing documents to the SEC in response to a subpoena requesting information about the transactions that were the subject of the investigation, and two of our employees, who are not officers, received subpoenas and have produced documents and provided testimony to the SEC. Our Audit Committee and its counsel are actively monitoring our response to the SEC, and they have conducted a review of certain documents and information provided to the SEC which we located after the Committee s original investigation. Intervoice is also honoring our pre-existing obligation to indemnify two former officers of Intervoice who received subpoenas to produce documents and provide testimony to the SEC in connection with the investigation.

The Audit Committee investigation found that we accounted for certain transactions incorrectly during our fiscal years 2000 through 2002. The Audit Committee investigation concluded that a $900,000 payment made by Intervoice to a publicly held supplier purportedly for certain prepaid licenses was linked to an agreement to amend a 1997 warrant issued to us by the supplier to permit our cashless exercise of the warrant. As a result, we believe that the $900,000 payment should have been recorded as a reduction in the $21.4 million gain we recognized on the sale of the shares underlying the warrant during the fourth quarter of fiscal 2001 and should not have been recorded as prepaid license inventory. Our payment to the supplier may have rendered unavailable a nonexclusive registration exemption for the sale of the shares underlying the warrant. The Audit Committee investigation also found that Intervoice intentionally provided the same supplier false or misleading documents for such supplier to use to support such supplier s improper recognition of revenue in calendar 2001.

The Audit Committee investigation and review further found that six of the seven customer sales transactions the Committee investigated were accounted for incorrectly and that there was intentional misconduct in at least one of those sales transactions. These six transactions occurred at the end of quarters in which we just met analysts expectations with respect to earnings per share. The Audit Committee found that Intervoice improperly recognized

revenue in a quarter-end barter transaction involving approximately 0.4% of annual revenues for fiscal 2000, and that we improperly accelerated the recognition of revenue in five quarter-end transactions totaling approximately 0.4% and 0.3% of annual revenues in fiscal 2000 and fiscal

Table of Contents

2002, respectively. We and the SEC have agreed that Intervoice will not assert any defenses based on a statute of limitations with respect to any future claims by the SEC concerning the two transactions investigated by the Audit Committee that occurred during February 2000. As a result of work performed in responding to the SEC subpoena, the Committee has concluded that Intervoice also improperly recognized approximately $5.4 million of revenue in two sales transactions during the second and third quarters of fiscal 2002 because the transactions were subject to oral side agreements that gave our customer expanded rights of return. We subsequently reversed the $5.4 million of revenue during the fourth quarter of fiscal 2002 in connection with a return of the related systems. We are providing documents to the SEC concerning these two additional sales transactions pursuant to a separate subpoena. Separately, the Audit Committee further determined that in September 2001 one of our current executive officers improperly communicated Intervoice information to a shareholder.

Intervoice s management concluded, with the concurrence of the Audit Committee and our external auditors, that restatement of our prior annual financial statements to adjust for the findings of the Audit Committee investigation and review is not necessary. In reaching this conclusion, we considered the impact of the incorrect accounting on each of the periods affected, the ages of the affected financial statements and the lack of any material changes in prior period trends as a result of the incorrect accounting. In addition, we noted that since the date of the most recent transaction reviewed in the investigation, we have restructured our business, made significant management changes, consolidated our physical operations, significantly reduced our fixed operating costs and refinanced and repaid all of our major debt obligations. We cannot predict whether we may have future losses relating to the matters investigated by the Audit Committee as a result of future claims, if any, including any claims by the government.

Other Matters

We are a defendant from time to time in lawsuits incidental to our business. Based on currently available information, we believe that resolution of the lawsuit and other matters described above is uncertain, and there can be no assurance that future costs related to such matters would not be material to our financial position or results of operations.

We are a party to many routine contracts in which we provide general indemnities and warranties in the normal course of business to third parties for various risks. These indemnities and warranties are discussed in the following paragraphs. Except in specific circumstances where we have determined that the likelihood of loss is probable and the amount of the loss quantifiable, we have not recorded a liability for any of these indemnities. In general, we are not able to estimate the potential amount of any liability relating to these indemnities and warranties.

Many of our contracts, particularly for managed services, foreign contracts and contracts with telecommunication companies, include provisions for the assessment of liquidated damages for delayed project completion and/or for our failure to achieve certain minimum service levels. We have had to pay liquidated damages in the past and may have to pay additional liquidated damages in the future. Any such future liquidated damages could be significant.

Our contracts with our customers generally contain qualified indemnifications against third party claims relating to the infringement of intellectual property as described in Intellectual Property Matters above.

Our contracts with our customers also generally contain warranties and, in some cases, general indemnifications against other unspecified third party and general liability claims. We have liability insurance protecting us against certain obligations, primarily certain claims related to property damage, that result from these indemnities.

We are obligated under letters of credit totaling approximately $0.2 million issued by a bank to guarantee our performance under a long-term international managed services contract and to guarantee our performance under several proposals. These letters of credit expire during calendar 2006.

We have employment agreements with two executive officers. One of these agreements requires us to make termination payments to the officer of one and one-half times the officer s annual base compensation in the event the officer s services are terminated without cause or payments of up to 2.99 times the officer s annual compensation including bonuses in connection with a termination of the officer s services within a two year period following a change in ownership of Intervoice, as defined in the agreement. If the officer with such agreement were terminated for one of the preceding reasons during fiscal 2006, the cost to us would range from $0.6 million to $1.7 million. The second employment agreement requires that in the event the officer s

Table of Contents

services are terminated without cause, we either must make termination payments to the officer of one times the officer s annual base compensation and accelerate vesting on 33,333 shares of our common stock covered by a stock option or make termination payments to the officer of two times the officer s annual base compensation. If the officer covered by this agreement were terminated during fiscal 2006, we would be required to make payments ranging from $0.3 million to $0.5 million.

Under the terms of our Articles of Incorporation, we indemnify our directors, officers, employees or agents or any other person serving at our request as a director, officer, employee or agent of another corporation in connection with a derivative suit if he or she (1) is successful on the merits or otherwise or (2) acted in good faith, and in a manner he or she reasonably believed to be in or not opposed to the best interests of the corporation. We will not provide indemnification, however, for any claim as to which the person was adjudged liable for negligence or misconduct unless the court determines that under the circumstances the person is fairly and reasonably entitled to indemnification. We provide the same category of persons with indemnification in a non-derivative suit only if such person (1) is successful on the merits or otherwise or (2) acted in good faith, and in a manner he or she reasonably believed to be in or not opposed to the best interests of the corporation, and with respect to any criminal action or proceeding, had no reason to believe his or her conduct was unlawful. Under the terms of our Bylaws, we also indemnify our current and former officers and directors to the fullest extent permitted or required under Article 2.02-1 of the Texas Business Corporation Act.

In connection with certain lawsuits filed against us and certain of our present and former officers and directors (see Pending Litigation above), we have agreed to pay in advance any expenses, including attorneys fees, incurred by such present and former officers and directors in defending such litigation, in accordance with Article 2.02-1 of the Texas Business Corporation Act and the Company s Articles of Incorporation and Bylaws. Each of these parties has provided us with a written undertaking to repay us the expenses advanced if the person is ultimately not entitled to indemnification.

We have a qualified obligation to indemnify two former officers in connection with activities resulting from the Audit Committee investigation and related SEC inquiries described in Audit Committee Investigation above.

Texas corporations are authorized to obtain insurance to protect officers and directors from certain liabilities, including liabilities against which the corporation cannot indemnify its officers and directors. We have obtained liability insurance for our officers and directors as permitted by Article 2.02-1 of the Texas Business Corporation Act. Our insurance policies provide coverage for losses and expenses incurred by us and our current and former directors and officers in connection with claims made under the federal securities laws. These policies, however, exclude losses and expenses related to the Barrie class action lawsuit, or to other litigation based on claims that are substantially the same as those in the Barrie class action, and contain other customary provisions to limit or exclude coverage for certain losses and expenses.

Note I Acquisition of Edify Corporation

On December 30, 2005, we acquired Edify, a Santa Clara, California based company that provides enterprises with voice and speech solutions, from S1 Corporation for approximately $33.5 million in cash. We funded the purchase out of existing cash reserves.

Table of Contents

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

Cautionary Disclosures To Qualify Forward Looking Statements

This report on Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements other than statements of historical facts included in this Form 10-Q, including, without limitation, statements contained in this Management s Discussion and Analysis of Financial Condition and Results of Operations and Notes to Consolidated Financial Statements located elsewhere in this report regarding our financial position, business strategy, plans and objectives of management for future operations, future sales and industry conditions, are forward-looking statements. Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. In addition to important factors described elsewhere in this report, we caution current and potential investors that the following important risk factors, among others, sometimes have affected, and in the future could affect, our actual results and could cause such results during fiscal 2006, and beyond, to differ materially from those expressed in any forward-looking statements made by or on behalf of Intervoice:

We may not be successful in integrating the operations and products, and retaining the customers, of Edify, and this could negatively impact our business. We believe we will be able to achieve certain cost savings and other synergies as a result of combining Intervoice and Edify, but there can be no assurance that such synergies will be realized. Our future success will depend in part upon our ability to integrate and operate Edify successfully with our business. Any inability to integrate the products of Intervoice and Edify while maintaining or increasing the market share that such products had prior to the merger could decrease the revenues historically generated from these products. Customers of Intervoice and Edify may delay their purchase of products or services from one or both companies to consider any potential implications the acquisition may have for products and services offered by either company. In addition, the integration process will require the dedication of management resources, which may temporarily distract attention from our day-to-day business. Our future success will also depend in part on our ability to retain and assimilate certain key employees of Edify. There can be no assurance that we will be able to efficiently integrate and operate Edify and its products with our business, maintain business relationships with Edify s customers and retain and assimilate key employees of Edify. Failure to do so could have a material adverse effect on our results of operations or our financial condition. Edify provides products and services which are similar to our products and services and, accordingly, our Edify operations are generally subject to most of the other risk factors discussed in this Item 2.

We are prone to quarterly sales fluctuations. The sales value of an individual order for our solutions and services can range from a few thousand dollars to several million dollars depending on the complexity of our customer s business need and the size of its operations. The quantity and size of large sales (sales valued at approximately $2.0 million or more) during any quarter can cause wide variations in our quarterly sales and earnings, as such sales are often unevenly distributed throughout the fiscal year. In addition, some of our sales transactions are completed in the same fiscal quarter as ordered. Our accuracy in estimating future sales is largely dependent on our ability to successfully qualify, estimate and close solution sales from our pipeline of sales opportunities during a quarter. No matter how promising a pipeline opportunity may appear, there is no assurance it will ever result in a sale. The accuracy of our estimate of future sales is also dependent on our ability to accurately estimate the amount of revenue to be contributed from beginning backlog and revenue from cash basis customers during any fiscal quarter. This estimate can be affected by factors outside our control, including changes in project timing requested by our customers. Accordingly, our actual sales for any fiscal reporting period may be significantly different than any estimate of sales we make for such period. See the discussion entitled Sales in this Item 2 for a discussion of our system for estimating sales and trends in our business.

We are subject to potential and pending lawsuits and other claims. We are subject to certain potential and pending lawsuits and other claims discussed in Note H of Item 1 Financial Statements of Part I of this quarterly

report on Form 10-Q. We believe the pending lawsuits to which we are subject are without merit, and we intend to defend the matters vigorously. There can be no assurances, however, that we will prevail in these matters. Furthermore, we may become subject to claims, including claims by the government, or other adverse consequences arising from the findings of the Audit Committee investigation discussed in Note H. We, two of our former officers and two current employees who are

Table of Contents

not officers are currently responding to SEC subpoenas to produce documents and provide testimony about the transactions that were the subject of the investigation. Any adverse judgment, penalty or settlement related to any lawsuit or other such claim could have consequences that would be material to our financial position or results of operations. We may be required to indemnify certain of our current and former directors and officers under existing arrangements in connection with the shareholder s derivative suit in addition to the indemnification we are currently providing to certain individuals in connection with the class action lawsuit and the SEC investigation. Our insurance policies provide coverage for losses and expenses incurred by us and our current and former directors and officers in connection with claims made under the federal securities laws. These policies, however, exclude losses and expenses related to the Barrie class action lawsuit discussed in Item 1 or to other litigation based on claims that are substantially the same as the claims in the Barrie class action and contain other customary provisions to limit or exclude coverage for certain losses and expenses.

We face intense competition based on product capabilities, and we experience ever increasing demands from our actual and prospective customers for our products to be compatible with a variety of rapidly proliferating computing, telephony and computer networking technologies and standards. Our success is dependent, to a large degree, on our effectiveness in allocating resources to developing and improving products compatible with those technologies, standards and functionalities that ultimately become widely accepted by our current and prospective customers. Our success is also dependent, to a large degree, on our ability to implement arrangements with vendors of complementary product offerings so that we can provide our current and prospective customers greater functionality. Our principal competitors include Genesys, Avaya, Nortel, Comverse Technology, Huawei and Lucent Technologies. Many of our competitors have greater financial, technological and marketing resources than we have. Although we have committed substantial resources to enhance our existing products and to develop and market new products, there is no assurance we will be successful.

We may not be successful in transitioning our products and services to an open, standards-based business model. Intervoice has historically provided complete, bundled hardware and software solutions using internally developed components to address our customers total business needs. Increasingly, the markets for our products are requiring a shift to the development of products and services based on an open, standards-based architecture such as the J2EE and Microsoft sâ.NET environments utilizing VoiceXML and/or SALT standards. Such an open, standards-based approach allows customers to independently purchase and combine hardware components, standardized software modules, and customization, installation and integration services from individual vendors deemed to offer the best value in the particular class of product or service. In such an environment, we believe we may sell less hardware and fewer bundled systems and may become increasingly dependent on our development and sale of software application packages, customized software and consulting and integration services. This shift will place new challenges on us to transition our products and to hire and retain the mix of personnel necessary to respond to this business environment, to adapt to the changing expense structure that the new environment may tend to foster, and to increase sales of services, customized software and application packages to offset reduced sales of hardware and bundled solutions. The shift to open standards will also challenge us to accurately estimate the level of R&D expenditures that will be necessary in future periods to comply with existing standards and, potentially, to migrate to new open standards. If we are unsuccessful in resolving one or more of these challenges, our revenues and profitability could decline.

We may not be able to retain our customer base, and, in particular, our more significant customers. Our success is heavily dependent on our ability to retain our significant customers, including those of Edify. The loss of one of our significant customers could negatively impact our operating results. Our installed base of customers generally is not contractually obligated to place further solutions orders with us or to extend their services contracts with us at the expiration of their current contracts.

We will be harmed if we lose key business and technical personnel. We rely upon the services of a relatively small number of key technical, project management and senior management personnel, most of whom do not have employment contracts. If we were to lose any of our key personnel, replacing them could be difficult and costly. If we were unable to successfully and promptly replace such personnel, our business could be materially harmed.

Table of Contents

Our reliance on significant vendor relationships could result in significant expense or an inability to serve our customers if we lose these relationships. Although we generally use standard parts and components in our products, some of our components, including semi-conductors and, in particular, digital signal processors manufactured by Texas Instruments, are available only from a small number of vendors. Likewise, we license speech recognition technology from a small number of vendors. Two of these vendors, ScanSoft, Inc. and Nuance Communications, Inc., recently completed a merger of their organizations. As we continue to migrate to open, standards-based systems, we will become increasingly dependent on our component suppliers and software vendors. To date, we have been able to obtain adequate supplies of needed components and licenses in a timely manner, and we expect to continue to be able to do so. Nevertheless, if our significant vendors are unable to supply components or licenses at current levels, we may not be able to obtain these items from another source or at historical prices. In such instances, we would be unable to provide products and services to our customers or generate historical operating margins, and our business and operating results would suffer.

If third parties assert claims that our products or services infringe on their technology and related intellectual property rights, whether the claims are made directly against us or against our customers, we could incur substantial costs to defend these claims. We believe software and technology companies, including Intervoice and others in our industry, increasingly may become subject to infringement claims. Such claims may require us to enter into costly license agreements or result in even more costly litigation. To the extent a licensing arrangement is required, the arrangement may not be available at all, or, if available, may be very expensive or even prohibitively expensive. As with any legal proceeding, there is no guarantee we will prevail in any litigation instituted against us asserting infringement of intellectual property rights. To the extent we suffer an adverse judgment, we might have to pay substantial damages, discontinue the use and sale of infringing products, repurchase infringing products from our customers in accordance with indemnity obligations, expend significant resources to acquire non-infringing alternatives, and/or obtain licenses to the intellectual property that has been infringed upon. As with licensing arrangements, non-infringing substitute technologies may not be available and, if available, may be very expensive, or even prohibitively expensive, to implement. Accordingly, for all of the foregoing reasons, a claim of infringement could ultimately have a material adverse effect on our business, financial condition and results of operations.

We are exposed to risks related to our international operations that could increase our costs and hurt our business. Our products are currently sold in more than 75 countries. Our international sales were 46% and 44% of total sales for the fiscal quarters ending November 30, 2005 and 2004, respectively. International sales, personnel and property are subject to certain risks, including:

- terrorism;
- fluctuations in currency exchange rates;
- the difficulty and expense of maintaining foreign offices and distribution channels;
- tariffs and other barriers to trade;
- greater difficulty in protecting and enforcing intellectual property rights;
- general economic and political conditions in each country;
- loss of revenue, property and equipment from expropriation;
- import and export licensing requirements; and

- § additional expenses and risks inherent in conducting operations in geographically distant locations, including risks arising from differences in language and cultural approaches to the conduct of business.

Our inability to meet contracted performance targets could subject us to significant penalties. Many of our contracts, particularly for managed services, foreign contracts and contracts with telecommunication companies, include provisions for the assessment of liquidated damages for delayed project completion and/or for our failure to achieve certain minimum service levels. We have had to pay liquidated damages in the past and may have to pay additional liquidated damages in the future. Any such future liquidated damages could be significant.

Increasing consolidation in the telecommunications and financial industries could adversely affect our revenues and profitability. The majority of our largest customers are in the telecommunications and financial industries. These industries are undergoing significant consolidation as a result of merger and acquisition activity. This activity could result in a decrease in the number of customers purchasing our products and/or in delayed purchases of our products by customers that are reviewing their

Table of Contents

strategic alternatives in light of a pending merger or acquisition. If these results occur, our revenues and profitability could decline.

The occurrence of force majeure events could impact our results from operations. The occurrence of one or more of the following events could potentially cause us to incur significant losses: acts of God, war, riot, embargoes, acts of civil or military authorities, acts of terrorism or sabotage, the spread of disease, fire, flood, explosion, earthquake, accident, strikes, radiation, inability to secure transportation, failure of communications, failure of utilities or similar events.

Sales. Our total sales for the third quarter and first nine months of fiscal 2006 were $41.0 million and $127.6 million, respectively, a decrease of $7.4 million (15.2%) and $7.0 million (5.2%) as compared to the same periods of fiscal 2005. Solutions sales of $19.3 million and $62.7 million for the third quarter and first nine months of fiscal 2006 reflected decreases of 30.1% and 15.3%, respectively, over corresponding amounts for the same periods of fiscal 2005, while recurring services revenues of $21.7 million and $64.8 million reflected increases of 4.6% and 7.2%, respectively, over corresponding amounts for the same periods of fiscal 2005.

We operate as a single, integrated business unit. Our chief operating decision maker assesses performance and allocates resources on an enterprise wide basis. Our product line includes voice automation/IVR solutions, network portal solutions, messaging solutions, payment solutions, maintenance and support services, and managed services provided for customers on an outsourced or managed service provider basis. We believe that product line distinction provides the most meaningful breakdown of quarterly and annual sales activity. Our net sales by product line for the three and nine month periods ended November 30, 2005 and 2004 were as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	November 30, 2005	November 30, 2004	November 30, 2005	November 30, 2004
Voice automation/IVR solution sales	$ 9,749	$ 15,152	$ 30,954	$ 48,990
Network portal solution sales	689	2,244	7,417	4,442
Messaging solution sales	5,877	2,321	16,743	6,951
Payment solution sales	3,013	7,921	7,606	13,644
Total solution sales	19,328	27,638	62,720	74,027
Maintenance and support services revenues	15,589	15,298	45,964	44,293
Managed services revenues	6,094	5,425	18,880	16,217
Total recurring services revenues	21,683	20,723	64,844	60,510
Total sales	$ 41,011	$ 48,361	$ 127,564	$ 134,537

We assign revenues to geographic areas based on the locations of our customers. Our net sales by geographic area for the three and nine month periods ended November 30, 2005 and 2004 were as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	November 30, 2005	November 30, 2004	November 30, 2005	November 30, 2004
North America	$ 22,105	$ 27,071	$ 67,508	$ 80,441

Europe	7,233	11,166	28,938	30,000
Middle East and Africa	5,201	6,055	17,146	15,562
Central and South America	4,831	2,520	10,207	4,883
Pacific Rim	1,641	1,549	3,765	3,651
Total	$ 41,011	$ 48,361	$ 127,564	$ 134,537

International sales comprised 46% of our total sales during the third quarter of fiscal 2006, up from 44% during the third quarter of fiscal 2005.

Table of Contents

As identified in the preceding chart, the decrease in solutions sales for the third quarter and first nine months of fiscal 2006 as compared to the same periods of fiscal 2005 is comprised primarily of decreases in sales of voice automation/IVR and payment solutions partially offset by an increase in messaging solution sales. Voice automation/IVR sales for the quarter and nine months ended November 30, 2004 included $3.3 million and $8.1 million, respectively, recognized as a result of work performed during the quarter and nine month period on a $12.5 million sale for a major U.S. wireless telecommunications provider that was accounted for on a percentage of completion basis. We have had no similarly sized sales in fiscal 2006. The largest voice automation/IVR solution sales in the third quarter and first nine months of fiscal 2006 produced revenue of $0.5 million and $1.8 million, respectively. The decrease in voice automation/IVR sales between comparable periods of fiscal 2006 and fiscal 2005 is almost entirely focused geographically in our North America business and reflects a general softness in our IVR sales in fiscal 2006 in both our direct and reseller channels. The decline in our payment solution sales for the third quarter of fiscal 2006 as compared to the third quarter of fiscal 2005 is comprised of reductions of $0.8 million to $1.5 million in each of our North American, Central and South American, European and Middle East and African markets. The increase in messaging solution sales for the quarter and nine months ended November 30, 2005 reflects the recognition of $2.5 million and $6.1 million, respectively, under the first two contracts for our new OMX messaging product. Both contracts are scheduled to be substantially complete by the end of fiscal 2006.

The 4.6% increase in recurring services revenues for the third quarter of fiscal 2006 is comprised of growth of $0.3 million or 1.9% in maintenance and support services revenues and growth of $0.7 million or 12.3% in managed services revenues when compared to the third quarter of fiscal 2005. For the first nine months of fiscal 2006 maintenance and support services revenues grew $1.7 million or 3.8% and managed services revenues grew $2.7 million or 16.4% as compared to the first nine months of fiscal 2005. Managed services revenues include revenues from an international managed services customer for which we recognize revenue on a cash basis. Such revenues totaled $0.2 million for the third quarter of fiscal 2006 as compared to $0.0 million for the third quarter of fiscal 2005 and $1.6 million for the first nine months of fiscal 2006 as compared to $0.4 million for the first nine months of fiscal 2005. The remainder of the increase in managed services revenue for the referenced periods is primarily the result of increased revenues from existing customers.

No customer accounted for 10% or more of revenue for the quarter or nine months ended November 30, 2005. One customer, O2, accounted for approximately 11% of our revenue for the quarter ended November 30, 2004 and for approximately 10% of our revenue during the nine month period ended November 30, 2004. Revenue recognized under one long term managed services contract with O2 totaled approximately $1.8 million and $2.6 million for the quarters ended November 30, 2005 and 2004, respectively, and $6.5 million and $7.5 million for the nine month periods ended November 30, 2005 and 2004, respectively. At current exchange rates, the contract is expected to yield managed services revenue of approximately $0.6 million per month through the completion of the contract in July 2006.

We use a system combining estimated sales from our recurring services contracts, our backlog of committed solutions orders and our pipeline of solutions sales opportunities to estimate sales and trends in our business. For the quarters ended November 30, 2005 and 2004, sales were sourced as follows:

	Three Months Ended November 30	
	2005	2004
Sales from recurring services and support contracts, including contracts for managed services	53%	43%
Sales from beginning solutions backlog	29%	45%
Sales from the quarter s pipeline	18%	12%
	100%	100%

Our service and support contracts range in original duration from one month to five years, with most managed service contracts having initial terms of two to three years and most maintenance and related contracts having initial terms of one year. Because many of the longer duration contracts give customers early cancellation privileges, we do not consider our book of services contracts to be reportable backlog, as a portion of the potential revenue reflected in the contract values may never be realized. Nevertheless, it is easier for us to estimate service and support revenues than to estimate solutions sales for the next quarter because the service and support contracts generally span multiple quarters and revenues recognized under each contract are generally similar from one quarter to the next.

Table of Contents

Our backlog is made up of customer orders for solutions for which we have received complete purchase orders and which we expect to ship within twelve months. Backlog as of the end of our last five fiscal quarters was as follows (in thousands):

Quarter Ended	Backlog
November 30, 2005	$29,915
August 31, 2005	$30,265
May 31, 2005	$28,473
February 28, 2005	$35,446
November 30, 2004	$35,166

The accuracy of any estimate of future sales is dependent, in part, on our ability to project the amount of revenue to be contributed from beginning solutions backlog during any fiscal quarter. Our ability to estimate the amount of backlog that will be converted to revenue in any fiscal quarter can be affected by factors outside our control, including changes in project timing requested by our customers.

Our pipeline of opportunities for solutions sales is the aggregation of our sales opportunities for which we have not received a purchase order, with each opportunity evaluated for the date the potential customer will make a purchase decision, competitive risks, and the potential amount of any resulting sale. No matter how promising a pipeline opportunity may appear, there is no assurance it will ever result in a sale. While this pipeline may provide us some sales guidance in our business planning and budgeting, pipeline estimates are necessarily speculative and may not consistently correlate to solutions sales in a particular quarter or over a longer period of time. While we know the amount of solutions backlog available at the beginning of a quarter, we must speculate on our pipeline of solutions opportunities for the quarter. Our accuracy in estimating total solutions sales for the next fiscal quarter is, therefore, highly dependent upon our ability to successfully estimate which pipeline opportunities will close during the quarter.

As previously described, we acquired Edify on December 30, 2005, subsequent to the close of our third quarter of fiscal 2006. The Edify operations will thus contribute sales and bookings to our operations during the last two months of our fourth fiscal quarter. Because we just acquired Edify, any estimate of future revenues or bookings associated with our Edify operations is speculative. Prior revenues for Edify reported by its former parent, S1 Corporation, may not be indicative of future revenues for a variety of reasons including those discussed in the Cautionary Disclosures to Qualify Forward Looking Statements in Item 2 of this Quarterly Report.

Cost of Goods Sold. Cost of goods sold for the third quarter and first nine months of fiscal 2006 was approximately $17.9 million or 43.6% of sales and $56.1 million or 44.0% of sales, respectively. This compares to $20.7 million or 42.9% of sales and $60.0 million or 44.6% of sales for the third quarter and first nine months of fiscal 2005. Cost of goods sold on solution sales was $11.5 million or 59.4% of solution sales and $37.3 million or 59.5% of solution sales for the third quarter and first nine months of fiscal 2006 as compared to $13.7 million or 49.7% and $39.0 million or 52.7% for the third quarter and first nine months of fiscal 2005. A significant portion of our solutions cost of goods sold is comprised of labor costs that are fixed over the near term as opposed to direct material and license/royalty costs that vary directly with sales volume.

Cost of goods sold on recurring services revenues was $6.4 million or 29.6% of recurring services revenues and $18.8 million or 29.0% of such revenues for the third quarter and first nine months of fiscal 2006 as compared to $7.0 million or 33.8% and $21.0 million or 34.7% for the same periods of fiscal 2005. The decrease as a percent of sales reflects cost reductions, the effect of greater cash basis managed service revenues recognized in fiscal 2006 as compared to fiscal 2005 and the improved leverage associated with the increase in managed service sales volumes to other existing managed service customers.

Research and Development Expenses. Research and development expenses during the third quarter and first nine months of fiscal 2006 were $4.2 million or 10.3% and $12.3 million or 9.6% of our total sales as compared to $4.1 million or 8.5% and $11.3 million or 8.4% of our total sales for the same periods of fiscal 2005. Most of the increase in year over year R&D expenditures relates to the continued investment in various research and development initiatives involving packaged applications and voice over IP (VoIP) as well as network product offerings.

Our research and development spending is focused in five key areas. First, we are developing software tools to aid in the development and deployment of customer applications incorporating speech recognition, text-to-speech, and other rich media technologies for enterprise, wireless, and fixed line providers. Next, we are

Table of Contents

developing server-based application software platforms for operations and management of contact center, speech and call completion applications. These applications are branded under the product name Omvia Voice Framework and are scheduled for release in the fourth quarter of fiscal 2006. We will use these software platforms for deployment and management of enterprise, wireless and wireline network operator applications, which are designed to operate in both J2EE and Microsoft sâ.NET enterprise computing environments. Third, we are developing media servers, voice browsers , and call processing infrastructure based on open standards such as SALT, VoiceXML and CCXML. These media servers are VoIP enabled, allowing operation in soft-switch and hybrid PSTN and VoIP networks. Fourth, we are developing packaged, speech enabled applications for the network operator and enterprise markets. These include a range of vertical and horizontal applications that are designed to greatly enhance customer return on investment by providing many commonly used, configurable functions that can be deployed more quickly than can custom applications. Certain of these applications are currently available under the product name Omvia Voice Express. Finally, we are developing modular productivity and communications applications for wireless and fixed-line applications including speech driven voice mail, voice activated dialing, and enhanced personal information management. The network products are branded under the product name Omvia Media Exchange and are scheduled for release in the fourth quarter of fiscal 2006.

We expect to maintain a strong commitment to research and development so that we can remain at the forefront of technology development in our markets.

Selling, General and Administrative Expenses. Selling, general and administrative expenses during the third quarter and first nine months of fiscal 2006 were approximately $15.8 million or 38.5% of our total sales and $46.6 million or 36.5% of our total sales. SG&A expenses for the same periods of fiscal 2005 were $16.4 million or 33.9% and $44.5 million or 33.1% of our total sales. Our SG&A expenses included approximately $0.1 million and $1.1 million for the third quarter and first nine months of fiscal 2006, respectively, related to producing documents and providing testimony to the SEC in connection with the transactions that were the subject of the Audit Committee investigation described in Item 1 of this Form 10-Q. Such costs for the third quarter and first nine months of fiscal 2005 were $1.5 million and $1.6 million, respectively. We expect to continue to incur investigation costs during at least the remainder of fiscal 2006 and part of fiscal 2007.

Income Taxes. We recorded income tax expense of $0.1 million and $1.8 million, respectively, for the three and nine month periods ended November 30, 2005. These amounts resulted from a combination of tax expense provided at an estimated annual tax rate of 27%, a reduction in tax expense during the third quarter of fiscal 2006 of $0.7 million in connection with the completion and filing of our fiscal 2005 federal and state income tax returns and the favorable settlement of certain foreign tax liabilities, and a reduction in tax expense during the first half of fiscal 2006 of $1.0 million as a result of the favorable settlement of additional foreign tax contingencies. The 27% annual rate differs from the 35% U.S. federal statutory rate primarily because of expected benefits to be realized from the use of previously reserved net operating losses and from the effect of non-U.S. tax rates.

We recorded an income tax benefit of $0.1 million and income tax expense of $2.5 million, respectively, for the three and nine month periods ended November 30, 2004. These amounts resulted from a combination of tax expense provided at an estimated annual tax rate of 24%, a reduction in tax expense during the third quarter of fiscal 2005 totaling $0.9 million as a result of adjustments to domestic tax liabilities made in connection with the completion of our fiscal 2004 tax returns, and a reduction in tax expense during the third quarter of fiscal 2005 of $0.9 million as a result of a favorable tax settlement with a foreign government. As in fiscal 2006, the annual rate differed from the 35% U.S. federal statutory rate because of benefits realized from the use of previously reserved net operating losses and from the effect of non-U.S. tax rates.

On October 22, 2004, the AJCA was signed into law. The AJCA provides for a deduction of 85% of certain foreign earnings that are repatriated, as defined in the AJCA. We may elect to apply this provision to qualifying earnings repatriations in fiscal 2006. We have begun an evaluation of the effects of the repatriation provision; however, we have not reached a decision on whether or not the election will be beneficial to us. The range of possible amounts we are considering for repatriation under the AJCA is from $0 to $13.0 million. The related potential range of income tax expense associated with the repatriation is from $0 to $0.7 million. We expect to complete our evaluation of the effects of the repatriation provision during the fourth quarter of fiscal 2006.

Income from Operations and Net Income. We generated operating income of $2.8 million and $11.8 million during the third quarter and first nine months of fiscal 2006 compared to $6.9 million and $17.6 million

Table of Contents

for the same periods of fiscal 2005. The reduction in operating income resulted primarily from the decline in solution sales offset, in part, by increases in recurring services sales and a slight improvement in overall margin. We generated net income of $3.6 million and $12.1 million during the third quarter and first nine months of fiscal 2006 compared to $7.0 million and $15.3 million for the third quarter and first nine months of fiscal 2005. Net income for the nine month period ended November 30, 2005 compared to the nine month period ended November 30, 2004 reflects the operating results described above, a reduction in interest expense and an increase in interest income.

Liquidity and Capital Resources. We had approximately $70.3 million in cash and cash equivalents at November 30, 2005, with no borrowings under our long-term debt facilities. Our cash balances increased $0.9 million during the three months ended November 30, 2005, with operating activities providing $4.3 million of cash, net investing activities using $3.1 million of cash and net financing activities providing $0.3 million in cash.

Operating cash flow for the quarter ended November 30, 2005 resulted primarily from our profitability for the quarter and reductions in our receivables balances. Our days sales outstanding of accounts receivable remained at 56 days.

For sales of certain of our more complex, customized systems (generally ones with a sales price of $500,000 or more), we recognize revenue based on a percentage of completion methodology. Unbilled receivables accrued under this methodology totaled $5.4 million (21.4% of total net receivables) at November 30, 2005, down $1.6 million from August 31, 2005. We expect to bill and collect unbilled receivables as of November 30, 2005 within the next twelve months.

While we continue to focus on the level of our investment in accounts receivable, we generate a significant percentage of our sales, particularly sales of enhanced telecommunications services systems, outside the United States. Customers in certain countries are subject to significant economic and political challenges that affect their cash flow, and many customers outside the United States are generally accustomed to vendor financing in the form of extended payment terms. To remain competitive in markets outside the United States, we may offer selected customers such payment terms. In all cases, however, we only recognize revenue at such time as our system or service fee is fixed or determinable, collectibility is probable and all other criteria for revenue recognition have been met. In some limited cases, this policy may result in our recognizing revenue on a cash basis , limiting revenue recognition on certain sales of systems and/or services to the actual cash received to date from the customer, provided that all other revenue recognition criteria have been satisfied.

We used $3.1 million of cash on investing activities during the third quarter of fiscal 2006, primarily for the purchase of computer equipment. Approximately $0.5 million of this amount related to increases in our managed services infrastructure. The remainder was primarily related to our overall computing environment. At November 30, 2005, the balance in our computer equipment and software account included approximately $6.0 million in capitalized costs associated with our SAP implementation. Such costs will be depreciated over a five year estimated life beginning in the third quarter of fiscal 2006 and in fiscal 2007 as the various components of the system are placed in service.

During the quarter ended November 30, 2005, our financing activities provided $0.3 million in net cash flow. Our option holders exercised options for 0.1 million shares of common stock and, in so doing, provided us with $0.3 million in cash.

On December 30, 2005, we acquired Edify, a Santa Clara, California based company that provides enterprises with voice and speech solutions, from S1 Corporation for approximately $33.5 million in cash. We funded the purchase out of existing cash reserves.

Adequacy of Cash Reserves. We believe our cash reserves and internally generated cash flow along with any cash availability under our line of credit will be sufficient to meet our cash requirements for at least the next twelve months. As of November 30, 2005, we were in compliance with all financial and operating covenants under our $5.5 million revolving line of credit agreement.

Impact of Inflation. We do not expect any significant short-term impact of inflation on our financial condition. We presently are not bound by long-term fixed price sales contracts. The absence of such contracts reduces our exposure to inflationary effects.

Table of Contents

Item 4 Controls and Procedures

Evaluation of disclosure controls and procedures. Our disclosure controls and procedures are designed to provide reasonable, but not absolute, assurance that the objectives of our disclosure control system are met. A control system, no matter how well conceived and operated, is subject to inherent limitations. These limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple errors or mistakes. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more persons or by management override of the control. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Based on the evaluation by our management (with the participation of our chief executive officer and chief financial officer), as of the end of the period covered by this report, our chief executive officer and chief financial officer have concluded that our disclosure controls and procedures (as defined in Securities Exchange Act Rules 13a-15(e) and 15d-15(e)) are effective to provide reasonable assurance that material information required to be disclosed by us in reports we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms. Such officers also have concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, to allow timely decisions regarding required disclosure.

Changes in internal control. There has been no change in our internal control over financial reporting identified in connection with the evaluation that occurred during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. We are in the process of implementing a new company-wide ERP system. During the third quarter of fiscal 2006, we implemented the payroll module of this system and modified certain of our internal controls related to payroll processing.

Table of Contents

PART II. OTHER INFORMATION

Item 1 Legal Proceedings

See Intellectual Property Matters , Pending Litigation and Audit Committee Investigation in Note H in Item 1 of Part I of this quarterly report on Form 10-Q.

Item 1A Risk Factors

See the disclosures set forth in Cautionary Disclosures to Qualify Forward Looking Statements in Item 2 of Part 1 of this Form 10-Q.

Item 6 Exhibits

(a) Exhibits

2.1	Agreement and Plan of Merger dated November 18, 2005 by and among S1 Corporation, Edify corporation, Edify Holding Company, Inc., Intervoice, Inc. and Arrowhead I, Inc. (7)
3.1	Articles of Incorporation, as amended, of Registrant. (1)
3.2	Amendment to Articles of Incorporation of Registrant. (2)
3.3	Amendment to Articles of Incorporation of Registrant. (3)
3.4	Third Restated Bylaws of Registrant. (6)
4.1	Third Amended and Restated Rights Agreement dated as of May 1, 2001 between the Registrant and Computershare Investor Services, LLC, as Rights Agent. (4)
4.2	Securities Purchase Agreement, dated as of May 20, 2002, between the Registrant and the Buyers named therein (the Securities Purchase Agreement). (5)
4.3	Registration Rights Agreement, dated as of May 29, 2002, between the Registrant and each of the Buyers under the Securities Purchase Agreement. (5)
4.4	First Amendment to Third Amended and Restated Rights Agreement dated as of May 29, 2002, between Registrant and Computershare Investor Services, LLC, as Rights Agent. (5)
10.1	Statement of Terms and Conditions of Employment for Francis Sherlock. (8)
31.1	Certification of Chief Executive Officer of Periodic Report Pursuant to Rule 13a-14(a) or Rule 15d-14(a). (8)
31.2	Certification of Chief Financial Officer of Periodic Report Pursuant to Rule 13a-14(a) or Rule 15d-14(a). (8)
32.1	Certification of Chief Executive Officer of Periodic Report Pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350. (8)*
32.2	Certification of Chief Financial Officer of Periodic Report Pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350. (8)*

(1) Incorporated by reference to

exhibits to the Company s 1995 Annual Report on Form 10-K for the fiscal year ended February 28, 1995, filed with the SEC on May 30, 1995.

(2) Incorporated by reference to the Company s Quarterly Report on Form 10-Q for the fiscal quarter ended August 31, 1999, filed with the SEC on October 14, 1999.

(3) Incorporated by reference to exhibits to the Company s Quarterly Report on Form 10-Q for the quarter ended August 31, 2002, filed with the SEC on October 15, 2002.

(4) Incorporated by reference to exhibits to Form 8-A/A (Amendment 3) filed with the SEC on May 9, 2001.

(5) Incorporated by reference to exhibits to the

Company s Current Report on Form 8-K, filed with the SEC on May 30, 2002.

(6) Incorporated by reference to the Company s Quarterly Report on Form 10-Q for the fiscal quarter ended August 31, 2004, filed with the SEC on October 12, 2004.

(7) Incorporated by reference to exhibits to the Company s Current Report on Form 8-K, filed with the SEC on January 3, 2006.

(8) Filed herewith.

* The certifications attached as Exhibit 32.1 and 32.2 accompany the Quarterly Report on Form 10-Q pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed filed by the Company for purposes of Section 18 of the Securities

Exchange Act of 1934, as amended.

Table of Contents

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.

INTERVOICE, INC.

Date: January 9, 2006

By: /s/ MARK C. FALKENBERG
Mark C. Falkenberg
Chief Accounting Officer

Table of Contents

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