SOCKET COMMUNICATIONS INC
Form 10-Q
November 13, 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 September 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 October 31, 2006: 31,851,285 shares

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Item 1. Financial Statements (Unaudited)

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

ASSETS		
Current assets:		
Cash and cash equivalents	$ 6,228,529	$ 6,833,193
Accounts receivable, net	3,333,953	2,952,429
Inventories	2,562,075	2,195,394
Prepaid expenses and other current assets	187,451	315,287
Total current assets	12,312,008	12,296,303
Property and equipment:		
Machinery and office equipment	1,974,842	1,821,367
Computer equipment	1,017,970	913,389
	2,992,812	2,734,756
Accumulated depreciation	(2,219,200)	(2,106,914)
Property and equipment, net	773,612	627,842
Intangible technology, net	642,299	748,937
Goodwill	9,797,946	9,797,946
Other assets	174,871	163,754
Total assets	$ 23,700,736	$ 23,634,782
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 2,742,316	$ 2,616,421
Accrued payroll and related expenses	785,829	729,768
Bank line of credit	2,219,394	2,308,771
Deferred income on shipments to distributors	1,207,280	1,114,450
Current portion of deferred rent and capital leases	18,222	42,639
Total current liabilities	6,973,041	6,812,049
Long term portion of deferred rent and capital leases	852	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 September 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 - 31,851,285 at September 30, 2006 and 30,223,709 at December 31, 2005	31,851	30,224
Additional paid-in capital	52,250,763	50,673,487
Accumulated deficit	(35,555,771)	(33,889,432)
Total stockholders' equity	16,726,843	16,814,361
Total liabilities and stockholders' equity	$ 23,700,736	$ 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 September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenues	$ 5,974,319	$ 6,547,894	$ 19,588,038	$ 19,110,504
Cost of revenue	3,151,352	3,265,803	9,990,419	9,468,863
Gross profit	2,822,967	3,282,091	9,597,619	9,641,641
Operating expenses:				
Research and development	1,238,875	848,009	3,754,223	2,635,019
Sales and marketing	1,838,660	1,654,139	5,441,797	4,846,349
General and administrative	594,932	563,225	2,078,675	1,975,105
Amortization of intangible technology	34,552	36,044	106,638	166,999
Total operating expenses	3,707,019	3,101,417	11,381,333	9,623,472
Operating income (loss)	(884,052)	180,674	(1,783,714)	18,169
Interest income and other	47,499	27,362	134,092	58,837
Interest expense	(1,783)	(764)	(6,064)	(3,360)
Net income (loss)	(838,336)	207,272	(1,655,686)	73,646
Preferred stock dividends	--	(12,087)	(10,653)	(36,461)
Net income (loss) applicable to common stockholders	$ (838,336)	$ 195,185	$ (1,666,339)	$ 37,185
Net income (loss) per share applicable to common stockholders:				
Basic	$ (0.03)	$ 0.01	$ (0.05)	$ 0.00
Diluted	$ (0.03)	$ 0.01	$ (0.05)	$ 0.00
Weighted average shares outstanding:				
Basic	31,846,451	30,197,768	31,312,593	30,171,251
Diluted	31,846,451	32,375,678	31,312,593	32,543,295

See accompanying notes.

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

	Nine Months Ended September 30,	
	2006	2005
Operating activities		
Net income (loss)	$ (1,655,686)	$ 73,646
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock-based compensation	934,018	--
Depreciation and amortization	530,054	331,602
Amortization of intangibles	106,638	166,999
(Gain) loss on foreign currency translations	(70,669)	115,846
(Gain) loss on forward exchange contracts	23,585	(71,617)
Change in deferred rent	(24,768)	(24,765)
Changes in operating assets and liabilities:		
Accounts receivable	(335,336)	329,096
Inventories	(366,681)	544,484
Prepaid expenses and other current assets	127,836	(81,388)
Other assets	(11,117)	(7,674)
Accounts payable and accrued expenses	130,813	290,868
Accrued payroll and related expenses	63,761	15,397
Deferred income on shipments to distributors	92,830	80,381
Net cash provided by (used for) operating activities	(454,722)	1,762,875
Investing activities		
Purchase of equipment and tooling	(675,824)	(383,228)
Net cash used in investing activities	(675,824)	(383,228)
Financing activities		
Payments on capital leases and equipment financing notes	(7,169)	(6,839)
Gross proceeds from bank line of credit	7,192,928	7,763,136
Gross payments on bank line of credit	(7,282,305)	(8,458,572)
Proceeds from stock options exercised	60,701	46,869
Proceeds from warrants exercised	584,102	--
Dividends paid	(22,682)	(36,574)
Net cash provided by (used for) financing activities	525,575	(691,980)
Effect of exchange rate changes on cash and cash equivalents	307	(48,520)
Net increase (decrease) in cash and cash equivalents	(604,664)	639,147
Cash and cash equivalents at beginning of period	6,833,193	5,931,752
Cash and cash equivalents at end of period	$ 6,228,529	$ 6,570,899

Supplemental cash flow information		
Cash paid for interest	$ 1,783	$ 765

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 Statement of Financial Accounting Standards No. 123R, "Share-Based Payment," ("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. Adoption of SFAS 123R 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 September 30, 2006, options issued to employees for 8,961,920 shares were outstanding, of which 6,705,619 were exercisable. The weighted average fair value of the individual options issued and outstanding during the three and nine months ended September 30, 2006 was estimated at $1.64 and $1.71 per share, respectively. The fair values were determined using a binomial lattice valuation model for options granted during the first nine 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 nine months ended September 30, 2006 are shown below:

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Risk-free interest rate (%)	3.54%	3.49%
Dividend yield	--	--
Volatility factor	1.2	1.2
Expected option life (years)	4.7	4.8

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

Income Statement Classification	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Cost of revenue	$ 27,141	$ 74,832
Research and development	65,228	247,924
Sales and marketing	113,232	353,799
General and administrative	91,973	257,463
Total	$ 297,574	$ 934,018

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 nine months ended September 30, 2005 would have changed to the pro forma net loss amounts indicated below:

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income (loss) applicable to common stockholders, as reported	$ 195,185	$ 37,185
Stock-based employee compensation expense determined under fair value based method	(360,567)	(1,923,018)
Pro forma net loss applicable to common stockholders	$ (165,382)	$ (1,885,833)
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	$ (0.01)	$ (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 nine months ended September 30, 2005 is presented below:

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Risk-free interest rate (%)	4.07%	3.92%
Dividend yield	--	--
Volatility factor	0.8	0.9
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.

	September 30, 2006	December 31, 2005
Raw materials and subassemblies	$ 2,280,129	$ 1,910,653
Finished goods	281,946	284,741

	$ 2,562,075	$ 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 September 30, 2006 were 8.75% on both the domestic and international lines. At September 30, 2006, outstanding amounts borrowed under the lines were $1,382,916 and $836,478, respectively, which were the approximate amounts available on the lines. These amounts outstanding at September 30, 2006 were repaid in October 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 three fiscal 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 for each of the first three fiscal 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 nine months ended September 30, 2005 were $12,087 and $36,461, 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 September 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 nine months ended September 30, 2006 was $34,552 and $106,638, respectively, compared to $36,044 and $166,999, respectively, for the same periods in 2005. Intangible assets as of September 30, 2006 consisted of the following:

	Gross Assets	Accumulated Amortization	Net
Patent	$ 600,000	$ (135,000)	$ 465,000
Project management tools	570,750	(402,882)	167,868
Licensing agreement	114,342	(104,911)	9,431
Intangible technology	$1,285,092	$ (642,793)	$ 642,299

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

Year	Amount
2006 (three months remaining)	$ 33,808
2007	134,557
2008	127,147
2009	76,787
2010	60,000
2011 and beyond	210,000
	$ 642,299

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NOTE 8 - Net Income (Loss) Per Share

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 September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Numerator:				
 Net income (loss)	$ (838,336)	$ 207,272	$ (1,655,686)	$ 73,646
 Preferred stock dividends	--	(12,087)	(10,653)	(36,461)
 Net income (loss) applicable to common stockholders	$ (838,336)	$ 195,185	$ (1,666,339)	$ 37,185
Denominator:				
 Weighted average common shares outstanding used in computing net income (loss) per share				
 Basic	31,846,451	30,197,768	31,312,593	30,171,251
 Diluted	31,846,451	32,375,678	31,312,593	32,543,295
Basic net income (loss) per share applicable to common stockholders	$ (0.03)	$ 0.01	$ (0.05)	$ 0.00
Diluted net income (loss) per share applicable to common stockholders	$ (0.03)	$ 0.01	$ (0.05)	$ 0.00

For the three and nine months ended September 30, 2006, the diluted net loss per share applicable to common stockholders is equivalent to the basic net loss per share applicable to common stockholders, because the Company experienced losses in these periods and thus no potential common shares underlying stock options or warrants have been included in the net loss per share calculation as their effect is anti-dilutive. Therefore, options and warrants to purchase 9,951,632 shares of common stock at September 30, 2006 from the exercise of stock options and warrants 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 nine months ended September 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 nine months ended September 30, 2006 and 2005 are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
Revenues:	2006	2005	2006	2005
United States	$ 4,024,945	$ 4,491,693	$13,738,995	$ 12,540,501
Europe	1,357,209	1,289,987	4,201,895	4,649,879
Asia and rest of world	592,165	766,214	1,647,148	1,920,124
Total revenues	$ 5,974,319	$ 6,547,894	$ 19,588,038	$ 19,110,504

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 nine months ended September 30, 2006 and 2005 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Tech Data	21%	32%	27%	31%
Ingram Micro	11%	16%	13%	14%

Revenues for our major distributors fell in the three months ended September 30, 2006 due primarily to a reduction in the level of corporate deployments by one of our North American channel partners.

NOTE 11 - Subsequent Event, New Facilities Lease

On October 24, 2006, the Company entered into a commercial building lease agreement. The sixty-four month lease, estimated to begin on or about January 24, 2007, provides for the lease by the Company of approximately 37,131 square feet of space in Newark, California. Base annual rent is initially set at approximately $27,300 per month. Total base rent payable over the lease period is $1,755,554. The Company has one option to extend the term of the lease for an additional five year period with respect to the entire premises.

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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, as emended, and Section 21E of the Securities Exchange Act of 1934, as amended. 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-looking statements are not guarantees of future performance and are subject to certain risks, uncertainties, and assumptions that are difficult to predict; therefore, actual results and outcomes may differ materially from what is expressed or forecasted in any such forward looking statements. Factors that could cause actual results and outcomes to differ materially include, but are not limited to, the risk of delays in the availability of our products due to technological, market or financial factors including, the availability of necessary working capital, our ability to successfully introduce and market future products, our ability to effectively manage and contain our operating costs, the availability of announced third-party handheld computer hardware and software that our products are intended to work with, product delays associated with new model introductions and product changeovers by the makers of products that our products are intended to work with, continued growth in demand for handheld computers, market acceptance of emerging standards such as Bluetooth and Wireless LAN and of our related connection and data collection products, the ability of our strategic relationships to benefit our business as expected, our ability to enter into additional distribution relationships, or other factors described in this Form 10-Q including "Item 1A. Risk Factors" and recent Form 8-K and Form 10-K reports filed with the Securities and Exchange Commission. We assume no obligation to update such forward-looking statements or to update the reasons why actual results could differ materially from those anticipated in such forward-looking statements.

You should read the following discussion in conjunction with the interim condensed consolidated financial statements and notes included elsewhere in this report, the Company's annual financial statements in the Form 10-K, and other information contained in other reports and documents filed from time to time with the Securities and Exchange Commission.

Revenue

We design, manufacture and sell data collection and connectivity products for use with mobile electronic devices, including handheld computers, tablet computers, notebook computers, and smartphones. We sell embedded products that are designed to be built into third-party mobile electronic devices, and we also design, manufacture and sell serial products that connect mobile electronic devices to peripheral and other electronic devices. Total revenue for the three and nine months ended September 30, 2006 of $6.0 million and $19.6 million, respectively, represented a decrease of 9% and an increase of 2% from revenue of $6.5 million and $19.1 million for the corresponding periods one year ago.

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Our products may be classified into four broad product families:

- Our *data collection products* consist of: 1) bar code scanning products that plug into or connect wirelessly to handheld computers, tablet computers, notebook computers and smartphones and turn these devices into portable bar code scanners that can be used in various retail and industrial workplaces; 2) Radio Frequency

Identification (RFID) plug-in products that read and write to RFID tags; 3) a combination plug-in bar code scanner and RFID reader-writer; and 4) a plug-in magnetic stripe reader. We have developed extensive bar code scanning software called SocketScan that supports all of our data collection products and have software developer kits that assist developers in integrating our SocketScan software into their applications. Our bar code scanning products include CompactFlash and SDIO Card plug-in bar code scanners for linear and two-dimensional bar code scanning, a stand alone hand held bar code scanner that connects to computing devices using the Bluetooth standard for short-range wireless connectivity, and a cordless ring scanner using Bluetooth wireless technology. Data collection products represented approximately 42% and 39% of our revenue for the three and nine month periods ended September 30, 2006.

- Our *connectivity products* are connection devices that can be plugged into standard expansion slots in handheld computers, tablet computers, notebook computers and smartphones or connect to these devices over wireless and wired connections. These products allow users to connect their devices to the Internet via mobile or wired phone services, or to private networks, or to communicate with other electronic devices such as desktop computers, other handheld, tablet and notebook computers, smartphones and printers. Wireless connection products include plug-in cards using the Bluetooth standard for short-range wireless connectivity, and plug-in cards for connecting to local wireless networks using the Wireless LAN 802.11b/g (or Wi-Fi) standards along with extensive communications software enabling the use of these products. Cable connection products include modems for telephone connections and Ethernet cards for local area network connections. Our Bluetooth technology products are of two types-those that add Bluetooth technology to mobile devices and those that work with devices that are Bluetooth-enabled. Those that add Bluetooth technology include our CompactFlash and SDIO Bluetooth plug-in cards, our Bluetooth embedded modules, and our Bluetooth USB adapter for Windows notebooks and desktops. Bluetooth and wireless LAN connection functions are built into many mobile devices which may reduce the demand for these categories of plug-in products. Our cordless modem and cordless serial adapter connectivity products utilize Bluetooth wireless technology as a connection mechanism to work with other Bluetooth-enabled products. Connectivity products represented approximately 23% and 28% of our revenue for the three and nine month periods ended September 30, 2006.

- Our *OEM embedded products and services* consist of Bluetooth cards and modules, WLAN cards, interface chips, and engineering design services. Our Bluetooth cards and modules, and our WLAN cards, allow manufacturers of handheld computers and other devices to build wireless connection functions into their products using the Bluetooth and WLAN standards for wireless connectivity. Our interface chips allow manufacturers of wide area network cards and other devices to transfer information to and from handheld or notebook computers. We are developing modules using Wireless LAN standards for wireless connectivity that are expected to begin shipping in the fourth quarter of 2006. Embedded products and services represented approximately 26% and 23% of our revenue in the three and nine month periods ended September 30, 2006.

- Our *serial products* add connection ports to a notebook, tablet or handheld computer that allow users to connect these portable computers to standard peripherals or to other electronic devices with serial connections over cables or using Bluetooth wireless technology for short-range wireless connectivity. Serial products represented approximately 9% and 10% of our revenue for the three and nine month periods ended September 30, 2006.

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Our data collection product revenues were $2.5 million for the three months ended September 30, 2006, an increase of 1% compared to the same period one year ago. Revenue increases totaling $0.6 million were from increased sales of our Cordless Hand Scanner and from sales of our Cordless Ring Scanner which began shipping in the fourth quarter of 2005. Partially offsetting these increases were declines in sales of our In-Hand Scan Imager card and our SDIO In-Hand Scan card. Our data collection product revenues were $7.6 million for the nine month period ended September 30, 2006, an increase of 2% compared to $7.5 million for the same period one year ago. Revenue increases totaling $0.6 million were due to increases in sales of our Cordless Ring Scanner and Cordless Hand Scanner, partially offset by declines in sales of our SDIO In-Hand Scan card, and our In-Hand Scan Imager card. Data collection revenues in 2006 have been slowed by the introduction of an operating system upgrade, Windows Mobile 5.0, announced in September 2005 by the major PDA manufacturers, which slowed customer deployments through the first nine months of 2006, as third party applications continued to be modified and tested with the operating system. Transition to lead-free products in the second quarter of 2006 to comply with the Reduction of Hazardous Substances (RoHS) rules implemented in Europe and around the world, limited the availability of units by the major PDA manufacturers until late in the second quarter of 2006. Third quarter 2006, traditionally our slowest quarter, was adversely affected by a reduction in deployments by a key North American channel partner. Our scanning products are sold both through general distribution and through value added resellers who contract with customers to provide scanning solutions. Our products are becoming more widely adopted by the value added reseller community for lightweight portable scanning.

Our connectivity product revenues were $1.4 million for the three months ended September 30, 2006, a decrease of 36% compared to $2.2 million for the same period one year ago. Revenue declines for the comparable three months are attributed to declines of $0.2 million each in sales of our Modem plug-in products, Bluetooth plug-in products, Wireless LAN products, and our Cordless GPS receiver with navigation kit. Sales of our Ethernet plug-in products were flat in the comparable three month periods. Our connectivity product revenues were $5.5 million for the nine months ended September 30, 2006, a decline of 15% compared to $6.4 million for the same period one year ago. Revenue declines for the comparable nine months are attributed to declines of $0.7 million in sales of Cordless GPs receiver with navigation kit, declines totaling $0.3 million in sales of our Ethernet plug-in products, Bluetooth plug-in products, and Wireless LAN plug-in products combined. Partially offsetting these declines were slight increases in sales of our Modem plug-in products. Connectivity revenues in 2006 have been slowed by the introduction of an operating system upgrade, Windows Mobile 5.0, announced in September 2005 by the major PDA manufacturers, which slowed customer deployments through the first nine months of 2006, as third party applications continued to be modified and tested with the operating system. Transition to lead-free products in the second quarter of 2006 to comply with the Reduction of Hazardous Substances (RoHS) rules implemented in Europe and around the world, limited the availability of units by the major PDA manufacturers until late in the second quarter of 2006. Third quarter 2006, traditionally our slowest quarter, was adversely affected by a reduction in deployments by a key North American channel partner.

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Our OEM embedded products and services revenues were $1.5 million for the three months ended September 30, 2006, an increase of 72% compared to $0.9 million in the same period one year ago. Our OEM embedded products and services revenues were $4.6 million for the nine month period ended September 30, 2006, an increase of 84% compared to $2.5 million for the same period one year ago. Revenue growth of $0.7 million and $2.2 million for the three and nine month periods in 2006 from sales of our Bluetooth modules was due to increased manufacturing volumes of industrial ruggedized PDAs by our customers, partially offset by declines in sales of our proprietary ASIC chip due to customers choosing higher speed alternative ASIC solutions beginning in the latter half of 2005. We expect continued reduced levels of chip sales for 2006 and onward due to limited marketability of this ASIC solution.

Our serial product revenues were $0.5 million for the three months ended September 30, 2006, a decrease of 38% compared to $0.8 million for the same period one year ago. Our serial product revenues were $1.9 million for the nine month period ended September 30, 2006, a decrease of 23% compared to $2.5 million for the same period one year ago. Revenue decreases of $0.2 million and $0.6 million from the three and nine month comparable periods in 2005, were from declining sales of our standard serial PC Card products. Sales of our cordless Bluetooth serial adapter decreased slightly in the comparable periods. Overall serial product revenues have declined in the first nine months of fiscal 2006 from 2005 levels, continuing a trend reflecting the gradual replacement of serial technology with USB and other newer connection technologies. Standard peripheral connection cards are primarily sold to connect peripheral devices or other electronic equipment to notebook computers.

Gross Margins

Gross margins for the three and nine month periods ended September 30, 2006 were 47% and 49%, compared to margins of 50% in the comparable periods in 2005. Margin reductions in the third quarter of 2006 are due to a product mix reflecting growth in products with lower than average margins, combined with lower initial margins on new products which began shipping in the third quarter of 2006. Additional impacts on margins for the nine month period ending September 30, 2006 are related to higher accruals for inventory reserves compared to the same period in 2005, reflecting estimates for excess non-RoHS compliant inventories. We generally price our products as a markup from our cost, and we offer discount pricing for higher volume purchases.

Research and Development Expense

Research and development expense for the three months ended September 30, 2006 was $1.2 million, an increase of 46% compared to research and development expense of $0.8 million in the corresponding period one year ago. Research and development expense for the nine months ended September 30, 2006 was $3.8 million, a 42% increase compared to research and development expense of $2.6 million in the corresponding period one year ago. Personnel costs increased by $0.2 million and $0.5 million in the three and nine months ended September 30, 2006, of which approximately half was related to the recognition of stock-based compensation expense resulting from the adoption and implementation of SFAS 123R beginning January 1, 2006. Additional increases were from increased equipment costs, outside services, and consulting and professional fees reflecting increased development activities. Expenses are expected to increase in the fourth quarter of 2006 from third quarter levels due to anticipated development activities.

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Sales and Marketing Expense

Sales and marketing expense for the three months ended September 30, 2006 was $1.8 million, an increase of 11% compared to sales and marketing expense of $1.7 million in the corresponding period one year ago. Sales and marketing expense for the nine month period ended September 30, 2006 was $5.4 million, an increase of 12% compared to sales and marketing expense of $4.8 million in the corresponding period one year ago. Over half of the overall increase in the comparable three and nine month periods was related to stock-based compensation expense recognized in 2006 resulting from the adoption and implementation of SFAS 123R beginning January 1, 2006. Remaining increases were from increased personnel expenses reflecting increased personnel and higher sales activities compared to the comparable periods in 2005. Expenses are expected to be flat in the fourth quarter of 2006 with third quarter levels.

General and Administrative Expense

General and administrative expense for the three months ended September 30, 2006 was $0.6 million, an increase of 6% compared to the corresponding period one year ago. General and administrative expense for the nine month period ended September 30, 2006 was $2.1 million, an increase of 5% compared to $2.0 million in the corresponding period one year ago. Increases in personnel costs of $0.1 million and $0.3 million in the three and nine months ended September 30, 2006 were from stock-based compensation expense recognized in the first three quarters of 2006 resulting from the adoption and implementation of SFAS 123R beginning January 1, 2006. Partially offsetting these increases in the comparable three and nine month periods were reduced professional fees related to Sarbanes-Oxley compliance requirements in 2005, and reduced business insurance costs. Expenses are expected to increase in the fourth quarter of 2006 from third quarter levels due primarily to increased consulting and profession fees related to our annual audit, historically charged during the fourth and first quarters.

Amortization of Intangibles

In July 2004 we acquired a patent which covers the design and functioning of plug-in bar code scanners, bar code imagers and RFID products. The patent was purchased for $600,000 and has been capitalized as an intangible asset. The patent is being amortized on a straight line basis over a ten year period. Intangible assets of $570,750 remaining from a prior acquisition in 2000 consist of developed software and technology with estimated lives at the time of acquisition of 8.5 years. At December 31, 2004, a licensing agreement with a book value of $38,000 was reclassified as an intangible asset and is being amortized over its remaining life of three years. During the first quarter of 2002, we acquired intangible assets in conjunction with the acquisition of Nokia's CompactFlash Bluetooth Card business and related product line technology valued at $980,000. Estimated useful lives of the acquired assets at the time of acquisition ranged from one to three years. At March 31, 2005, all components of the acquired Nokia intangibles were fully amortized. Amortization charges for all acquired intangibles for the three and nine months ended September 30, 2006 were $35,000 and $107,000, respectively, compared to $36,000 and $167,000, for the same periods one year ago. The lower amortization charges in 2006 are due to components of intangible property becoming fully amortized.

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Interest Income, Interest Expense, Net

Interest income reflects interest earned on cash balances. Interest income of $47,000 and $134,000 for the three and nine month periods ended September 30, 2006, respectively, compared to interest income of $27,000 and $59,000, respectively, for the comparable periods one year ago. Higher levels of interest income reflects higher average levels of cash on hand combined with higher rates of return in the three and nine months of 2006 compared to the same periods in 2005.

Interest expense of $1,800 and $6,100 for the three and nine months ended September 30, 2006 respectively, compared to interest expense of $800 and $3,400, respectively, for the comparable periods one year ago. Interest expense is related to interest on equipment lease financing obligations and interest on amounts drawn on our bank lines of credit. We used our bank lines of credit only at the end of the first three fiscal quarters of 2006, and the end of each quarter in fiscal 2005. Higher interest expense in 2006 is due to higher interest rates on our lines of credit in 2006 compared to 2005.

Preferred Stock Dividends

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. Preferred stock dividends for the nine months ended September 30, 2006 reflect dividends of $10,700 on the Series F Preferred Stock up through the date of mandatory conversion in the first quarter 2006, which were paid prior to the end of the first quarter. On March 21, 2006 the outstanding shares of Series F Preferred Stock automatically converted into common stock resulting in the issuance of 823,300 shares of common stock. Dividends on the Series F Preferred Stock for the three and nine month periods ended September 30, 2005 were $12,100 and $36,500, respectively, which were paid in cash subsequent to the end of each of those respective quarters.

Income Taxes

There were no provisions for income taxes for the three and nine months ended September 30, 2006 due to our year-to-date net losses. We were not profitable in fiscal 2005, profitable in fiscal 2004, and not profitable in fiscal 2003 and all prior periods. We have maintained a full valuation allowance for all deferred tax assets.

Liquidity and Capital Resources

We were unprofitable in each of the first three quarters of fiscal 2006 due in part to the negative impact of the adoption of SFAS 123R on January 1, 2006, which does not require the use of cash. We were profitable in two of the quarters in fiscal year 2005, but unprofitable for fiscal year 2005. Historically we have financed our operations through the sale of equity securities, equipment financing, and revolving bank lines of credit. Since our inception, we have raised approximately $51 million in equity capital. Prior to the first quarter of 2004, we incurred significant quarterly and annual operating losses in every fiscal period. We may continue to be unprofitable in the future.

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Cash used in operating activities was $0.5 million in the first nine months of 2006, compared to cash provided of $1.8 million in the first nine months of 2005. Cash used in the first nine months of 2006 from our net loss adjusted for non-cash items was $0.2 million, compared to cash provided from our net income adjusted for non-cash items of $0.4 million in the first nine months of 2005. Adjustments for non-cash items, including depreciation and amortization, amortization of intangibles, gains and losses on foreign currency forward exchange contracts, changes in deferred rent, and beginning January 1, 2006, stock-based compensation, totaled $1.5 million in the first nine months of 2006, compared to $0.5 million in the first nine months of 2005. Changes in working capital balances in the first nine months of 2006 resulted in a use of cash of $0.3 million, which was primarily from increases in inventory and accounts receivable, partially offset by increases in payables and deferred revenue, and decreases in prepaid and other current assets. Changes in working capital balances in the first nine months of 2005 resulted in a source of cash of $1.2 million, and were primarily from reductions in levels of inventory, decreases in receivables due to early collections from key distributors, and increases in payables, partially offset by increases in prepaid assets.

Cash used in investing activities was $0.7 million in the first nine months of 2006 compared to $0.4 million in the first nine months of 2005. Investing activities in both 2006 and 2005 primarily reflect the cost of new computer hardware and software, and tooling costs.

Cash provided from financing activities was $0.5 million in the first nine months of 2006, compared to cash used of $0.7 million during the first nine months of 2005. Financing activities in the first nine months of 2006 consisted primarily of proceeds from the exercise of warrants and stock options, partially offset by a net decrease in the amounts drawn on our bank lines of credit, and the final dividend payments on Series F Preferred Stock. Financing activities in the first nine months of 2005 consisted primarily of a net decrease in the amounts drawn on our bank lines of credit, payment of cash dividends, and payments on capital leases partially offset by proceeds from the exercise of stock options.

Our cash balances at September 30, 2006 were $6.2 million, including cash of $2.2 million drawn against our bank line of credit. In March 2006, we extended our bank line of credit agreement which will now expire on March 3, 2008. We have warrants outstanding from our private placement financings and outstanding employee stock options that, if exercised, would further increase our cash and equity balances. We believe our existing cash, plus our ability to reduce costs, and our bank line will be sufficient to meet our funding requirements at least through September 30, 2007. If we can return to profitability and revenue growth, we anticipate requirements for cash will include funding of higher receivable and inventory balances, and increasing expenses, including more employees to support our growth and increases in salaries, benefits, and related support costs for employees. If we cannot return to profitability, we will not be able to support our operations from positive cash flows, and we would use our existing cash to support operating losses. Should the need arise, we cannot assure you that additional capital will be available on acceptable terms, if at all, and any such terms may be dilutive to existing stockholders. Although we do not anticipate the need to raise additional capital at this time to fund our operations, we may raise additional capital if market conditions are appropriate.

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Our contractual cash obligations at September 30, 2006 are outlined in the table below:

	Payments Due by Period				
Contractual Obligations	Total	Less than 1 year	1 to 3 years	4 to 5 years	More than 5 years
Capital leases	$ 10,800	$ 10,000	$ 800	$ --	$ --
Operating leases	94,800	94,800	--	--	--
Unconditional purchase obligations with contract manufacturers	1,171,700	1,171,700	--	--	--
Total contractual cash obligations	$ 1,277,300	$ 1,276,500	$ 800	--	--

On October 24, 2006, we entered into a commercial building lease agreement. The sixty-four month lease is estimated to begin on or about January 24, 2007. Base annual rent is initially set at approximately $27,300 per month. Total base rent payable over the lease period is $1,755,554. The Company has one option to extend the term of the lease for an additional five year period with respect to the entire premises.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements as defined in Item 303 of Regulation S-K.

Stock Based Compensation

On January 1, 2006, we 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, we use 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 our 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. We adopted the modified prospective recognition method and implemented the provisions of SFAS 123R beginning with the first quarter of 2006.

Adoption of SFAS 123R resulted in stock-based compensation expense of $298,000 and $934,000 for the three and nine months ended September 30, 2006, and had a material impact on our consolidated financial position, results of operations and cash flows. We expect that the adoption of FAS 123R will continue to have a material impact on our reported results in future quarters. See Note 3 for additional information regarding our stock-based compensation assumptions and expenses, including pro forma disclosures for prior periods.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

Our exposure to market risk for changes in interest rates relates primarily to invested cash. Our cash is invested in short-term money market investments backed by U.S. Treasury notes and other investments that mature within one year and whose principal is not subject to market rate fluctuations. Accordingly, interest rate declines would adversely affect our interest income but would not affect the carrying value of our cash investments. Based on a sensitivity analysis of our cash investments during the quarter ended September 30, 2006, a decline of 1% in interest rates would reduce our quarterly interest income by approximately $16,000.

Our bank credit line facilities of up to $4.0 million have variable interest rates based upon the lender's index rate plus 0.5% for both the domestic line (up to $2.5 million) and the international line (up to $1.5 million). Accordingly, interest rate increases would increase our interest expense on outstanding credit line balances. We utilized our credit line facility only at the end of the first three fiscal quarters of 2006, and the end of each quarter in fiscal 2005, and therefore did not subject ourselves to interest rate exposure. Based on a sensitivity analysis, an increase of 1% in the interest rate would increase our borrowing costs by $10,000 for each $1 million of borrowings against our bank credit facility, if outstanding for the entire year, or a maximum of $40,000 if we utilized our entire credit line.

Foreign Currency Risk

A substantial majority of our revenue, expense and purchasing activities are transacted in US dollars. However, we require our European distributors to purchase our products in Euros, we pay the expenses of our European subsidiary in Euros, and we expect to enter into selected future purchase commitments with foreign suppliers that may be paid in the local currency of the supplier. To date these balances have been small, and we have not been subject to significant losses from material foreign currency fluctuations. Based on a sensitivity analysis of our net foreign currency denominated assets and subsidiary expenses at the beginning, during and at the end of the quarter ended September 30, 2006, an adverse change of 10% in exchange rates would result in a decrease in our net income for the second quarter of approximately $63,000, if left unprotected. For the third quarter of 2006 the total net adjustment for the effects of changes in foreign currency on cash balances, collections, payables, and derivatives was a net gain of $5,000. We hedge a significant portion of our European receivable balances denominated in Euros to reduce the foreign currency risk associated with these assets. We will continue to monitor and assess the risk associated with these exposures and may at some point in the future take additional actions to mitigate these risks.

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Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is (i) recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (ii) accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

(b) Changes in internal control over financial reporting

There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1A. Risk Factors

There are no material changes to the risk factors described in Part I, "Item 1A. Risk Factors," in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005. The risk factor below titled, "*Failure to maintain effective internal controls could have a material adverse effect on our business, operating results and stock price*," has been updated to reflect that under our current status as a non-accelerated filer, the requirement under Section 404 of the Sarbanes-Oxley Act that our Independent Registered Public Accounting Firm issue a report on the annual assessment by management of the design and effectiveness of internal controls over financial reporting, is no longer in effect, and therefore the reference has been deleted. The presentation of numerical amounts and percentages in the following risk factors below titled: "*A significant portion of our revenue currently comes from two distributors, and any decrease in revenue from these distributors could harm our business;" "Our operating results could be harmed by economic, political, regulatory and other risks associated with export sales;" "The sale of a substantial number of shares of common stock could cause the market price of our common stock to decline;" and "Volatility in the trading price of our common stock could negatively impact the price of our common stock*," have been updated to reflect information for the nine month period ending September 30, 2006.

The risks described in our Annual Report on Form 10-K, as updated in this Quarterly Report on Form 10-Q, are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition, and operating results.

We have a history of operating losses and may not achieve ongoing profitability.

We were unprofitable in each of the first three quarters of 2006. We were profitable in two quarters in 2005, but unprofitable for fiscal year 2005. Fiscal year 2004 was our first profitable year in our history, but only to the extent of $288,000. Prior to 2004, we incurred significant operating losses in each financial period since our inception. To achieve ongoing profitability, we must accomplish numerous objectives, including growth in our business and the development of successful new products. We cannot foresee with any certainty whether we will be able to achieve these objectives in the future. Accordingly, we may not generate sufficient net revenue to achieve ongoing profitability. If we cannot achieve ongoing profitability, we will not be able to support our operations from positive cash flows, and we would use our existing cash to support operating losses. If we are unable to secure the necessary capital to replace that cash, we may need to suspend some or all of our current operations.

We may require additional capital in the future, but that capital may not be available on reasonable terms, if at all, or on terms that would not cause substantial dilution to your stock holdings.

Although we do not anticipate the need to raise additional capital during the next twelve months to fund our operations, we may incur operating losses in future quarters and may need to raise capital to fund these losses. Our forecasts are highly dependent on factors beyond our control, including market acceptance of our products and sales of handheld computers. If capital requirements vary materially from those currently planned, we may require additional capital sooner than expected. There can be no assurance that such capital will be available in sufficient amounts or on terms acceptable to us, if at all. In addition, the availability of our bank line is dependent upon our meeting certain covenants, including a tangible net worth covenant. Future operating losses could cause us to lose the availability of our bank line as a result of becoming non-compliant with these covenants.

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If third-parties do not produce and sell innovative products with which our products are compatible, we may not achieve our sales projections.

Our success is dependent upon the ability of third-parties in the mobile personal computer industry to complete development of products that include or are compatible with our technology and then to sell these products into the marketplace. Our ability to generate increased revenue depends significantly on the commercial success of Windows-mobile handheld devices, particularly the Pocket PC and other devices, such as the line of handhelds with expansion options offered by Palm and the adoption of smartphones for business use. If manufacturers are unable or choose not to ship new products such as Pocket PC and other Windows-mobile devices or Palm devices on schedule, or experience difficulties with new product transitions that cause delays in the market as we experienced in 2005 and the first nine months of 2006, or if these products fail to achieve or maintain market acceptance, the number of our potential new customers would be reduced and we would not be able to meet our sales expectations.

If we fail to develop and introduce new products rapidly and successfully, we will not be able to compete effectively, and our ability to generate sufficient revenues will be negatively affected.

The market for our products is prone to rapidly changing technology, evolving industry standards and short product life cycles. If we are unsuccessful at developing and introducing new products and services on a timely basis that include the latest technologies conforming to the newest standards and that are appealing to end users, we will not be able to compete effectively, and our ability to generate significant revenues will be seriously harmed.

The development of new products and services can be very difficult and requires high levels of innovation. The development process is also lengthy and costly. Short product life cycles expose our products to the risk of obsolescence and require frequent new product introductions. We will be unable to introduce new products and services into the market on a timely basis and compete successfully, if we fail to:

- identify emerging standards in the field of mobile computing products;
- enhance our products by adding additional features;
- invest significant resources in research and development, sales and marketing, and customer support;
- maintain superior or competitive performance in our products; and
- anticipate our end users' needs and technological trends accurately.

We cannot be sure that we will have sufficient resources to make adequate investments in research and development or that we will be able to identify trends or make the technological advances necessary to be competitive.

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Beginning January 1, 2006 we began to expense options granted under our employee stock plans as compensation, and as a result our net income and earnings per share were negatively affected, we may continue to have net losses as a result of the requirement to expense options, and may find it necessary to change our business practices to attract and retain employees.

Historically, we have used stock options as a key component of our employee compensation packages. We believe that stock options provide an incentive to our employees to maximize long-term stockholder value and, through the use of vesting, encourage valued employees to remain with us. The expensing of employee stock options has adversely affected our net income and earnings per share in the first three quarters of fiscal 2006, will continue to adversely affect future quarters, and will make profitability harder to achieve or make our net losses worse. In addition, we may decide in response to the effects of expensing stock options on our operating results to reduce the number of stock options granted to employees or to grant options to fewer employees. This could adversely affect our ability to retain existing employees and attract qualified candidates, and also could increase the cash compensation we would have to pay to them.

A significant portion of our revenue currently comes from two distributors, and any decrease in revenue from these distributors could harm our business.

A significant portion of our revenue comes from two distributors, Tech Data Corp. and Ingram Micro, Inc., which together represented approximately 40% and 42% of our worldwide revenue in the first nine months of 2006 and fiscal year 2005, respectively. We expect that a significant portion of our revenue will continue to depend on sales to Tech Data Corp. and Ingram Micro, Inc. We do not have long-term commitments from Tech Data Corp. or Ingram Micro, Inc. to carry our products. Either could choose to stop selling some or all of our products at any time, and each of these companies also carries our competitors' products. If we lose our relationship with Tech Data Corp. or Ingram Micro, Inc., we would experience disruption and delays in marketing our products. Revenues related to these two major distributors fell in the third quarter 2006 to 32%, due primarily to a reduction in the level of corporate deployments by one of our North American channel partners.

If the market for mobile computers fails to grow, we will not achieve our sales projections.

Substantially all of our products are designed for use with mobile personal computers, including handhelds, notebook computers, tablets and smartphones. If the mobile personal computer industry does not grow, if its growth slows, or if product or operating system changeovers by mobile computer manufacturers and partners cause delays in the market, as we experienced in 2005 and in the first nine months of 2006, we will not achieve our sales projections.

Our sales will be hurt if the new technologies used in our products do not become widely adopted, or are adopted slower than expected.

Many of our products use new technologies, such as 2D bar code scanning and RFID, which are not yet widely adopted in the market. If these technologies fail to become widespread, or are adopted slower than expected, our sales will suffer.

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We could face increased competition in the future, which would adversely affect our financial performance.

The market for handheld computers in which we operate is very competitive. Our future financial performance is contingent on a number of unpredictable factors, including that:

- some of our competitors have greater financial, marketing, and technical resources than we do;
- we periodically face intense price competition, particularly when our competitors have excess inventories and discount their prices to clear their inventories; and
- certain original equipment manufacturers of personal computers, mobile phones and handheld computers offer built-in functions, such as Bluetooth wireless technology, Wi-Fi, or bar code scanning, that compete with our products.

Increased competition could result in price reductions, fewer customer orders, reduced margins, and loss of market share. Our failure to compete successfully against current or future competitors could harm our business, operating results and financial condition.

If we do not correctly anticipate demand for our products, our operating results will suffer.

The demand for our products depends on many factors and is difficult to forecast. We expect that it will become more difficult to forecast demand as we introduce and support more products and as competition in the market for our products intensifies. If demand increases beyond forecasted levels, we would have to rapidly increase production at our third-party manufacturers. We depend on suppliers to provide additional volumes of components, and suppliers might not be able to increase production rapidly enough to meet unexpected demand. Even if we were able to procure enough components, our third-party manufacturers might not be able to produce enough of our devices to meet our customer demand. In addition, rapid increases in production levels to meet unanticipated demand could result in higher costs for manufacturing and supply of components and other expenses. These higher costs could lower our profit margins. Further, if production is increased rapidly, manufacturing yields could decline, which may also lower operating results.

If demand is lower than forecasted levels, we could have excess production resulting in higher inventories of finished products and components, which could lead to write-downs or write-offs of some or all of the excess inventories. Lower than forecasted demand could also result in excess manufacturing capacity at our third-party manufacturers and in our failure to meet minimum purchase commitments, each of which may lower our operating results.

We rely primarily on distributors, resellers, and original equipment manufacturers to sell our products, and our sales would suffer if any of these third-parties stops selling our products effectively.

Because we sell our products primarily through distributors, resellers, and original equipment manufacturers, we are subject to risks associated with channel distribution, such as risks related to their inventory levels and support for our products. Our distribution channels may build up inventories in anticipation of growth in their sales. If such growth in their sales does not occur as anticipated, the inventory build up could contribute to higher levels of product returns. The lack of sales by any one significant participant in our distribution channels could result in excess inventories and adversely affect our operating results.

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Our agreements with distributors, resellers, and original equipment manufacturers are generally nonexclusive and may be terminated on short notice by them without cause. Our distributors, resellers, and original equipment manufacturers are not within our control, are not obligated to purchase products from us, and may offer competitive lines of products simultaneously. Sales growth is contingent in part on our ability to enter into additional distribution relationships and expand our sales channels. We cannot predict whether we will be successful in establishing new distribution relationships, expanding our sales channels or maintaining our existing relationships. A failure to enter into new distribution relationships or to expand our sales channels could adversely impact our ability to grow our sales.

We allow our distribution channels to return a portion of their inventory to us for full credit against other purchases. In addition, in the event we reduce our prices, we credit our distributors for the difference between the purchase price of products remaining in their inventory and our reduced price for such products. Actual returns and price protection may adversely affect future operating results, particularly since we seek to continually introduce new and enhanced products and are likely to face increasing price competition.

We depend on alliances and other business relationships with a small number of third-parties, and a disruption in any one of these relationships would hinder our ability to develop and sell our products.

We depend on strategic alliances and business relationships with leading participants in various segments of the communications and mobile personal computer markets to help us develop and market our products. Our strategic partners may revoke their commitment to our products or services at any time in the future or may develop their own competitive products or services. Accordingly, our strategic relationships may not result in sustained business alliances, successful product or service offerings, or the generation of significant revenues. Failure of one or more of such alliances could result in delay or termination of product development projects, failure to win new customers, or loss of confidence by current or potential customers.

We have devoted significant research and development resources to design activities for Windows-mobile products and, more recently, to design activities for Palm devices, smartphones using Windows Mobile and Symbian System 60 and 80 operating systems, and handheld computers from Research-in-Motion. Such design activities have diverted financial and personnel resources from other development projects. These design activities are not undertaken pursuant to any agreement under which Microsoft, Palm, Symbian or Research-in-Motion is obligated to continue the collaboration or to support the products produced from the collaboration. Consequently, these organizations may terminate their collaborations with us for a variety of reasons, including our failure to meet agreed-upon standards or for reasons beyond our control, such as changing market conditions, increased competition, discontinued product lines, and product obsolescence.

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Our intellectual property and proprietary rights may be insufficient to protect our competitive position.

Our business depends on our ability to protect our intellectual property. We rely primarily on patent, copyright, trademark, trade secret laws, and other restrictions on disclosure to protect our proprietary technologies. We cannot be sure that these measures will provide meaningful protection for our proprietary technologies and processes. We cannot be sure that any patent issued to us will be sufficient to protect our technology. The failure of any patents to provide protection to our technology would make it easier for our competitors to offer similar products. In connection with our participation in the development of various industry standards, we may be required to license certain of our patents to other parties, including our competitors, that develop products based upon the adopted standards.

We also generally enter into confidentiality agreements with our employees, distributors, and strategic partners, and generally control access to our documentation and other proprietary information. Despite these precautions, it may be possible for a third-party to copy or otherwise obtain and use our products, services, or technology without authorization, develop similar technology independently, or design around our patents.

Effective copyright, trademark, and trade secret protection may be unavailable or limited in certain foreign countries. Furthermore, certain of our customers have entered into agreements with us which provide that the customers have the right to use our proprietary technology in the event we default in our contractual obligations, including product supply obligations, and fail to cure the default within a specified period of time.

We may become subject to claims of intellectual property rights infringement, which could result in substantial liability.

In the course of operating our business, we may receive claims of intellectual property infringement or otherwise become aware of potentially relevant patents or other intellectual property rights held by other parties. Many of our competitors have large intellectual property portfolios, including patents that may cover technologies that are relevant to our business. In addition, many smaller companies, universities, and individuals have obtained or applied for patents in areas of technology that may relate to our business. The industry is moving towards aggressive assertion, licensing, and litigation of patents and other intellectual property rights.

If we are unable to obtain and maintain licenses on favorable terms for intellectual property rights required for the manufacture, sale, and use of our products, particularly those products which must comply with industry standard protocols and specifications to be commercially viable, our results of operations or financial condition could be adversely impacted.

In addition to disputes relating to the validity or alleged infringement of other parties' rights, we may become involved in disputes relating to our assertion of our own intellectual property rights. Whether we are defending the assertion of intellectual property rights against us or asserting our intellectual property rights against others, intellectual property litigation can be complex, costly, protracted, and highly disruptive to business operations by diverting the attention and energies of management and key technical personnel. Plaintiffs in intellectual property cases often seek injunctive relief, and the measures of damages in intellectual property litigation are complex and often subjective or uncertain. Thus, any adverse determinations in this type of litigation could subject us to significant liabilities and costs.

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New industry standards may require us to redesign our products, which could substantially increase our operating expenses.

Standards for the form and functionality of our products are established by standards committees. These independent committees establish standards, which evolve and change over time, for different categories of our products. We must continue to identify and ensure compliance with evolving industry standards so that our products are interoperable and we remain competitive. Unanticipated changes in industry standards could render our products incompatible with products developed by major hardware manufacturers and software developers. Should any major changes, even if anticipated, occur, we would be required to invest significant time and resources to redesign our products to ensure compliance with relevant standards. If our products are not in compliance with prevailing industry standards for a significant period of time, we would miss opportunities to sell our products for use with new hardware components from mobile computer manufacturers and original equipment manufacturers, thus affecting our business.

Undetected flaws and defects in our products may disrupt product sales and result in expensive and time-consuming remedial action.

Our hardware and software products may contain undetected flaws, which may not be discovered until customers have used the products. From time to time, we may temporarily suspend or delay shipments or divert development resources from other projects to correct a particular product deficiency. Efforts to identify and correct errors and make design changes may be expensive and time consuming. Failure to discover product deficiencies in the future could delay product introductions or shipments, require us to recall previously shipped products to make design modifications, or cause unfavorable publicity, any of which could adversely affect our business and operating results.

Our quarterly operating results may fluctuate in future periods, which could cause our stock price to decline.

We expect to experience quarterly fluctuations in operating results in the future. We generally ship orders as received, and as a result we may have little backlog. Quarterly revenue and operating results therefore depend on the volume and timing of orders received during the quarter, which are difficult to forecast. Historically, we have often recognized a substantial portion of our revenue in the last month of the quarter. This subjects us to the risk that even modest delays in orders may adversely affect our quarterly operating results. Our operating results may also fluctuate due to factors such as:

- the demand for our products;
- the size and timing of customer orders;
- unanticipated delays or problems in our introduction of new products and product enhancements;
- the introduction of new products and product enhancements by our competitors;
- the timing of the introduction of new products that work with our connection products;
- changes in the proportion of revenues attributable to royalties and engineering development services;

- product mix;
- timing of software enhancements;
- changes in the level of operating expenses;
- competitive conditions in the industry including competitive pressures resulting in lower average selling prices; and
- timing of distributors' shipments to their customers.

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Because we base our staffing and other operating expenses on anticipated revenue, delays in the receipt of orders can cause significant variations in operating results from quarter to quarter. As a result of any of the foregoing factors, or a combination, our results of operations in any given quarter may be below the expectations of public market analysts or investors, in which case the market price of our common stock would be adversely affected.

The loss of one or more of our senior personnel could harm our existing business.

A number of our officers and senior managers have been employed for ten to fourteen years by us, including our President, Chief Financial Officer, Chief Technical Officer, Vice President of Marketing, and Senior Vice President for Business Development/General Manager Development Services. Our future success will depend upon the continued service of key officers and senior managers. Competition for officers and senior managers is intense, and there can be no assurance that we will be able to retain our existing senior personnel. The loss of one or more of our officers or key senior managers could adversely affect our ability to compete.

If we are unable to attract and retain highly skilled sales and marketing and product development personnel, our ability to develop new products and product enhancements will be adversely affected.

We believe our ability to achieve increased revenues and to develop successful new products and product enhancements will depend in part upon our ability to attract and retain highly skilled sales and marketing and product development personnel. Our products involve a number of new and evolving technologies, and we frequently need to apply these technologies to the unique requirements of mobile connection products. Our personnel must be familiar with both the technologies we support and the unique requirements of the products to which our products connect. Competition for such personnel is intense, and we may not be able to attract and retain such key personnel. In addition, our ability to hire and retain such key personnel will depend upon our ability to raise capital or achieve increased revenue levels to fund the costs associated with such key personnel. Failure to attract and retain such key personnel will adversely affect our ability to develop new products and product enhancements.

We may not be able to collect revenues from customers who experience financial difficulties.

Our accounts receivable are derived primarily from distributors and original equipment manufacturers. We perform ongoing credit evaluations of our customers' financial conditions but generally require no collateral from our customers. Reserves are maintained for potential credit losses, and such losses have historically been within such reserves. However, many of our customers may be thinly capitalized and may be prone to failure in adverse market conditions. Although our collection history has been good, from time to time a customer may not pay us because of financial difficulty, bankruptcy or liquidation.

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We may be unable to manufacture our products, because we are dependent on a limited number of qualified suppliers for our components.

Several of our component parts, including our serial interface chip, our Ethernet chip, and our bar code scanning modules, are produced by one or a limited number of suppliers. Shortages could occur in these essential components due to an interruption of supply or increased demand in the industry. If we are unable to procure certain component parts, we could be required to reduce our operations while we seek alternative sources for these components, which could have a material adverse effect on our financial results. To the extent that we acquire extra inventory stocks to protect against possible shortages, we would be exposed to additional risks associated with holding inventory, such as obsolescence, excess quantities, or loss.

Our operating results could be harmed by economic, political, regulatory and other risks associated with export sales.

Export sales (sales to customers outside the United States) accounted for approximately 33% of our revenue in the first nine months of 2006 and 35% of our revenue in the fiscal year 2005. Accordingly, our operating results are subject to the risks inherent in export sales, including:

- longer payment cycles;
- unexpected changes in regulatory requirements, import and export restrictions and tariffs;
- difficulties in managing foreign operations;
- the burdens of complying with a variety of foreign laws;
- greater difficulty or delay in accounts receivable collection;
- potentially adverse tax consequences; and
- political and economic instability.

Our export sales are primarily denominated in United States dollars and in Euros for our sales to European distributors. Accordingly, an increase in the value of the United States dollar relative to foreign currencies could make our products more expensive and therefore potentially less competitive in foreign markets. Declines in the value of the Euro relative to the United States dollar may result in foreign currency losses relating to collection of Euro denominated receivables if left unhedged.

Our operations are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure, and other events beyond our control.

Our corporate headquarters are located near an earthquake fault. The potential impact of a major earthquake on our facilities, infrastructure, and overall business is unknown. Additionally, we may experience electrical power blackouts or natural disasters that could interrupt our business. Should a disaster be widespread, such as a major earthquake, or result in the loss of key personnel, we may not be able to implement our disaster recovery plan in a timely manner. Any losses or damages incurred by us as a result of these events could have a material adverse effect on our business.

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Failure to maintain effective internal controls could have a material adverse effect on our business, operating

results and stock price.

We have evaluated and will continue to evaluate our internal control procedures in order to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act, which requires an annual management assessment of the design and effectiveness of our internal controls over financial reporting. If we fail to maintain the adequacy of our internal controls, as such standards are modified, supplemented or amended from time to time, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal controls over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act. Moreover, effective internal controls, particularly those related to revenue recognition, are necessary for us to produce reliable financial reports and are important to helping prevent financial fraud. If we cannot provide reliable financial reports or prevent fraud, our business and operating results could be harmed, investors could lose confidence in our reported financial information, and the trading price of our stock could drop significantly.

The sale of a substantial number of shares of common stock could cause the market price of our common stock to decline.

Sales of a substantial number of shares of our common stock in the public market could adversely affect the market price for our common stock. The market price of our common stock could also decline if one or more of our significant stockholders decided for any reason to sell substantial amounts of our common stock in the public market.

As of October 31, 2006, we had 31,851,285 shares of common stock outstanding. Substantially all of these shares are freely tradable in the public market, either without restriction or subject, in some cases, only to S-3 prospectus delivery requirements and, in other cases, only to manner of sale, volume, and notice requirements of Rule 144 under the Securities Act.

As of October 31, 2006, we had 8,965,602 shares subject to outstanding options under our stock option plans, and 741,306 shares were available for future issuance under the plans. We have registered the shares of common stock subject to outstanding options and reserved for issuance under our stock option plans. Accordingly, shares underlying vested options will be eligible for resale in the public market as soon as the options are exercised.

As of October 31, 2006, we had warrants outstanding to purchase a total of 989,712 shares of our common stock at exercise prices ranging from $0.722 to $2.73. All such warrants may be exercised at any time, and the shares issuable upon exercise may be resold, either without restrictions or subject, in some cases, only to S-3 prospectus delivery requirements, and, in some cases, only to manner of sale, volume, and notice requirements of Rule 144.

Volatility in the trading price of our common stock could negatively impact the price of our common stock.

During the period from January 1, 2005 through October 31, 2006, our common stock price fluctuated between a high of $1.94 and a low of $0.79. The trading price of our common stock could be subject to wide fluctuations in response to many factors, some of which are beyond our control, including general economic conditions and the outlook of securities analysts and investors on our industry. In addition, the stock markets in general, and the markets for high technology stocks in particular, have experienced high volatility that has often been unrelated to the operating performance of particular companies. These broad market fluctuations may adversely affect the trading price of our common stock.

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PART II. OTHER INFORMATION

Item 6. Exhibits

Exhibits

10.10 Standard Lease Agreement by and between Del Norte Farms, Inc. and the Company dated October 24, 2006.

10.11 Addendum to the Standard Lease Agreement by and between Del Norte Farms, Inc. and the Company dated October 24, 2006.

31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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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.

SOCKET COMMUNICATIONS, INC.
Registrant

Date: November 10, 2006

/s/ Kevin J. Mills
Kevin J. Mills
President and Chief Executive Officer
(Duly Authorized Officer and Principal Executive Officer)

Date: November 10, 2006

/s/ David W. Dunlap
David W. Dunlap
Vice President of Finance and Administration and Chief Financial Officer
(Duly Authorized Officer and Principal Financial and Accounting Officer)

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Index to Exhibits

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