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PATRON SYSTEMS INC  
Form 10KSB/A  
May 21, 2007

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-KSB/A  
(AMENDMENT NO. 1)

(Mark One)

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

For the fiscal year ended December 31, 2006

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

COMMISSION FILE NUMBER 0-25675

PATRON SYSTEMS, INC.  
(NAME OF SMALL BUSINESS ISSUER IN ITS CHARTER)

DELAWARE  
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)

74-3055158  
(I.R.S. EMPLOYER IDENTIFICATION NO.)

5775 FLATIRON PARKWAY, SUITE 230  
BOULDER, CO  
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

80301  
(ZIP CODE)

(303) 541-1005  
(ISSUER'S TELEPHONE NUMBER)

SECURITIES REGISTERED UNDER SECTION 12(B) OF THE EXCHANGE ACT: NONE  
SECURITIES REGISTERED UNDER SECTION 12(G) OF THE EXCHANGE ACT:

COMMON STOCK, \$0.01 PAR VALUE PER SHARE  
(TITLE OF CLASS)

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act.

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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  No

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.) Yes  No

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The issuer's revenues for the fiscal year ended December 31, 2006 were \$1,188,045.

At March 28, 2007, the aggregate market value of the voting stock held by non-affiliates of the issuer was \$14,366,706.

At March 28, 2007, the issuer had 14,512,260 shares of Common Stock, \$0.01 par value, issued and outstanding.

Transitional Small Business Disclosure Format (Check One) Yes  No

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EXPLANATORY NOTE

Patron Systems, Inc. is filing this Amendment No. 1 to its Annual Report on Form 10-KSB (the "Form 10-KSB") for the year ended December 31, 2006 filed with the Securities and Exchange Commission on April 10, 2007. This filing amends and restates our previously reported financial statements for the year ended December 31, 2006 to reflect the determination by us that our accounting for a deemed dividend that was recognized upon a reduction in the conversion price of our Series A Preferred Stock was in error. The reduction in the conversion price occurred upon our issuance of additional convertible securities featuring a conversion price lower than the conversion price embedded in the Series A Preferred. In calculating the deemed dividend, we originally determined that the net loss available to our common stockholders should be increased by \$589,175. We reevaluated our computations during the quarter ended March 31, 2007 and

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determined that the net loss available to our common stockholders should have been increased by \$3,759,059. The nature of the adjustment relates to our use of an incorrect price for the value of our common stock when we computed the intrinsic value of the conversion feature embedded in the Series A Preferred stock at the time of the reduction in the conversion price. The effect on our financial statements for the year ended December 31, 2006 was to increase additional paid in capital, accumulated deficit and net loss available to common stockholders by \$3,169,884, net loss per share for continuing operations by \$0.43 and total net loss per share available to common stockholders by \$0.43.

This Amendment No. 1 amends and restates the following items of our Form 10-KSB as described above: (i) Part I, Item 3 - Legal Proceedings; (ii) Part II, Item 6 - Management's Discussion and Analysis of Results of Operations and Financial Condition; (iii) Part II, Item 7 - Financial Statements; and (iv) Part III, Item 13 - Exhibits.

All information in the Form 10-KSB, as amended by this Amendment No. 1, speaks as to the date of the original filing of the Form 10-KSB for such period and does not reflect any subsequent information or events except as noted in this Amendment No. 1. All information contained in this Amendment No. 1 is subject to updating and supplementing as provided in our reports, as amended, filed with the Securities and Exchange Commission subsequent to the date of the filing of the Form 10-KSB.

### PART I

#### FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-KSB/A contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). We use words such as "believes", "intends", "expects", "anticipates", "plans", "may", "will" and similar expressions to identify forward-looking statements. Discussions containing forward-looking statements may be found in the material set forth under "Business," "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in other sections of the report. All forward-looking statements, including, but not limited to, projections or estimates concerning our business, including demand for our products and services, mix of revenue streams, ability to control and/or reduce operating expenses, anticipated operating results, cost savings, product development efforts, general outlook of our business and industry, competitive position, and adequate liquidity to fund our operations and meet our other cash requirements, are inherently uncertain as they are based on our expectations and assumptions concerning future events. These forward-looking statements are subject to numerous known and unknown risks and uncertainties. You should not place undue reliance on these forward-looking statements. Our actual results could differ materially from those anticipated in the forward-looking statements for many reasons, including our ability to attract customers for our products, our ability to effectively integrate our acquired businesses, and all other risks described below in the section entitled "Risk Factors" appearing in "Management's Discussion and Analysis of Financial Condition and Risk of Operations" and elsewhere in this report. All forward-looking statements in this document are made as of the date hereof, based on information available to us as of the date hereof, and we assume no obligation to update any forward-looking statement.

#### ITEM 3. LEGAL PROCEEDINGS

Effective January 1, 2006, the Company and Mr. Patrick Allin, former Company Chief Executive Officer, and the Allin Dynastic Trust entered into Stock Subscription Agreement and Mutual Release agreements (the "Series A-1

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Agreements") to settle all claims, including claims related to the settlement agreement entered into in 2005 which settled certain employment and indemnification related claims brought against the Company in 2004, under the creditor and claimant liabilities restructuring (Note 18). The settlement resulted in the release of all claims and the reversal of \$2,600,000 of obligations to purchase common stock from Mr. Allin and the Allin Dynastic Trust. These

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liabilities were reclassified to stockholders' equity since Mr. Allin and the Allin Dynastic Trust retained the shares that were subject to the Company's repurchase obligation. In addition, the Company issued an aggregate of 2,500,000 Shares of Series A-1 Preferred stock with a fair value of \$1,500,000 to Mr. Allin and the Allin Dynastic Trust in settlement of \$1,317,089 of liabilities that were payable in cash. Accordingly, the Company recorded a \$182,911 loss on this settlement based on the difference between the fair value of the Series A-1 Preferred shares and the liabilities payable in cash.

Sherleigh Associates Inc. Profit Sharing Plan ("Sherleigh") filed a complaint against the Company, Patrick Allin, former Chief Executive Officer of the Company, and Robert E. Yaw, the Company's non-executive Chairman, on February 3, 2004, in the United States District Court for the Southern District of New York (the "Court") alleging common law fraud. On April 24, 2006, the Company and Sherleigh Associates Inc. Profit Sharing Plan entered into a final and binding settlement of all claims as part of the creditor and claimant liabilities restructuring (Note 18).

On January 5, 2006, Mark P. Gertz, Trustee in bankruptcy for Arter & Hadden, LLP, filed an Adversary Complaint for Recovery of Assets of the Estate in the United States Bankruptcy Court Northern District of Ohio Eastern Division, against the Company as successor in merger to Entelagent. On September 11, 2006, the Company entered into a settlement and release agreement with Mark P. Gertz, Trustee in bankruptcy for Arter & Hadden, LLP which calls for the payment of \$32,500 in 13 installments of \$2,500.

On May 4, 2006, we became aware that Lok Technologies, Inc. had filed a complaint on or about March 30, 2006 against us, Entelagent Software Corp. and unnamed defendants in the Superior Court of California, County of Santa Clara alleging breach of contract, breach of duty of good faith and fair dealing and unjust enrichment related to a license agreement and certain promissory notes, and seeking damages, interest, disgorgement of any unjust enrichment, attorneys' fees and cost in an amount to be provided. Prior to receipt of this notice of litigation, we had recorded a note payable of approximately \$320,000 plus accrued interest of \$159,432. We believe that we have defenses to these claims. We cannot provide any assurance that the ultimate settlement of this claim will not have a material adverse affect on our financial condition.

The Company was previously subject to an investigation by the SEC. On February 1, 2007, the Securities and Exchange Commission issued a letter to the Company indicating that the SEC's investigation of the Company has been terminated and that no enforcement action has been recommended to the Commission.

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PART II

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### ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

THE FOLLOWING DISCUSSION OF OUR FINANCIAL CONDITION AND RESULTS OF OPERATIONS SHOULD BE READ IN CONJUNCTION WITH THE CONSOLIDATED FINANCIAL STATEMENTS AND RELATED NOTES INCLUDED ELSEWHERE IN THIS ANNUAL REPORT ON FORM 10-KSB. THE FOLLOWING DISCUSSION CONTAINS FORWARD-LOOKING STATEMENTS THAT INVOLVE RISKS AND UNCERTAINTIES. OUR ACTUAL RESULTS COULD DIFFER SUBSTANTIALLY FROM THOSE ANTICIPATED IN THESE FORWARD-LOOKING STATEMENTS AS A RESULT OF SEVERAL FACTORS, INCLUDING THE RISK FACTORS DISCUSSED BELOW.

#### OVERVIEW

From our inception through December 31, 2004, we were principally engaged in developing our business plan, raising capital, identifying merger and acquisition candidates and negotiating merger and acquisition transactions that we closed during the first quarter of 2005. On February 25, 2005, we consummated the acquisitions of Complete Security Solutions, Inc. ("CSSI") and LucidLine, Inc. ("LucidLine") pursuant to the filings of Agreements and Plans of Merger with the Secretaries of State of the States of Delaware and Illinois, respectively. On February 28, 2005, we consummated a private placement with accredited investors in the amount of \$3.5 million. On March 30, 2005, we consummated the acquisition of Entelagent Software Corp. ("Entelagent") pursuant to the filing of an Agreement and Plan of Merger with the Secretary of State of the State of California. From March 31, 2005 to December 31, 2005, we borrowed \$4,934,000 from a shareholder, Apex Investment Fund V, LP. During the year ended December 31, 2005 we raised approximately \$6,343,000 in additional gross funds. Net proceeds from all of these transaction amounted to approximately \$10,649,000, which were used principally to fund operations and repay certain liabilities. During the three months ended December 31, 2005, we raised approximately \$1,634,000 in additional gross funds in seven capital financing transactions.

Patron Systems, Inc. provides application software and services focused on business process management (BPM) in the public sector. Our current application software offering, FormStream, is an open standards information sharing tool that addresses the need for law enforcement and public safety agencies to share information between local, state and federal law enforcement and homeland security agencies. FormStream is a mobile electronic forms (e-forms) application which provides a highly scalable, open standard, network independent method for the distribution and synchronization of e-forms to mobile devices. The implementation of FormStream allows its user agencies to update and modernize their business processes to utilize the sophisticated form and user based business rules and process routing capabilities of FormStream to increase officer and supervisor productivity, increase officer availability in the field, reduce back-office workloads involved with entry of data and review of data entered, provide real-time information sharing of field generated reports and other field generated information to officers and users within the agency(s) served by a particular FormStream installation and provide the ability for an agency to meet the federally mandated requirements to provided police reports and other information to the state and federal governments in standard formats for information sharing purposes. FormStream addresses mobile e-form creation, capture and sharing over wireless networks and manages data in industry standard formats (forms: .pdf, XDP and XML; law enforcement: Global Justice XML data model (GJXDM) and National Information Exchange Model (NIEM)).

By improving the information flow and the business processes within law enforcement and public safety agencies, FormStream allows these agencies to much more cost effectively serve their constituents and provide improved local law enforcement as well as enhanced local, regional and national homeland security.

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### CRITICAL ACCOUNTING POLICIES

The preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to exercise its judgment. We exercise considerable judgment with respect to establishing sound accounting policies and in making estimates and assumptions that affect the reported amounts of our assets and liabilities, our recognition of revenues and expenses, and disclosures of commitments and contingencies at the date of the financial statements.

On an ongoing basis, we evaluate our estimates and judgments. Areas in which we exercise significant judgment include, but are not necessarily limited to, our valuation of accounts receivable, recoverability of long-lived assets, income taxes, equity transactions (compensatory and financing) and contingencies. We have also adopted certain policies with respect to our recognition of revenue that we believe are consistent with the guidance provided under

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Securities and Exchange Commission Staff Accounting Bulletin No. 104 and estimate values of delivered and undelivered elements.

We base our estimates and judgments on a variety of factors including our historical experience, knowledge of our business and industry, current and expected economic conditions, the composition of our products, regulatory environment, and in certain cases, the results of outside appraisals. We constantly re-evaluate our estimates and assumptions with respect to these judgments and modify our approach when circumstances indicate that modifications are necessary.

While we believe that the factors we evaluate provide us with a meaningful basis for establishing and applying sound accounting policies, we cannot guarantee that the results will always be accurate. Since the determination of these estimates requires the exercise of judgment, actual results could differ from such estimates.

A description of significant accounting policies that require us to make estimates and assumptions in the preparation of our consolidated financial statements are as follows:

#### ACCOUNTS RECEIVABLE AND REVENUE RECOGNITION

We derive our revenues from the following sources: (1) sales of computer software, which includes new software licenses and software updates and product support revenues and (2) professional consulting services.

We apply the revenue recognition principles set forth under AICPA Statement of Position ("SOP") 97-2 "Software Revenue Recognition" and Securities and Exchange Commission Staff Accounting Bulletin ("SAB") 104 "Revenue Recognition" with respect to its revenue. Accordingly, we record revenue when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the vendor's fee is fixed or determinable, and (iv) collectability is reasonably assured.

We also accrue unbilled revenue under software licenses and services delivered under contractual arrangements which provide for billings to be made at intervals that may differ from the periods of delivery or performance.

We generate revenues through sales of software licenses and annual support

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subscription agreements, which include access to technical support and software updates (if and when available). Software license revenues are generated from licensing the rights to use products directly to end-users and through third party service providers.

Revenues from software license agreements are generally recognized upon delivery of software to the customer. All of our software sales are supported by a written contract or other evidence of sale transaction such as a customer purchase order. These forms of evidence clearly indicate the selling price to the customer, shipping terms, payment terms (generally 30 days) and refund policy, if any. The selling prices of these products are fixed at the time the sale is consummated.

Revenue from post-contract customer support arrangements or undelivered elements are deferred and recognized at the time of delivery or over the period in which the services are performed based on vendor specific objective evidence of fair value for such undelivered elements. Vendor specific objective evidence is typically based on the price charged when an element is sold separately or, if an element is not sold separately, on the price established by an authorized level of management, if it is probable that the price, once established, will not change before market introduction. We use the residual method prescribed in SOP 98-9, "Modification of SOP 97-2, Software Revenue Recognition With Respect to Certain Transaction" to allocate revenues to delivered elements once it has established vendor-specific objective evidence of fair value for such undelivered elements.

Professional consulting services are billed based on the number of hours of consultant services provided and the hourly billing rates. We recognize revenue under these arrangements as the service is performed.

We adjust our accounts receivable balances that we deem to be uncollectible. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable. We review our allowance for doubtful accounts on a monthly basis to determine the allowance based on an analysis of its past due accounts. All past due balances that are over 90 days are reviewed individually for collectability. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. An allowance for doubtful accounts is not provided because in our opinion, all accounts recorded are deemed to be collectible.

### INCOME TAXES

We are required to determine the aggregate amount of income tax expense or loss based upon tax statutes in jurisdictions in which we conduct business. In making these estimates, we adjust our results determined in accordance with generally accepted accounting principles for items that are treated differently by the applicable taxing authorities. Deferred tax assets and liabilities, as a result of these differences, are reflected on our balance sheet for temporary differences loss and credit carry forwards that will reverse in subsequent years. We also establish a valuation allowance against deferred tax assets when it is more likely than not that some or all of the deferred tax assets will not be realized. Valuation allowances are based, in part, on predictions that management must make as to our results in future periods. The outcome of events could differ over time which would require us to make changes in our valuation allowance.

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### GOODWILL AND INTANGIBLE ASSETS

We account for Goodwill and Intangible Assets in accordance with Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets." Under SFAS No. 142, goodwill and intangibles that are deemed to have indefinite lives are no longer amortized but, instead, are to be reviewed at least annually for impairment. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value. Significant judgments required to estimate the fair value of reporting units include estimating future cash flows, determining appropriate discount rates and other assumptions. Changes in these estimates and assumptions could materially affect the determination of fair value and/or goodwill impairment for each reporting unit. During the year ended December 31, 2005 we recorded \$22,440,212 of goodwill in connection with the acquisitions of LucidLine, CSSI and Entelagent. In accordance with SFAS 142, we conducted our annual impairment review of goodwill for the year ended December 31, 2006, which resulted in a goodwill impairment charge of \$210,716.

This 2006 charge, which principally represents goodwill remaining from the PolicyBridge business we acquired from Entelagent is classified in discontinued operations as a result of our decision to exit that business. The remaining amount of goodwill, which amounts to \$9,300,000 at December 31, 2006, relates to our acquisition of CSSI in February 2005 from which we acquired the FormStream software technology, our sole line of business. We engaged an outside specialist to assist us with performing our annual goodwill impairment tests. These tests were made using a discounted cash flow model to value the business. This approach requires us to forecast our expectation of revenues and cash flows in future periods and to work with an independent specialist on developing assumptions relating to the risk that such cash flows may or may not materialize in future periods.

### SHARE BASED PAYMENTS AND OTHER EQUITY TRANSACTIONS

Prior to January 1, 2006, we accounted for employee stock based compensation in accordance with Accounting Principles Board ("APB") Opinion No. 25 "Accounting for Stock Issued to Employees." We applied the pro forma disclosure requirements of SFAS No. 123 "Accounting for Stock-Based Compensation."

Effective January 1, 2006, we adopted SFAS No. 123R "Share Based Payment." This statement is a revision of SFAS Statement No. 123, and supersedes APB Opinion No. 25, and its related implementation guidance. SFAS 123R addresses all forms of share based payment ("SBP") awards including shares issued under employee stock purchase plans, stock options, restricted stock and stock appreciation rights. Under SFAS 123R, SBP awards result in a cost that is measured at fair value on the awards' grant date, based on the estimated number of awards that are expected to vest. We adopted the modified prospective method with respect to accounting for our transition to SFAS 123(R) and measured unrecognized compensation cost. Under this method of accounting, we are required to estimate the fair value of share based payments that we make to our employees by developing assumptions regarding expected holding terms of stock options, volatility rates and expectation of forfeitures and future vesting that can significantly impact the amount of compensation cost that we recognize in each reporting period.

We are also required to apply complex accounting principles with respect to accounting for financing transactions that we have consummated in order to sustain our business. These transactions, which generally consist of convertible debt and equity instruments, require us to use significant judgment in order to assess the fair values of these instruments at their dates of issuance, which is critical to making a reasonable presentation of our financing costs and how we



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finance our business.

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Formulating estimates in any of the above areas requires us to exercise significant judgment. It is at least reasonably possible that the estimates of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements that we considered in formulating our estimates could change in the near term due to one or more future confirming events. Accordingly, the actual results regarding estimates of any of the above items as they are presented in the financial statements could differ materially from our estimates.

### RESULTS OF OPERATIONS FOR THE YEAR ENDED DECEMBER 31, 2006 COMPARED TO THE YEAR ENDED DECEMBER 31, 2005

For the year ended December 31, 2006, our consolidated revenues from continuing operations amounted to \$1,188,045 compared to \$178,821 for the year ended December 31, 2005. The increase is the result of growth of our FormStream product, since the combination was consummated with CSSI in February 2005.

Cost of Sales for the year ended December 31, 2006 amounted to \$147,951 compared to \$219,173 for the year ended December 31, 2005. Cost of sales during the year ended December 31, 2006 and December 31, 2005 includes \$38,943 and \$111,670, respectively, associated with the amortization of developed technology that we acquired from CSSI.

Operating expenses amounted to \$4,251,799 for the year ended December 31, 2006 as compared to \$23,405,761 for the year ended December 31, 2005, a reduction of \$19,153,962. The reduction in operating expenses includes an increase of approximately \$253,000 for salaries associated with increased staffing in the development, support and sales organizations, approximately \$361,000 of employee stock option compensation expense, approximately \$252,000 for increased legal and professional fees associated with the negotiation and settlement of various legal matters under the creditor and claimant liabilities restructuring program, and approximately \$442,000 for increased general and administrative expenses. These increases were partially offset by an approximately \$12,930,000 reduction associated with goodwill impairment in 2005, a reduction of approximately \$1,421,000 associated with consulting fees, a reduction of approximately \$558,000 associated with an acquired technology impairment charge in 2005, a reduction in losses associated with legal settlements of approximately \$4,337,000, a reduction of \$859,000 associated with registration penalties, an expense reduction of approximately \$358,000 associated with penalties under a collateralized financing arrangement.

Our loss from operations for the year ended December 31, 2006 amounted to \$3,211,705 compared to a loss of \$23,446,113 for the same period in 2005. Our loss was reduced as a result of the reductions in operating expenses and the increase in revenues discussed above.

Interest expense during the year ended December 31, 2006 amounted to \$1,169,105 as compared to \$17,453,447 for the year ended December 31, 2005. The reduction is due to the issuance of Series A Preferred stock and its associated amortization of deferred financing costs and the accretion of debt discounts and the intrinsic value of the conversion option for bridge note holders being lower in total during the year ended December 31, 2006 than the amortization of deferred financing costs and the accretion of debt discounts incurred during the year ended December 31, 2005. Offsetting this reduction was the increase in interest expense due to the increased level of total debt financing during the

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year ended December 31, 2006 when compared to the same period in 2005. Non-cash interest relating to the amortization of deferred financing costs and the accretion of debt discounts during the year ended December 31, 2006 amounted to approximately \$303,039 compared to \$4,096,297 in same period in 2005. The intrinsic value of the conversion option for bridge note holders, which has been classified as interest expense amounted to \$192,000 for the year ended December 31, 2006 compared to \$12,393,000 in the same period in 2005. Interest income, was \$10,553 and \$19,250 in the year ended December 31, 2006 and 2005, respectively. Interest income represents the interest earned from loans that we made to Entelagent prior to our acquisition of that business on March 30, 2005 and interest on cash balances in the year ended December 31, 2006.

For the year ended December 31, 2006, the net loss from continuing operations was \$4,372,329 or \$(1.41) per share on 7,366,088 weighted average common shares outstanding compared to a net loss from continuing operations of \$40,589,196 or \$(20.80) per share on 1,951,389 weighted average common shares outstanding for the year ended December 31, 2005.

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Our loss from discontinued operations was reduced to \$2,036,660 during the year ended December 31, 2006 from \$3,856,955 during the year ended December 31, 2005. This reduction is principally due to the sale of the LucidLine business in April 2006 and the resulting reduction in the losses incurred in that business. The loss from discontinued operations in the year ended December 31, 2006 also includes a charge of \$781,740 associated with the write-off of the intangible assets associated with the PolicyBridge business and a goodwill impairment charge in the amount of \$210,716 associated with the impairment of the remaining goodwill associated with the Entelagent acquisition. Additionally, we recorded in 2006 a loss on disposal of the discontinued LucidLine business of \$75,920.

For the year ended December 31, 2006, the net loss available to common stockholders was \$12,514,315 or \$(1.70) per share on 7,366,088 weighted average common shares outstanding compared to a net loss available to common stockholders of \$44,446,151 or \$(22.78) per share on 1,951,389 weighted average common shares outstanding for the year ended December 31, 2005.

### LIQUIDITY AND CAPITAL RESOURCES

We incurred a net loss from continuing operations of \$4,372,329 for the year ended December 31, 2006, which includes \$1,139,496 of non-cash charges including depreciation and amortization of \$168,068, aggregate stock based compensation of \$523,915, non-cash interest expense of \$543,438, loss on sale of property and equipment \$2,072 and a loss on the disposition of discontinued operations of \$75,920. The non-cash charges were offset by non-cash gains of \$2,452,909 associated with the settlements of outstanding liabilities, claims and litigation under the creditor and claimant liabilities restructuring program that occurred in the year ended December 31, 2006. We used \$511,691 of our restricted cash escrowed to settle liabilities assumed in a business combination. Including the amounts above, we used net cash flows in our operating activities of \$5,301,169 during the year ended December 31, 2006. Our working capital deficiency at December 31, 2006 amounted to \$2,795,521 and we are continuing to experience shortages of working capital. We cannot provide any assurance that the outcome of these matters will not have a material adverse affect on our ability to sustain the business. These matters raise substantial doubt about our ability to continue as a going concern. The financial statements do not include any adjustments that might be necessary should we be unable to continue as a going concern.

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We expect to continue incurring losses for the foreseeable future due to the inherent uncertainty that is related to establishing the commercial feasibility of technological products and developing a presence in new markets. We raised \$8,773,217 of gross proceeds (\$7,832,348 net proceeds after the payment of certain transaction expenses) in financing transactions during the year ended December 31, 2006. We used \$5,301,169 of these proceeds to fund our operations and a net of \$425,589 in investing activities.

We will need to raise additional capital and have taken certain steps to conserve our liquidity while we continue to develop our business. Although we believe that we have access to capital resources, we have not secured any commitments for additional financing at this time nor can we provide any assurance that we will be successful in our efforts to raise additional capital and/or successfully execute our business plan.

### OFF-BALANCE SHEET ARRANGEMENTS

At December 31, 2006, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, variable interest or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

### RISK FACTORS

The risks noted below and elsewhere in this report and in other documents we file with the SEC are risks and uncertainties that could cause our actual results to differ materially from the results contemplated by the forward-looking statements contained in this report and other public statements we make.

### RISKS RELATED TO OUR COMMON STOCK

THERE IS SUBSTANTIAL DOUBT ABOUT OUR ABILITY TO CONTINUE AS A GOING CONCERN.

We currently have a number of obligations that we are unable to meet without generating additional revenues or raising additional capital. If we cannot generate additional revenues or raise additional capital in the near future, we may become insolvent. As of December 31, 2006, our cash balance was \$541,570 and we had a working capital deficit of \$2,795,521. This raises substantial doubt about our ability to continue as a going concern. Historically, we have funded our capital requirements with debt and equity financing. Our ability to obtain additional equity or debt

financing depends on a number of factors including our financial performance and the overall conditions in our industry. If we are not able to raise additional financing or if such financing is not available on acceptable terms, we may liquidate assets, seek or be forced into bankruptcy, and/or continue operations but suffer material harm to our operations and financial condition. These measures could have a material adverse affect on our ability to continue as a going concern.

We have restructured approximately 93% of our previously outstanding claims, liabilities, demands, causes of action, costs, expenses, attorneys' fees, damages, indemnities, and obligations of every kind and nature that certain

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creditors and claimants had with us pursuant to our Creditor and Claimant Liabilities Restructuring described elsewhere in this annual report. We are currently unable to provide assurance that the acceptance of the Creditor and Claimant Liabilities Restructuring will actually improve our ability to fund the further development of our business plan or improve our operations. Our failure to fund the further development of our business plan and operations would materially adversely affect our ability to continue as a going concern.

INVESTORS MAY NOT BE ABLE TO ADEQUATELY EVALUATE OUR BUSINESS AND PROSPECTS DUE TO OUR LIMITED OPERATING HISTORY, LACK OF REVENUES AND LACK OF PRODUCT OFFERINGS.

We are at an early stage of executing our business plan and have no history of offering information security capabilities. We were incorporated in Delaware in 2002. Significant business operations only began with the acquisitions completed in February and March 2005. As a result of our limited history, it may be difficult to plan operating expenses or forecast our revenues accurately. Our assumptions about customer or network requirements may be wrong. The revenue and income potential of these products is unproven, and the markets addressed by these products are volatile. If such products are not successful, our actual operating results could be below our expectations and the expectations of investors and market analysts, which would likely cause the price of our common stock to decline.

We have generated limited revenues and have relied on financing generated from our capital raising activities to fund the implementation of our business plan. We have incurred operating and net losses and negative cash flows from operations since our inception. As of December 31, 2006, we had an accumulated deficit of approximately \$96.5 million. We may continue to incur operating and net losses, due in part to implementing our acquisitions strategy, engaging in financing activities and expansion of our personnel and our business development capabilities. We will continue to seek financing for the acquisition of other acquisition targets that we may identify in the future. We continue to believe that we will secure financing in the near future, but there can be no assurance of our success. If we are unable to obtain the necessary funding, it will materially adversely affect our ability to execute our business plan and to continue our operations.

In addition, we may not be able to achieve or maintain profitability, and, even if we do achieve profitability, the level of any profitability cannot be predicted and may vary significantly from quarter to quarter.

THE AUTOMATIC CONVERSION OF OUR SERIES A-1 PREFERRED STOCK HAS RESULTED IN SIGNIFICANT DILUTION TO OUR EXISTING STOCKHOLDERS AND A CHANGE IN CONTROL OF OUR COMPANY, AND COULD ALSO RESULT IN ADDITIONAL VOLATILITY IN THE PRICE OF OUR COMMON STOCK.

The automatic conversion of our Series A-1 Preferred Stock on July 31, 2006 resulted in significant dilution to our existing stockholders and resulted in our former creditors and claimants owning approximately 85.0% of our outstanding shares of common stock. These creditors and claimants, to the extent they act in concert, would be able to determine all actions brought before our stockholders. As a result of the automatic conversion of our Series A-1 Preferred Stock, each of Per Gustafsson, Arco van Nieuwland and Sherleigh Associates, Inc. Profit Sharing Plan became greater than five percent beneficial owners of our common stock.

Upon the registration of the shares of common stock issued upon the conversion of our Series A-1 Preferred Stock, there will be a substantial amount of shares eligible for sale in the public market. If former holders of our Series A-1 Preferred Stock decide to sell their shares of registered stock, such sales could result in significant volatility in the market price of our common stock

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and would likely cause the market price of our common stock to decline.

THERE CAN BE NO GUARANTY THAT A MARKET WILL DEVELOP FOR THE PRODUCTS WE INTEND TO OFFER.

We currently have a limited offering of products. We intend to acquire products through the acquisition of existing businesses. There is no guarantee, however, that a market will develop for Internet security solutions of the type we

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intend to offer. We cannot predict the size of the market for Internet security solutions, the rate at which the market will grow, or whether our target customers will accept our acquired products.

OUR OPERATING RESULTS MAY FLUCTUATE SIGNIFICANTLY, WHICH MAY RESULT IN VOLATILITY OR HAVE AN ADVERSE EFFECT ON THE MARKET PRICE OF OUR COMMON STOCK.

The market prices of the securities of technology-related companies have historically been volatile and may continue to be volatile. Thus, the market price of our common stock is likely to be subject to wide fluctuations. If our revenues do not grow or grow more slowly than we anticipate, if operating or capital expenditures exceed our expectations and cannot be reduced appropriately, or if some other event adversely affects us, the market price of our common stock could decline. Only a small public market currently exists for our common stock and the number of shares eligible for sale in the public market is currently very limited, but is expected to increase. Sales of substantial shares in the future would depress the price of our common stock. In addition, we currently do not receive any stock market research coverage by any recognized stock market research or trading firm and our shares are not traded on any national securities exchange. A larger and more active market for our common stock may not develop.

Because of our limited operations history and lack of assets and revenues to date, our common stock is believed to be currently trading on speculation that we will be successful in implementing our acquisition and growth strategies. There can be no assurance that such success will be achieved. The failure to implement our acquisitions and growth strategies would likely adversely affect the market price of our common stock. In addition, if the market for technology-related stocks or the stock market in general experiences a continued or greater loss in investor confidence or otherwise fails, the market price of our common stock could decline for reasons unrelated to our business, results of operations and financial condition. The market price of our common stock also might decline in reaction to events that affect other companies in our industry even if these events do not directly affect us. General political or economic conditions, such as an outbreak of war, a recession or interest rate or currency rate fluctuations, could also cause the market price of our common stock to decline. Our common stock has experienced, and is likely to continue to experience, these fluctuations in price, regardless of our performance.

FUTURE SALES OF SHARES BY EXISTING STOCKHOLDERS COULD CAUSE OUR STOCK PRICE TO DECLINE.

If our existing or future stockholders sell, or are perceived to sell, substantial amounts of our common stock in the public market, the market price of our common stock could decline. As of March 28, 2007, there were 14,512,260 shares of common stock outstanding, of which 1,244,012 shares were beneficially held by directors, executive officers and other affiliates, the sale of which are subject to volume limitations under Rule 144, various vesting agreements and

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our quarterly and other "blackout" periods. Furthermore, shares subject to outstanding options and warrants and shares reserved for future issuance under our stock option plan will become eligible for sale in the public market to the extent permitted by the provisions of various vesting agreements, the lock-up arrangements and Rule 144 under the Securities Act.

THE UNPREDICTABILITY OF AN ACQUIRED COMPANY'S QUARTERLY RESULTS MAY CAUSE THE TRADING PRICE OF OUR COMMON STOCK TO DECLINE.

The quarterly revenues and operating results of companies we may acquire will likely continue to vary in the future due to a number of factors, many of which are outside of our control. Any of these factors could cause the price of our common stock to decline. The primary factors that may affect future revenues and future operating results include the following:

- o the demand for our subsidiaries' current product offerings and our future products;
- o the length of sales cycles;
- o the timing of recognizing revenues;
- o new product introductions by us or our competitors;
- o changes in our pricing policies or the pricing policies of our competitors;
- o variations in sales channels, product costs or mix of products sold;
- o our ability to develop, introduce and ship in a timely manner new products and product enhancements that meet customer requirements;
- o our ability to obtain sufficient supplies of sole or limited source components for our products;
- o variations in the prices of the components we purchase;

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- o our ability to attain and maintain production volumes and quality levels for our products at reasonable prices at our third-party manufacturers;
- o our ability to manage our customer base and credit risk and to collect our accounts receivable; and
- o the financial strength of our value-added resellers and distributors.

Our operating expenses are largely based on anticipated revenues and a high percentage of our expenses are, and will continue to be, fixed in the short term. As a result, lower than anticipated revenues for any reason could cause significant variations in our operating results from quarter to quarter and, because of our rapidly growing operating expenses, could result in substantial operating losses.

OUR COMMON STOCK IS SUBJECT TO THE SEC'S PENNY STOCK RULES. THEREFORE, BROKER-DEALERS MAY EXPERIENCE DIFFICULTY IN COMPLETING CUSTOMER TRANSACTIONS AND TRADING ACTIVITY IN OUR SECURITIES MAY BE ADVERSELY AFFECTED.

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If at any time a company has net tangible assets of \$5,000,000 or less and the common stock has a market price per share of less than \$5.00, transactions in the common stock may be subject to the "penny stock" rules promulgated under the Exchange Act. Under these rules, broker-dealers who recommend such securities to persons other than institutional accredited investors must:

- o make a special written suitability determination for the purchaser;
- o receive the purchaser's written agreement to a transaction prior to sale;
- o provide the purchaser with risk disclosure documents which identify certain risks associated with investing in "penny stocks" and which describe the market for these "penny stocks" as well as a purchaser's legal remedies; and
- o obtain a signed and dated acknowledgment from the purchaser demonstrating that the purchaser has actually received the required risk disclosure document before a transaction in a "penny stock" can be completed.

As our common stock is subject to these rules, broker-dealers may find it difficult to effectuate customer transactions and trading activity in our securities may be adversely affected. As a result, the market price of our securities may be depressed, and stockholders may find it more difficult to sell their shares of our common stock.

### RISKS RELATED TO OUR BUSINESS

#### WE MAY BE UNABLE TO SUCCESSFULLY INTEGRATE ACQUIRED BUSINESSES.

Our business plan is dependent upon the acquisition and integration of companies that have previously operated independently. To date we have experienced delays in implementing our business plan as a result of limited capital resources, which have had a material adverse effect on our business. Further delays in the process of integrating could cause an interruption of, or loss of momentum in, the activities of our business and the loss of key personnel. The diversion of management's attention and any delays or difficulties encountered in connection with our integration of acquired operations could have an adverse effect on our business, results of operations, financial condition or prospects.

WE CURRENTLY DO NOT HAVE SUFFICIENT REVENUES TO SUPPORT OUR BUSINESS ACTIVITIES AND IF OPERATING LOSSES CONTINUE, WILL BE REQUIRED TO OBTAIN ADDITIONAL CAPITAL THROUGH FINANCINGS WHICH WE MAY NOT BE ABLE TO SECURE.

To achieve our intended growth, we will require substantial additional capital. We have encountered difficulty and delays in raising capital to date and the market environment for development stage companies, like ours, remains particularly challenging. There can be no assurance that funds will be available when needed or on acceptable terms. Technology companies in general have experienced difficulty in recent years in accessing capital. Our inability to obtain additional financing may require us to delay, scale back or eliminate certain of our growth plans which could have a material and adverse effect on our business, financial condition or results of operations or could cause us to cease operations. Even if we are able to obtain additional financing, such financing could be structured as equity financing that would dilute the ownership percentage of any investor in our securities.

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DOWNTURNS IN THE INTERNET INFRASTRUCTURE, NETWORK SECURITY AND RELATED MARKETS MAY DECREASE OUR REVENUES AND MARGINS.

The market for our current products and other products we intend to offer depends on economic conditions affecting the broader Internet infrastructure, network security and related markets. Downturns in these markets may cause enterprises and carriers to delay or cancel security projects, reduce their overall or security-specific information technology budgets or reduce or cancel orders for our current products and other products we intend to offer. In this environment, customers such as distributors, value-added resellers and carriers may experience financial difficulty, cease operations and fail to budget or reduce budgets for the purchase of our current products or other products we intend to offer. This, in turn, may lead to longer sales cycles, delays in purchase decisions, payment and collection, and may also result in price pressures, causing us to realize lower revenues, gross margins and operating margins. In addition, general economic uncertainty caused by potential hostilities involving the United States, terrorist activities, the decline in specific markets such as the service provider market in the United States, and the general decline in capital spending in the information technology sector make it difficult to predict changes in the purchase and network requirements of our potential customers and the markets we intend to serve. We believe that, in light of these events, some businesses may curtail or eliminate capital spending on information technology. A decline in capital spending in the markets we intend to serve may adversely affect our future revenues, gross margins and operating margins and make it necessary for us to gain significant market share from our future competitors in order to achieve our financial goals and achieve profitability.

COMPETITION MAY DECREASE OUR PROJECTED REVENUES, MARKET SHARE AND MARGINS.

The market for network security products is highly competitive, and we expect competition to intensify in the future. Competitors may gain market share and introduce new competitive products for the same markets and customers we intend to serve with our products. These products may have better performance, lower prices and broader acceptance than the products we currently offer or intend to offer.

Many of our potential competitors have longer operating histories, greater name recognition, large customer bases and significantly greater financial, technical, sales, marketing and other resources than we have. In addition, some of our potential competitors currently combine their products with other companies' networking and security products. These potential competitors also often combine their sales and marketing efforts. Such activities may result in reduced prices, lower gross and operating margins and longer sales cycles for the products we currently offer and intend to offer. If any of our larger potential competitors were to commit greater technical, sales, marketing and other resources to the markets we intend to serve, or reduce prices for their products over a sustained period of time, our ability to successfully sell the products we intend to offer, increase revenue or meet our or market analysts expectations could be adversely affected.

FAILURE TO ADDRESS EVOLVING STANDARDS IN THE NETWORK SECURITY INDUSTRY AND SUCCESSFULLY DEVELOP AND INTRODUCE NEW PRODUCTS OR PRODUCT ENHANCEMENTS WOULD CAUSE OUR REVENUES TO DECLINE.

The market for network security products is characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. We expect to introduce our products and enhancements to existing products to address current and evolving customer requirements and broader networking trends and vulnerabilities. We also expect to develop products with strategic partners and incorporate third-party advanced



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security capabilities into our intended product offerings. Some of these products and enhancements may require us to develop new hardware architectures that involve complex and time consuming processes. In developing and introducing our intended product offerings, we have made, and will continue to make, assumptions with respect to which features, security standards and performance criteria will be required by our potential customers. If we implement features, security standards and performance criteria that are different from those required by our potential customers, market acceptance of our intended product offerings may be significantly reduced or delayed, which would harm our ability to penetrate existing or new markets.

Furthermore, we may not be able to develop new products or product enhancements in a timely manner, or at all. Any failure to develop or introduce these new products and product enhancements might cause our existing products to be less competitive, may adversely affect our ability to sell solutions to address large customer deployments and, as a consequence, our revenues may be adversely affected. In addition, the introduction of products embodying new technologies could render existing products we intend to offer obsolete, which would have a direct, adverse effect on our market share and revenues. Any failure of our future products or product enhancements to achieve market

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acceptance could cause our revenues to decline and our operating results to be below our expectations and the expectations of investors and market analysts, which would likely cause the price of our common stock to decline.

WE HAVE EXPERIENCED ISSUES WITH OUR FINANCIAL SYSTEMS, CONTROLS AND OPERATIONS THAT COULD HARM OUR FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Our ability to sell our intended product offerings and implement our business plan successfully in a volatile and growing market requires effective management and financial systems and a system of financial processes and controls. Through the quarter ended December 31, 2006, our Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of our disclosure controls and procedures in accordance with Exchange Act Rules 13a-15 or 15d-15 and identified material weaknesses in our internal controls. These material weaknesses related to the fact that that our overall financial reporting structure and current staffing levels were not sufficient to support the complexity of our financial reporting requirements. We currently lack the expertise we need to apply complex accounting principles relating to our business combinations and equity transactions and have experienced difficulty in applying income tax accounting principles. Although we have taken steps to correct these previous deficiencies, including the hiring of a Chief Financial Officer, and are currently in compliance with the SEC's reporting requirements, additional time is still required to test and document our internal and disclosure control processes to ensure their operating effectiveness. In addition, we have limited capital resources and are still at risk for the loss of key personnel in our finance department. The loss of key personnel in our finance department, or any other conditions that could disrupt our operations in this area, could have a material adverse affect on our ability to communicate critical information to management and our investors, raise capital and/or maintain compliance with our SEC reporting obligations. These circumstances, if they arise, could have a material adverse affect on our business.

We have limited management resources to date and are still establishing our management and financial systems. Growth, to the extent it occurs, is likely to place a considerable strain on our management resources, systems, processes and controls. To address these issues, we will need to continue to improve our

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financial and managerial controls, reporting systems and procedures, and will need to continue to expand, train and manage our work force worldwide. If we are unable to maintain an adequate level of financial processes and controls, we may not be able to accurately report our financial performance on a timely basis and our business and stock price would be harmed.

WE MAY NOT BE ABLE TO IMPLEMENT SECTION 404 OF THE SARBANES-OXLEY ACT ON A TIMELY BASIS.

The SEC, as directed by Section 404 of the Sarbanes-Oxley Act of 2002, adopted rules generally requiring each public company to include a report of management on the company's internal controls over financial reporting in its annual report on Form 10-KSB that contains an assessment by management of the effectiveness of the company's internal controls over financial reporting beginning in the year ended December 31, 2007. In addition, the company's independent registered accounting firm must attest to and report on management's assessment of the effectiveness of the company's internal controls over financial reporting. This requirement will first apply to our annual report on Form 10-KSB for the fiscal year ending December 31, 2008. We have not yet developed a Section 404 implementation plan. We have in the past discovered, and may in the future discover, areas of our internal controls that need improvement. How companies should be implementing these new requirements including internal control reforms to comply with Section 404's requirements and how independent auditors will apply these requirements and test companies' internal controls, is still reasonably uncertain. We expect that we may need to hire and/or engage additional personnel and incur incremental costs in order to complete the work required by Section 404. We can not guarantee that we will be able to complete a Section 404 plan on a timely basis. Additionally, upon completion of a Section 404 plan, we may not be able to conclude that our internal controls are effective, or in the event that we conclude that our internal controls are effective, our independent accountants may disagree with our assessment and may issue a report that is qualified. Any failure to implement required new or improved controls, or difficulties encountered in their implementation, could negatively affect our operating results or cause us to fail to meet our reporting obligations.

IF OUR FUTURE PRODUCTS DO NOT INTEROPERATE WITH OUR END CUSTOMERS' NETWORKS, INSTALLATIONS WOULD BE DELAYED OR CANCELLED, WHICH COULD SIGNIFICANTLY REDUCE OUR ANTICIPATED REVENUES.

Future products will be designed to interface with our end customers' existing networks, each of which have different specifications and utilize multiple protocol standards. Many end customers' networks contain multiple generations of products that have been added over time as these networks have grown and evolved. Our future products must interoperate with all of the products within these networks as well as with future products that might

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be added to these networks in order to meet end customers' requirements. If we find errors in the existing software used in our end customers' networks, we may elect to modify our software to fix or overcome these errors so that our products will interoperate and scale with their existing software and hardware. If our future products do not interoperate with those within our end customers' networks, installations could be delayed or orders for our products could be cancelled, which could significantly reduce our anticipated revenues.

AS A PUBLIC COMPANY, WE MAY INCUR INCREASED COSTS AS A RESULT OF RECENTLY ENACTED AND PROPOSED CHANGES IN LAWS AND REGULATIONS RELATING TO CORPORATE

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### GOVERNANCE MATTERS AND PUBLIC DISCLOSURE.

Recently enacted and proposed changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and rules adopted or proposed by the SEC will result in increased costs for us as we evaluate the implications of these laws, regulations and standards and respond to their requirements. In addition, we will become subject to the internal control reporting requirement specified in Section 404 of the Sarbanes-Oxley Act of 2002 beginning in the year ended December 31, 2007, which will require us to expend substantial financial resources in order to become compliant with these requirements. These laws and regulations could make it more difficult or more costly for us to obtain certain types of insurance, including director and officer liability insurance, and we may be forced to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. The impact of these events could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors, board committees or as executive officers. We cannot estimate the amount or timing of additional costs we may incur as a result of these laws and regulations.

WE DEPEND ON OUR KEY PERSONNEL TO MANAGE OUR BUSINESS EFFECTIVELY IN A RAPIDLY CHANGING MARKET, AND IF WE ARE UNABLE TO HIRE ADDITIONAL PERSONNEL OR RETAIN EXISTING PERSONNEL, OUR ABILITY TO EXECUTE OUR BUSINESS STRATEGY WOULD BE IMPAIRED.

Our future success depends upon the continued services of our executive officers. The loss of the services of any of our key employees, the inability to attract or retain qualified personnel in the future, or delays in hiring required personnel, could delay the development and introduction of, and negatively impact our ability to sell, our intended product offerings.

WE MIGHT HAVE TO DEFEND LAWSUITS OR PAY DAMAGES IN CONNECTION WITH ANY ALLEGED OR ACTUAL FAILURE OF OUR PRODUCTS AND SERVICES.

Because our intended product offerings and services provide and monitor network security and may protect valuable information, we could face claims for product liability, tort or breach of warranty. Anyone who circumvents our security measures could misappropriate the confidential information or other property of end customers using our products, or interrupt their operations. If that happens, affected end customers or others may sue us. Defending a lawsuit, regardless of its merit, could be costly and could divert management attention. Our business liability insurance coverage may be inadequate or future coverage may be unavailable on acceptable terms or at all.

WE COULD BECOME SUBJECT TO LITIGATION REGARDING INTELLECTUAL PROPERTY RIGHTS THAT COULD BE COSTLY AND RESULT IN THE LOSS OF SIGNIFICANT RIGHTS.

In recent years, there has been significant litigation in the United States involving patents and other intellectual property rights. We may become a party to litigation in the future to protect our intellectual property or as a result of an alleged infringement of another party's intellectual property. Claims for alleged infringement and any resulting lawsuit, if successful, could subject us to significant liability for damages and invalidation of our proprietary rights. These lawsuits, regardless of their success, would likely be time-consuming and expensive to resolve and would divert management time and attention. Any potential intellectual property litigation could also force us to do one or more of the following:

- o stop or delay selling, incorporating or using products that use the challenged intellectual property; and/or
- o obtain from the owner of the infringed intellectual property right a

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license to sell or use the relevant technology, which license might not be available on reasonable terms or at all; or redesign the products that use that technology.

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If we are forced to take any of these actions, our business might be seriously harmed. Our insurance may not cover potential claims of this type or may not be adequate to indemnify us for all liability that could be imposed.

OUR INABILITY TO OBTAIN ANY THIRD-PARTY LICENSE REQUIRED TO DEVELOP NEW PRODUCTS AND PRODUCT ENHANCEMENTS COULD REQUIRE US TO OBTAIN SUBSTITUTE TECHNOLOGY OF LOWER QUALITY OR PERFORMANCE STANDARDS OR AT GREATER COST, WHICH COULD SERIOUSLY HARM OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

From time to time, we may be required to license technology from third parties to develop new products or product enhancements. Third-party licenses may not be available to us on commercially reasonable terms or at all. Our inability to obtain any third-party license required to develop new products or product enhancements could require us to obtain substitute technology of lower quality or performance standards or at greater cost, which could seriously harm our business, financial condition and results of operations.

GOVERNMENTAL REGULATIONS AFFECTING THE IMPORT OR EXPORT OF PRODUCTS COULD NEGATIVELY AFFECT OUR REVENUES.

Governmental regulation of imports or exports or failure to obtain required export approval of our encryption technologies could harm our international and domestic sales. The United States and various foreign governments have imposed controls, export license requirements and restrictions on the import or export of some technologies, especially encryption technology. In addition, from time to time, governmental agencies have proposed additional regulation of encryption technology, such as requiring the escrow and governmental recovery of private encryption keys.

In particular, in light of recent terrorist activity, governments could enact additional regulation or restrictions on the use, import or export of encryption technology. Additional regulation of encryption technology could delay or prevent the acceptance and use of encryption products and public networks for secure communications. This might decrease demand for our intended product offerings and services. In addition, some foreign competitors are subject to less stringent controls on exporting their encryption technologies. As a result, they may be able to compete more effectively than we can in the domestic and international network security market.

MANAGEMENT COULD INVEST OR SPEND OUR CASH OR CASH EQUIVALENTS AND INVESTMENTS IN WAYS THAT MIGHT NOT ENHANCE OUR RESULTS OF OPERATIONS OR MARKET SHARE.

We have made no specific allocations of our cash or cash equivalents and investments. Consequently, management will retain a significant amount of discretion over the application of our cash or cash equivalents and investments and could spend the proceeds in ways that do not improve our operating results or increase our market share. In addition, these proceeds may not be invested to yield a favorable rate of return.

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## ITEM 7. FINANCIAL STATEMENTS

PATRON SYSTEMS, INC.  
DECEMBER 31, 2006

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### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Audit Committee of the Board of  
Directors and Stockholders of Patron  
Systems, Inc.

We have audited the accompanying balance sheet of Patron Systems, Inc (the "Company") as of December 31, 2006, and the related consolidated statements of operations, changes in stockholders' (deficiency) equity and cash flows for each of the two years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Patron Systems, Inc, as of December 31, 2006, and the results of its operations and its cash flows for each of the two years in the period then ended in conformity with United States generally accepted accounting principles.

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The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 3 to the financial statements, the Company has incurred net losses since its inception, has a working capital deficiency and limited capital resources. These conditions raise substantial doubt about the Company's ability to continue as a going concern. The financial statements do not include any adjustments that might be necessary should the company be unable to continue as a going concern.

As discussed in Note 2, the accompanying financial statements for the year ended December 31, 2006 have been restated.

/S/ MARCUM & KLIEGMAN LLP  
 Marcus & Kliegman LLP

New York, New York  
 March 20, 2007, except  
 for Note 2 as to which the  
 date is May 18, 2007

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### PATRON SYSTEMS, INC. BALANCE SHEET

|  | DECEMBER 31,<br>2006<br>(AS RESTATED) |
|--|---------------------------------------|
| -----  |                                       |
| <b>ASSETS</b>  |                                       |
| Current Assets:  |                                       |
| Cash .....   | \$ 541,570                            |
| Accounts receivable .....  | 828,875                               |
| Other current assets .....   | 133,841                               |
| -----  |                                       |
| Total current assets .....   | 1,504,286                             |
| Property and equipment, net .....  | 174,791                               |
| Computer software development costs .....  | 414,560                               |
| Intangible assets, net .....   | 127,290                               |
| Assets held for sale .....   | 210,710                               |
| Goodwill .....   | 9,300,000                             |
| -----  |                                       |
| Total assets .....   | \$ 11,731,637                         |
| =====  |                                       |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                                       |
| Current Liabilities  |                                       |
| Accounts payable .....   | \$ 535,128                            |
| Other current liabilities .....  | 1,858,878                             |
| Demand notes payable .....   | 312,557                               |
| Bridge notes payable .....   | 519,975                               |
| Notes payable (to creditors of acquired business,<br>including \$554,202 to related parties) ..... | 799,982                               |
| Deferred revenue .....   | 164,295                               |
| Liabilities of discontinued operations .....   | 108,992                               |
| -----  |                                       |
| Total current liabilities .....  | 4,299,807                             |

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### Commitments and Contingencies

#### Stockholders' Equity

|   |  |               |
|---|--|---------------|
| Preferred stock, par value \$0.01 per share,<br>75,000,000 shares authorized,   |  |               |
| Series A convertible: 2,160 shares authorized;<br>964 shares issued and outstanding; .....                                    |  | 10            |
| liquidation preference of \$6,394,098   |  |               |
| Series A-1 convertible: 50,000,000 shares<br>authorized; no shares outstanding .....  |  | --            |
| Series B convertible: 2,000 shares authorized;<br>791 shares issued and outstanding;  |  |               |
| liquidation preference of \$5,037,705 .....   |  | 8             |
| Common stock, par value \$0.01 per share,<br>150,000,000 shares authorized,<br>14,512,260 shares issued and outstanding ..... |  | 145,127       |
| Additional paid-in capital .....  |  | 103,743,111   |
| Accumulated deficit .....   |  | (96,456,426)  |
|   |  | -----         |
| Total stockholders' equity .....  |  | 7,431,830     |
|   |  | -----         |
| Total liabilities and stockholders' equity .....  |  | \$ 11,731,637 |
|   |  | =====         |

The accompanying notes are an integral part of these financial statements

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### PATRON SYSTEMS, INC. STATEMENTS OF OPERATIONS

|   | FOR THE YEAR ENDED<br>DECEMBER 31, |            |
|---|------------------------------------|------------|
|   | 2006<br>(AS RESTATED)              | 2005       |
|   | -----                              | -----      |
| Revenue .....                                     | \$ 1,188,045                       | \$ 178,821 |
|   | -----                              | -----      |
| Cost of Sales                                     |                                    |            |
| Cost of products/services .....                   | 109,008                            | 107,503    |
| Amortization of technology .....                  | 38,943                             | 111,670    |
|   | -----                              | -----      |
| Total cost of sales .....                         | 147,951                            | 219,173    |
|   | -----                              | -----      |
| Gross Profit .....                                | 1,040,094                          | (40,352)   |
|   | -----                              | -----      |
| Operating Expenses                                |                                    |            |
| Salaries and related expenses .....               | 3,755,130                          | 3,140,219  |
| Consulting expense .....                          | 63,120                             | 1,483,933  |
| Professional fees .....                           | 1,313,754                          | 1,061,831  |
| General and administrative .....                  | 1,564,144                          | 1,122,036  |
| Registration penalties .....                      | --                                 | 859,004    |
| Loss on collateralized financing arrangement .... | 8,560                              | 366,193    |

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|  |                 |                 |
|--|-----------------|-----------------|
| Goodwill impairment charge .....                                     | --              | 12,929,696      |
| Acquired technology impairment charge .....                          | --              | 558,330         |
| Losses associated with legal and other<br>settlements, net .....     | (2,452,909)     | 1,884,519       |
|  | -----           | -----           |
| Total operating expenses .....                                       | 4,251,799       | 23,405,761      |
|  | -----           | -----           |
| Loss from operations .....   | (3,211,705)     | (23,446,113)    |
|  | -----           | -----           |
| Other Income (Expense)   |                 |                 |
| Interest income .....  | 10,553          | 19,250          |
| Change in intrinsic value of common stock<br>put right .....         | --              | 300,000         |
| Loss on sale of property and equipment .....                         | (2,072)         | (8,886)         |
| Interest expense .....   | (1,169,105)     | (17,453,447)    |
|  | -----           | -----           |
| Total Other Expense .....  | (1,160,624)     | (17,143,083)    |
|  | -----           | -----           |
| Loss from continuing operations before income taxes                  | (4,372,329)     | (40,589,196)    |
| Loss from discontinued operations .....                              | (2,036,660)     | (3,856,955)     |
| Loss on disposal of discontinued operations .....                    | (75,920)        | --              |
|  | -----           | -----           |
|  | (2,112,580)     | (3,856,955)     |
|  | -----           | -----           |
| Net loss .....   | (6,484,909)     | (44,446,151)    |
| Preferred stock deemed dividend .....                                | (5,583,490)     | --              |
| Preferred stock contractual dividend .....                           | (445,916)       | --              |
|  | -----           | -----           |
| Net loss available to common stockholders .....                      | \$ (12,514,315) | \$ (44,446,151) |
|  | =====           | =====           |
| Net Loss Per Share - Basic and Diluted                               |                 |                 |
| - Continuing operations .....  | \$ (1.41)       | \$ (20.80)      |
| - Discontinued operations .....                                      | (0.29)          | (1.98)          |
|  | -----           | -----           |
| - Total Net Loss per share available to common<br>stockholders ..... | \$ (1.70)       | \$ (22.78)      |
|  | =====           | =====           |
| Weighted Average Number of Shares Outstanding                        |                 |                 |
| - Basic and diluted .....  | 7,366,088       | 1,951,389       |
|  | =====           | =====           |

The accompanying notes are an integral part of these financial statements



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SHARES OF  
SERIES A  
CONVERTIBLE  
PREFERRED  
STOCK

|   |     |
|---|-----|
| BALANCE - JANUARY 1, 2005 .....   | --- |
| Common stock issued in purchase business combinations   |     |
| Complete Security Solutions, Inc. ....  | --- |
| LucidLine, Inc. ....  | --- |
| Entelagent Software Corporation .....   | --- |
| Amortization of deferred stock-based compensation .....   | --- |
| Issuance of warrants to Bridge Note I Investors .....   | --- |
| Issuance of warrants issued as purchase consideration .....   | --- |
| Issuance of warrants to transaction advisors .....  | --- |
| Issuance of warrants to placement agent - Interim Bridge Financing I .....                                  | --- |
| Common stock under accommodation agreement as a penalty .....   | --- |
| Common stock issued under collateralized financing arrangement .....  | --- |
| Common stock issued in lieu of cash for services .....  | --- |
| Common stock issued on consulting agreement .....   | --- |
| Recission of common stock under consulting agreement .....  | --- |
| Issuance of warrants to Bridge Note II investors .....  | --- |
| Issuance of warrants to placement agent - Interim Bridge Financing II .....                                 | --- |
| Issuance of warrants in connection with bridge loan extension .....   | --- |
| Issuance of stock options to Chief Executive Officer .....  | --- |
| Issuance of warrants to Bridge Note III investors .....   | --- |
| Reduction of intrinsic value of put right .....   | --- |
| Conversion option penalty incurred upon default of Bridge Financing I .....                                 | --- |
| Conversion option penalty incurred upon default of Subordinated Notes .....                                 | --- |
| Conversion option penalty incurred upon default of Bridge Financing II .....                                | --- |
| Conversion option penalty incurred upon default of Bridge Financing III .....                               | --- |
| Issuance of options to non-employee .....   | --- |
| Net loss .....  | --- |
| <hr/>   |     |
| BALANCE - DECEMBER 31, 2005 .....   | --- |
| Reclassification of deferred compensation upon adoption of FAS 123(R) .....                                 | --- |
| Issuance of Series A Convertible Preferred Stock to investors .....   | 964 |
| Conversion of Bridge Notes to Series A Convertible Preferred Stock .....                                    | --- |
| Fees associated with Series A Convertible Preferred Stock offerings .....                                   | --- |
| Issuance of warrants in connection with bridge loan extension - extension<br>warrants .....                 | --- |
| Conversion option penalty incurred upon default of Bridge Financing III .....                               | --- |
| Issuance of Series A-1 Convertible Preferred stock in settlement of debt .....                              | --- |
| Cancellation of stock repurchase obligations to former officer .....  | --- |
| Issuance of shares in connection with anti-dilution provision .....   | --- |
| Issuance of common stock for services rendered .....  | --- |
| Stock based compensation - employees .....  | --- |
| Stock based compensation - nonemployees .....   | --- |
| Conversion of Preferred Series A-1 to common stock .....  | --- |
| Issuance of Series B Convertible Preferred Stock to investors .....   | --- |
| Conversion of Bridge Notes to Series B Convertible Preferred Stock .....                                    | --- |
| Fees associated with Series B Convertible Preferred Stock offerings .....                                   | --- |
| Beneficial Conversion Feature under Series B Convertible Preferred stock .....                              | --- |
| Beneficial Conversion Feature upon modification of Series A Convertible<br>Preferred conversion price ..... | --- |
| Net Loss .....  | --- |
| <hr/>   |     |
| BALANCE - DECEMBER 31, 2006 (as Restated) .....   | 964 |

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|   | PAR VALUE<br>SERIES A-1<br>PREFERRED<br>STOCK |
|---|---|
|   | -----   |
| BALANCE - JANUARY 1, 2005 .....   | \$ --   |
| Common stock issued in purchase business combinations   |   |
| Complete Security Solutions, Inc. ....  | --  |
| LucidLine, Inc. ....  | --  |
| Entelagent Software Corporation .....   | --  |
| Amortization of deferred stock-based compensation .....   | --  |
| Issuance of warrants to Bridge Note I Investors .....   | --  |
| Issuance of warrants issued as purchase consideration .....   | --  |
| Issuance of warrants to transaction advisors .....  | --  |
| Issuance of warrants to placement agent - Interim Bridge Financing I .....                                  | --  |
| Common stock under accommodation agreement as a penalty .....   | --  |
| Common stock issued under collateralized financing arrangement .....  | --  |
| Common stock issued in lieu of cash for services .....  | --  |
| Common stock issued on consulting agreement .....   | --  |
| Recission of common stock under consulting agreement .....  | --  |
| Issuance of warrants to Bridge Note II investors .....  | --  |
| Issuance of warrants to placement agent - Interim Bridge Financing II .....                                 | --  |
| Issuance of warrants in connection with bridge loan extension .....   | --  |
| Issuance of stock options to Chief Executive Officer .....  | --  |
| Issuance of warrants to Bridge Note III investors .....   | --  |
| Reduction of intrinsic value of put right .....   | --  |
| Conversion option penalty incurred upon default of Bridge Financing I .....                                 | --  |
| Conversion option penalty incurred upon default of Subordinated Notes .....                                 | --  |
| Conversion option penalty incurred upon default of Bridge Financing II .....                                | --  |
| Conversion option penalty incurred upon default of Bridge Financing III .....                               | --  |
| Issuance of options to non-employee .....   | --  |
| Net loss .....  | --  |
|   | -----   |
| BALANCE - DECEMBER 31, 2005 .....   | --  |
| Reclassification of deferred compensation upon adoption of FAS 123(R) .....                                 | --  |
| Issuance of Series A Convertible Preferred Stock to investors .....   | --  |
| Conversion of Bridge Notes to Series A Convertible Preferred Stock .....                                    | --  |
| Fees associated with Series A Convertible Preferred Stock offerings .....                                   | --  |
| Issuance of warrants in connection with bridge loan extension - extension<br>warrants .....                 | --  |
| Conversion option penalty incurred upon default of Bridge Financing III .....                               | --  |
| Issuance of Series A-1 Convertible Preferred stock in settlement of debt .....                              | 369,930                                       |
| Cancellation of stock repurchase obligations to former officer .....  | --  |
| Issuance of shares in connection with anti-dilution provision .....   | --  |
| Issuance of common stock for services rendered .....  | --  |
| Stock based compensation - employees .....  | --  |
| Stock based compensation - nonemployees .....   | --  |
| Conversion of Preferred Series A-1 to common stock .....  | (369,930)                                     |
| Issuance of Series B Convertible Preferred Stock to investors .....   | --  |
| Conversion of Bridge Notes to Series B Convertible Preferred Stock .....                                    | --  |
| Fees associated with Series B Convertible Preferred Stock offerings .....                                   | --  |
| Beneficial Conversion Feature under Series B Convertible Preferred stock .....                              | --  |
| Beneficial Conversion Feature upon modification of Series A Convertible<br>Preferred conversion price ..... | --  |
| Net Loss .....  | --  |

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|   | -----<br>\$ --<br>=====               |
|---|---------------------------------------|
|   | SHARES OF<br>COMMON<br>STOCK<br>----- |
| BALANCE - DECEMBER 31, 2006 .....   | \$ --                                 |
|   |                                       |
| BALANCE - JANUARY 1, 2005 .....   | 1,382,304                             |
| Common stock issued in purchase business combinations   |                                       |
| Complete Security Solutions, Inc. ....  | 250,000                               |
| LucidLine, Inc. ....  | 146,667                               |
| Entelagent Software Corporation .....   | 100,000                               |
| Amortization of deferred stock-based compensation .....   | --                                    |
| Issuance of warrants to Bridge Note I Investors .....   | --                                    |
| Issuance of warrants issued as purchase consideration .....   | --                                    |
| Issuance of warrants to transaction advisors .....  | --                                    |
| Issuance of warrants to placement agent - Interim Bridge Financing I .....                                  | --                                    |
| Common stock under accommodation agreement as a penalty .....   | 60,000                                |
| Common stock issued under collateralized financing arrangement .....  | 29,684                                |
| Common stock issued in lieu of cash for services .....  | --                                    |
| Common stock issued on consulting agreement .....   | 13,334                                |
| Rescission of common stock under consulting agreement .....   | (3,334)                               |
| Issuance of warrants to Bridge Note II investors .....  | --                                    |
| Issuance of warrants to placement agent - Interim Bridge Financing II .....                                 | --                                    |
| Issuance of warrants in connection with bridge loan extension .....   | --                                    |
| Issuance of stock options to Chief Executive Officer .....  | --                                    |
| Issuance of warrants to Bridge Note III investors .....   | --                                    |
| Reduction of intrinsic value of put right .....   | --                                    |
| Conversion option penalty incurred upon default of Bridge Financing I .....                                 | --                                    |
| Conversion option penalty incurred upon default of Subordinated Notes .....                                 | --                                    |
| Conversion option penalty incurred upon default of Bridge Financing II .....                                | --                                    |
| Conversion option penalty incurred upon default of Bridge Financing III .....                               | --                                    |
| Issuance of options to non-employee .....   | --                                    |
| Net loss .....  | --                                    |
| -----   |                                       |
| BALANCE - DECEMBER 31, 2005 .....   | 1,978,655                             |
| Reclassification of deferred compensation upon adoption of FAS 123(R) .....                                 | --                                    |
|   |                                       |
| Issuance of Series A Convertible Preferred Stock to investors .....   | --                                    |
| Conversion of Bridge Notes to Series A Convertible Preferred Stock .....                                    | --                                    |
| Fees associated with Series A Convertible Preferred Stock offerings .....                                   | --                                    |
| Issuance of warrants in connection with bridge loan extension - extension<br>warrants .....                 | --                                    |
| Conversion option penalty incurred upon default of Bridge Financing III .....                               | --                                    |
| Issuance of Series A-1 Convertible Preferred stock in settlement of debt .....                              | (98,626)                              |
| Cancellation of stock repurchase obligations to former officer .....  | --                                    |
| Issuance of shares in connection with anti-dilution provision .....   | 251,175                               |
| Issuance of common stock for services rendered .....  | 50,000                                |
| Stock based compensation - employees .....  | --                                    |
| Stock based compensation - nonemployees .....   | --                                    |
| Conversion of Preferred Series A-1 to common stock .....  | 12,331,056                            |
| Issuance of Series B Convertible Preferred Stock to investors .....   | --                                    |
| Conversion of Bridge Notes to Series B Convertible Preferred Stock .....                                    | --                                    |
| Fees associated with Series B Convertible Preferred Stock offerings .....                                   | --                                    |
| Beneficial Conversion Feature under Series B Convertible Preferred stock .....                              | --                                    |
| Beneficial Conversion Feature upon modification of Series A Convertible<br>Preferred conversion price ..... | --                                    |

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|   |   |
|---|---|
| Net Loss .....  | --  |
| BALANCE - DECEMBER 31, 2006 .....   | 14,512,260                                  |
|   | =====                                       |
|   | COMMON<br>STOCK<br>REPURCHASE<br>OBLIGATION |
|   | -----                                       |
| BALANCE - JANUARY 1, 2005 .....   | \$ (1,300,000)                              |
| Common stock issued in purchase business combinations                                       |   |
| Complete Security Solutions, Inc. ....  | --  |
| LucidLine, Inc. ....  | --  |
| Entelagent Software Corporation .....   | --  |
| Amortization of deferred stock-based compensation .....                                     | --  |
| Issuance of warrants to Bridge Note I Investors .....                                       | --  |
| Issuance of warrants issued as purchase consideration .....                                 | --  |
| Issuance of warrants to transaction advisors .....  | --  |
| Issuance of warrants to placement agent - Interim Bridge Financing I .....                  | --  |
| Common stock under accommodation agreement as a penalty .....                               | --  |
| Common stock issued under collateralized financing arrangement .....                        | --  |
| Common stock issued in lieu of cash for services .....                                      | --  |
| Common stock issued on consulting agreement .....   | --  |
| Rescission of common stock under consulting agreement .....                                 | --  |
| Issuance of warrants to Bridge Note II investors .....                                      | --  |
| Issuance of warrants to placement agent - Interim Bridge Financing II .....                 | --  |
| Issuance of warrants in connection with bridge loan extension .....                         | --  |
| Issuance of stock options to Chief Executive Officer .....                                  | --  |
| Issuance of warrants to Bridge Note III investors .....                                     | --  |
| Reduction of intrinsic value of put right .....   | --  |
| Conversion option penalty incurred upon default of Bridge Financing I .....                 | --  |
| Conversion option penalty incurred upon default of Subordinated Notes .....                 | --  |
| Conversion option penalty incurred upon default of Bridge Financing II .....                | --  |
| Conversion option penalty incurred upon default of Bridge Financing III .....               | --  |
| Issuance of options to non-employee .....   | --  |
| Net loss .....  | --  |
| BALANCE - DECEMBER 31, 2005 .....   | (1,300,000)                                 |
| Reclassification of deferred compensation upon adoption of FAS 123(R) .....                 | --  |
| Issuance of Series A Convertible Preferred Stock to investors .....                         | --  |
| Conversion of Bridge Notes to Series A Convertible Preferred Stock .....                    | --  |
| Fees associated with Series A Convertible Preferred Stock offerings .....                   | --  |
| Issuance of warrants in connection with bridge loan extension - extension<br>warrants ..... | --  |
| Conversion option penalty incurred upon default of Bridge Financing III .....               | --  |
| Issuance of Series A-1 Convertible Preferred stock in settlement of debt .....              | --  |
| Cancellation of stock repurchase obligations to former officer .....                        | 1,300,000                                   |
| Issuance of shares in connection with anti-dilution provision .....                         | --  |
| Issuance of common stock for services rendered .....  | --  |
| Stock based compensation - employees .....  | --  |
| Stock based compensation - nonemployees .....   | --  |
| Conversion of Preferred Series A-1 to common stock .....                                    | --  |
| Issuance of Series B Convertible Preferred Stock to investors .....                         | --  |
| Conversion of Bridge Notes to Series B Convertible Preferred Stock .....                    | --  |
| Fees associated with Series B Convertible Preferred Stock offerings .....                   | --  |
| Beneficial Conversion Feature under Series B Convertible Preferred stock .....              | --  |
| Beneficial Conversion Feature upon modification of Series A Convertible                     |   |

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|  |                |
|--|----------------|
| Preferred conversion price .....   | ---            |
| Net Loss .....   | ---            |
|  | -----          |
| BALANCE - DECEMBER 31, 2006 .....  | \$ ---         |
|  | =====          |
|  | TOTAL          |
|  | -----          |
| BALANCE - JANUARY 1, 2005 .....  | \$ (8,702,036) |
| Common stock issued in purchase business combinations  |                |
| Complete Security Solutions, Inc. ....   | 6,375,000      |
| LucidLine, Inc. ....   | 3,740,000      |
| Entelagent Software Corporation .....  | 2,550,000      |
| Amortization of deferred stock-based compensation .....  | 1,467,833      |
| Issuance of warrants to Bridge Note I Investors .....  | 1,043,860      |
| Issuance of warrants issued as purchase consideration .....  | 1,912,500      |
| Issuance of warrants to transaction advisors .....   | 255,000        |
| Issuance of warrants to placement agent - Interim Bridge Financing I .....                               | 297,500        |
| Common stock under accommodation agreement as a penalty .....  | 777,076        |
| Common stock issued under collateralized financing arrangement .....                                     | 406,205        |
| Common stock issued in lieu of cash for services .....   | --             |
| Common stock issued on consulting agreement .....  | 35,600         |
| Recission of common stock under consulting agreement .....   | (78,900)       |
| Issuance of warrants to Bridge Note II investors .....   | 532,723        |
| Issuance of warrants to placement agent - Interim Bridge Financing II .....                              | 80,867         |
| Issuance of warrants in connection with bridge loan extension .....                                      | 946,924        |
| Issuance of stock options to Chief Executive Officer .....   | 30,000         |
| Issuance of warrants to Bridge Note III investors .....  | 587,595        |
| Reduction of intrinsic value of put right .....  | (300,000)      |
| Conversion option penalty incurred upon default of Bridge Financing I .....                              | 3,500,000      |
| Conversion option penalty incurred upon default of Subordinated Notes .....                              | 4,500,000      |
| Conversion option penalty incurred upon default of Bridge Financing II .....                             | 2,543,000      |
| Conversion option penalty incurred upon default of Bridge Financing III .....                            | 1,850,000      |
| Issuance of options to non-employee .....  | 20,936         |
| Net loss .....   | (44,446,151)   |
|  | -----          |
| BALANCE - DECEMBER 31, 2005 .....  | (20,074,468)   |
| Reclassification of deferred compensation upon adoption of FAS 123(R) .....                              | --             |
| Issuance of Series A Convertible Preferred Stock to investors .....                                      | 3,205,499      |
| Conversion of Bridge Notes to Series A Convertible Preferred Stock .....                                 | 1,615,001      |
| Fees associated with Series A Convertible Preferred Stock offerings .....                                | (368,550)      |
| Issuance of warrants in connection with bridge loan extension - extension warrants .....                 | 48,129         |
| Conversion option penalty incurred upon default of Bridge Financing III .....                            | 192,000        |
| Issuance of Series A-1 Convertible Preferred stock in settlement of debt .....                           | 22,614,816     |
| Cancellation of stock repurchase obligations to former officer .....                                     | 2,600,000      |
| Issuance of shares in connection with anti-dilution provision .....                                      | --             |
| Issuance of common stock for services rendered .....   | 100,000        |
| Stock based compensation - employees .....   | 360,795        |
| Stock based compensation - nonemployees .....  | 63,120         |
| Conversion of Preferred Series A-1 to common stock .....   | --             |
| Issuance of Series B Convertible Preferred Stock to investors .....                                      | 2,952,716      |
| Conversion of Bridge Notes to Series B Convertible Preferred Stock .....                                 | 1,000,000      |
| Fees associated with Series B Convertible Preferred Stock offerings .....                                | (392,319)      |
| Beneficial Conversion Feature under Series B Convertible Preferred stock .....                           | --             |
| Beneficial Conversion Feature upon modification of Series A Convertible Preferred conversion price ..... | --             |
| Net Loss .....   | (6,484,909)    |

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|                                   |              |
|-----------------------------------|--------------|
| BALANCE - DECEMBER 31, 2006 ..... | \$ 7,431,830 |
|                                   | =====        |

The accompanying notes are an integral part of these financial statements

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PATRON SYSTEMS, INC.  
STATEMENTS OF CASH FLOWS

|   | FOR THE YEAR<br>DECEMBER<br>2006 | -----    |
|---|----------------------------------|----------|
| Cash Flows from Continuing Operating Activities                             |                                  |          |
| Net loss .....  | \$ (4,372,329)                   | \$ ----- |
| Adjustments to reconcile net loss to net cash used in operating activities: |                                  |          |
| Depreciation and amortization .....   | 168,068                          |          |
| Stock based compensation .....  | 523,915                          |          |
| Non cash interest expense .....   | 543,438                          |          |
| Stock based penalty under accomodation agreement .....                      | --                               |          |
| Goodwill impairment charge .....  | --                               |          |
| Acquired technology impairment charge .....                                 | --                               |          |
| Loss/(gain) associated with legal settlements .....                         | (2,452,909)                      |          |
| Loss on collateralized financing arrangement .....                          | --                               |          |
| Loss on sale of property and equipment .....                                | 2,072                            |          |
| Loss on disposition of discontinued operations .....                        | 75,920                           |          |
| Reduction in intrinsic value of put right .....                             | --                               |          |
| Gain on settlement of consulting agreement payable .....                    | --                               |          |
| Non-cash interest income .....  | --                               |          |
| Changes in operating assets and liabilities:                                |                                  |          |
| Restricted cash .....   | 511,691                          |          |
| Prepaid expenses .....  | --                               |          |
| Accounts receivable .....   | (707,206)                        |          |
| Other current assets .....  | (107,230)                        |          |
| Accounts payable .....  | (197,641)                        |          |
| Accrued interest .....  | 618,289                          |          |
| Deferred revenue .....  | (80,712)                         |          |
| Expense reimbursements payable .....  | (26,835)                         |          |
| Accrued payroll and payroll related expenses .....                          | 88,709                           |          |
| Amounts due under settlement with former officer .....                      | --                               |          |
| Other current liabilities .....   | 103,031                          |          |
| Consulting agreements payable .....   | --                               |          |
| Accrued registration penalty .....  | 8,560                            |          |
| Other accrued expenses .....  | --                               |          |
| Total adjustments .....   | (928,840)                        | -----    |
| NET CASH USED IN CONTINUING OPERATING ACTIVITIES .....                      | (5,301,169)                      | -----    |
| CASH FLOWS USED IN CONTINUING INVESTING ACTIVITIES                          |                                  |          |
| Cash payments in purchase business combinations .....                       | --                               |          |

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|   |              |       |
|---|--------------|-------|
| Cash acquired in purchase business combinations .....                       | --           |       |
| Computer software development costs .....                                   | (281,373)    |       |
| Proceeds from sale of property and equipment .....                          | 1,704        |       |
| Purchase of fixed assets .....  | (145,920)    |       |
|   | -----        |       |
| NET CASH USED IN CONTINUING INVESTING ACTIVITIES .....                      | (425,589)    |       |
|   | -----        |       |
| <br>CASH FLOWS FROM CONTINUING FINANCING ACTIVITIES                         |              |       |
| Expenses (repaid to) officers and stockholders .....                        | --           |       |
| Payments on settlement of accommodation agreements .....                    | (125,000)    |       |
| Deferred financing costs .....  | (54,000)     |       |
| Repayments of amounts due under settlement with former officer .....        | --           |       |
| Proceeds from issuance of bridge notes .....                                | --           |       |
| Proceeds from issuances of Series A convertible preferred stock .....       | 3,025,500    |       |
| Proceeds from issuances of Series B convertible preferred stock .....       | 2,952,716    |       |
| Proceeds from bridge notes to Series A convertible preferred stock .....    | 1,615,001    |       |
| Proceeds from bridge notes to Series B convertible preferred stock .....    | 1,000,000    |       |
| Placement agent fees for preferred stock issuances .....                    | (760,869)    |       |
| Principal payments on notes payable .....                                   | (7,001)      |       |
| Proceeds from disposition of discontinued operations .....                  | 50,000       |       |
| Proceeds received in connection with financing settlement .....             | 180,000      |       |
| Repayments of advances from shareholders .....                              | --           |       |
|   | -----        |       |
| NET CASH PROVIDED BY CONTINUING FINANCING ACTIVITIES .....                  | 7,876,347    |       |
|   | -----        |       |
| <br>CASH FLOWS FROM DISCONTINUED OPERATIONS                                 |              |       |
| Operating cash flows .....  | (1,373,703)  |       |
| Investing cash flows .....  | (234,330)    |       |
| Financing cash flows .....  | --           |       |
|   | -----        |       |
| NET CASH USED IN DISCONTINUED OPERATIONS .....                              | (1,608,033)  |       |
|   | -----        |       |
| <br>NET INCREASE (DECREASE) IN CASH .....                                   |              |       |
|   | 541,556      |       |
| <br>CASH, beginning of year .....   |              |       |
|   | 14           |       |
|   | -----        |       |
| CASH, end of year .....   | \$ 541,570   | \$    |
|   | =====        | ===== |
| <br>Supplemental Disclosures of Cash Flow Information:                      |              |       |
| Conversion of outstanding notes into Series A Convertible Preferred Stock . | \$ 1,615,001 | \$    |
| Settlement of outstanding claims and liabilities in exchange for Series A-1 |              |       |
| Convertible Preferred Stock .....   | 24,467,781   |       |
| Conversion of outstanding notes into Series B Convertible Preferred Stock . | 1,000,000    |       |
| <br>Cash paid during the period for:  |              |       |
| Interest .....  | 7,241        |       |
| <br>Supplemental non-cash investing and financial activity:                 |              |       |
| Acquisition of businesses:  |              |       |
| Current tangible assets acquired .....                                      |              |       |
| Non-current tangible assets acquired .....                                  |              |       |
| Current liabilities assumed with acquisitions .....                         |              |       |
| Non-current liabilities assumed with acquisitions .....                     |              |       |
| Intangible assets acquired .....  |              |       |
| Goodwill recognized on purchase business combinations .....                 |              |       |
| Non-cash consideration .....  |              |       |
| Cash acquired in purchase business combinations .....                       |              |       |
| <br>Cash paid to acquire businesses .....                                   |              |       |

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The accompanying notes are an integral part of these financial statements

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### PATRON SYSTEMS, INC. NOTES TO AUDITED FINANCIAL STATEMENTS DECEMBER 31, 2006

#### NOTE 1 - THE COMPANY

##### ORGANIZATION AND DESCRIPTION OF BUSINESS

Patron Systems, Inc. (the "Company") is a Delaware corporation formed in April 2002. The Company provides application software and services focused on business process management (BPM) in the public sector. Patron's current application software offering, FormStream, is an open standards information sharing tool that addresses the need for law enforcement and public safety agencies to share information between local, state and federal law enforcement and homeland security agencies.

On July 31, 2006, the Company effectuated a 1-for-30 reverse stock split of its common stock following the effectiveness of the amendment to its Second Amended and Restated Certificate of Incorporation which was approved by stockholders at the 2006 Annual Meeting of Stockholders on July 20, 2006. The accompanying financial statements give retroactive effect to the reverse split for all periods presented.

Effective September 19, 2006, the Company merged its wholly-owned subsidiaries Entelagent, CSSI and PILEC Distribution Company into the Company through the filing with the Secretary of State of the States of Delaware and California, a Certificate of Ownership and Merger merging Entelagent Software Corp., (a California corporation), Complete Security Solutions, Inc., (a Delaware corporation) and PILEC Disbursement Company, (a Delaware corporation) into Patron Systems, Inc., (a Delaware corporation).

#### NOTE 2 - RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS

On May 18, 2007, the Board of Directors of the Company determined that certain amounts reported in its audited financial statements for the year ended December 31, 2006 needed to be restated as described below.

The Company, while undergoing a review of its financial statements for the three months ended March 31, 2007, became aware of a possible misstatement in its accounting for a deemed dividend it recorded during the fourth quarter of its year ended December 31, 2006. Upon review of this transaction, Company management specifically determined that there was an error in the accounting for a deemed dividend that was recognized upon a reduction in the conversion price of the Company Series A Preferred Stock that occurred on November 16, 2006. The reduction in the conversion price occurred upon the Company's issuance of additional convertible securities featuring a conversion price lower than the conversion price embedded in the Series A Preferred. The Company, in calculating the deemed dividend, originally determined that the net loss available to its common stockholders should be increased by \$589,175. The Company reevaluated its computations during the quarter ended March 31, 2007 and determined that the net loss available to its common stockholders should have been increased by \$3,759,059. The nature of the adjustment relates to the Company's use of an



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incorrect price for the value of its common stock when it computed the intrinsic value of the conversion feature embedded in the Series A Preferred stock at the time of the reduction in the conversion price.

The effect of the restatement on the Company's previously issued financial statements is as follows:

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|  | As Previously<br>Reported | As<br>Reported  |
|--|---------------------------|-----------------|
|  | -----                     | -----           |
| Additional paid in capital .....                                     | \$ 100,573,227            | \$ 103,743,111  |
| Accumulated deficit .....  | (93,286,542)              | (96,456,426)    |
| Preferred stock deemed dividend .....                                | \$ (2,413,606)            | \$ (5,583,490)  |
| Net loss available to common stockholders                            | \$ (9,344,431)            | \$ (12,514,315) |
| Net Loss Per Share - Basic and Diluted                               |                           |                 |
| - Continuing operations .....  | \$ (0.98)                 | \$ (1.41)       |
| - Discontinued operations .....                                      | (0.29)                    | (0.29)          |
|  | -----                     | -----           |
| - Total Net Loss per share available to<br>common stockholders ..... | \$ (1.27)                 | \$ (1.70)       |
|  | =====                     | =====           |

The effect on our financial statements for the year ended December 31, 2006 was to increase additional paid in capital, accumulated deficit and net loss available to common stockholders by \$3,169,884, net loss per share for continuing operations by \$0.43 and total net loss per share available to common stockholders by \$0.43. There was no effect on the Company's net loss.

### NOTE 3 - LIQUIDITY AND FINANCIAL CONDITION

The Company incurred a net loss from continuing operations of \$4,372,329 for the year ended December 31, 2006, which includes \$1,139,496 of non-cash charges including depreciation and amortization of \$168,068, aggregate stock based compensation of \$523,915, non-cash interest expense of \$543,438, loss on sale of property and equipment \$2,072 and a loss on the disposition of discontinued operations of \$75,920. The non-cash charges were offset by non-cash gains of \$2,452,909 associated with the settlements of outstanding liabilities, claims and litigation under the creditor and claimant liabilities restructuring program that occurred during the year ended December 31, 2006 (Note 18). The Company used \$511,691 of its restricted cash escrowed to settle liabilities assumed in a business combination. Including the amounts above, the Company used net cash flows in its operating activities of \$5,301,169 during the year ended December 31, 2006. The Company's working capital deficiency at December 31, 2006 amounted to \$2,795,521 and the Company continues to experience shortages of working capital.

The Company expects to continue incurring losses for the foreseeable future due to the inherent uncertainty that is related to establishing the commercial feasibility of technological products and developing a presence in new markets. The Company raised \$8,773,217 of gross proceeds (\$7,832,348 net proceeds after the payment of certain transaction expenses) in financing transactions during

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the year ended December 31, 2006. The Company used \$5,301,169 of these proceeds to fund its operations and a net of \$425,589 in investing activities. The Company also settled \$24,467,871 of outstanding liabilities, claims and litigation under the creditor and claimant liabilities restructuring program that occurred during the year ended December 31, 2006 (Note 18). The Company believes that its completion of this program has enabled it to improve its financial condition by eliminating substantial requirements to settle these obligations for cash; however, the Company's capital resources are still significantly limited and there can be no assurance that the completion of this program will enable the Company to actually attain positive operating cash flows.

The Company has taken certain steps to conserve its liquidity while it continues to develop its business; however, the Company will still need to raise additional capital to sustain the business until such time that it is able to generate sufficient revenue and operating cash flows. The Company believes it has access to capital resources, however, the Company has not secured any commitments for additional financing at this time nor can it provide any assurance that it will be successful in its efforts to raise additional capital or that if capital is raised, the proceeds will be sufficient to sustain the business until it is able to generate operating cash flow. These matters raise substantial doubt about the Company's ability to continue as a going concern. The financial statements do not include any adjustments that might be necessary should the Company be unable to continue as a going concern.

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### NOTE 4 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### CASH

The Company considers all highly liquid securities purchased with original maturities of three months or less to be cash.

#### CONCENTRATION OF CREDIT RISK

The Company maintains cash with major financial institutions. Cash is insured by the Federal Deposit Insurance Corporation ("FDIC") up to \$100,000 at each institution. From time to time amounts may exceed the FDIC limits. At December 31, 2006 the uninsured bank cash balances were \$441,570. The Company has not experienced any losses on these accounts.

#### REVENUE RECOGNITION

The Company derives revenues from the following sources: (1) sales of computer software, which includes new software licenses and software updates and product support revenues and (2) professional consulting services.

The Company applies the revenue recognition principles set forth under AICPA Statement of Position ("SOP") 97-2 "Software Revenue Recognition" and Securities and Exchange Commission Staff Accounting Bulletin ("SAB") 104 "Revenue Recognition" with respect to its revenue. Accordingly, the Company records revenue when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the vendor's fee is fixed or determinable, and (iv) collectability is reasonably assured.

The Company generates revenues through sales of software licenses and annual support subscription agreements, which include access to technical support and software updates (if and when available). Software license revenues are

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generated from licensing the rights to use products directly to end-users and through third party service providers.

Revenues from software license agreements are generally recognized upon delivery of software to the customer. All of the Company's software sales are supported by a written contract or other evidence of sale transaction such as a customer purchase order. These forms of evidence clearly indicate the selling price to the customer, shipping terms, payment terms (generally 30 days) and refund policy, if any. The selling prices of these products are fixed at the time the sale is consummated.

Revenue from post-contract customer support arrangements or undelivered elements are deferred and recognized at the time of delivery or over the period in which the services are performed based on vendor specific objective evidence of fair value for such undelivered elements. Vendor specific objective evidence is typically based on the price charged when an element is sold separately or, if an element is not sold separately, on the price established by an authorized level of management, if it is probable that the price, once established, will not change before market introduction. The Company uses the residual method prescribed in SOP 98-9, "Modification of SOP 97-2, Software Revenue Recognition With Respect to Certain Transaction" to allocate revenues to delivered elements once it has established vendor-specific objective evidence of fair value for such undelivered elements.

Professional consulting services are billed based on the number of hours of consultant services provided and the hourly billing rates. The Company recognizes revenue under these arrangements as the service is performed.

### ACCOUNTS RECEIVABLE

The Company adjusts its accounts receivable balances that it deems to be uncollectible. The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company reviews its allowance for doubtful accounts on a monthly basis to determine the allowance based on an analysis of its past due accounts. All past due balances that are over 90 days are reviewed individually for collectability. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. Accounts receivable includes \$577,000 of accrued revenue for software licenses and services delivered under contractual arrangements that were billed, pursuant to contracts subsequent to December 31, 2006. The Company has determined that an allowance for doubtful accounts is not necessary with respect to the balance due from customers as of December 31, 2006.

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### SOFTWARE DEVELOPMENT COSTS

Capitalization of computer software development costs begins upon the establishment of technological feasibility. Technological feasibility for the Company's computer software products is generally based upon achievement of a detail program design free of high risk development issues. The Company capitalizes only those costs directly attributable to the development of the software. The establishment of technological feasibility and the ongoing assessment of recoverability of capitalized computer software development costs require considerable judgment by management with respect to certain external factors, including, but not limited to, technological feasibility, anticipated future gross revenue, estimated economic life and changes in software and hardware technology.

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Prior to reaching technological feasibility the Company's policy is to expense these costs as incurred and include them in general and administrative. Activities undertaken after the products are available for general release to customers to correct errors or keep the product updated are expensed as incurred and included in general and administrative. The Company has incurred no research and development costs in the years ended December 31, 2005 and 2006. The Company currently has only one core product (FormStream) for which it is in the process of developing certain functionalities that are expected to increase its potential to generate revenue.

Amortization of capitalized computer software development costs commences when the related products become available for general release to customers. Amortization is provided on a product by product basis and is included in the applicable cost of revenue. Amortization is being provided for using the straight-line method over the estimated economic life of the product, which is five years.

The Company periodically performs reviews of the recoverability of such capitalized software costs. At the time a determination is made that capitalized amounts are not recoverable based on the estimated cash flows to be generated from the applicable software, any remaining capitalized amounts are written off.

### PROPERTY AND EQUIPMENT

Property and equipment is stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets (generally three to five years). Maintenance and repairs are charged to expense as incurred; cost of major additions and betterments are capitalized. When property and equipment is sold or otherwise disposed of, the cost and related accumulated depreciation are eliminated from the accounts and any resulting gains or losses are reflected in the statement of operations in the period of disposal.

### GOODWILL AND INTANGIBLE ASSETS

The Company accounts for Goodwill and Intangible Assets in accordance with Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets." Under SFAS No. 142, goodwill and intangibles that are deemed to have indefinite lives are no longer amortized but, instead, are to be reviewed at least annually for impairment. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value. Significant judgments required to estimate the fair value of reporting units include estimating future cash flows, determining appropriate discount rates and other assumptions. Changes in these estimates and assumptions could materially affect the determination of fair value of and/or goodwill impairment for each reporting unit. During the year ended December 31, 2005, the Company recorded goodwill in connection with the acquisitions described in Note 5. The Company's annual impairment review of goodwill resulted in a goodwill impairment charge of \$210,716 for the year ended December 31, 2006 (Note 6) resulting in \$9,300,000 in goodwill at December 31, 2006. The 2006 charge, which principally represents goodwill remaining from the PolicyBridge business the Company acquired from Entelagent, is classified in discontinued operations as a result of its decision to exit that business in November 2006. The remaining amount of goodwill, which amounts to \$9,300,000 at December 31, 2006, relates to the Company's acquisition of CSSI in February 2005 in which the Company acquired FormStream.

### LONG LIVED ASSETS

The Company periodically reviews the carrying values of its long lived assets

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(which include property and equipment and amortizable intangible assets) in accordance with SFAS 144, "Long Lived Assets" when events or changes in circumstances would indicate that it is more likely than not that their carrying values may exceed their realizable value and records impairment charges when necessary. The Company's review of the carrying values of its long lived assets used in continuing operations has resulted in no impairment charge for the year ended December

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31, 2006 (Note 9). The Company has classified its PolicyBridge software business as a discontinued operation at December 31, 2006 (Note 8, Note 9 and Note 21). This business had \$931,470 of intangible assets associated with acquired software technology in which the recovery of only portion of its value is considered likely. A substantial portion of the carrying value, in the amount of \$781,470, has been expensed as a loss from discontinued operations in the year ended December 31, 2006. The remaining carrying value of \$150,000, which represents the Company's best estimate of the recoverable value of the PolicyBridge intangible assets at December 31, 2006 is included in assets held for sale in the accompanying balance sheet.

Making estimates about the carrying values of intangible assets requires management to exercise significant judgment. It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements which management considered in formulating its estimate could change in the near term due to one or more future confirming events. Accordingly, the actual results regarding estimates of carrying value of these intangibles could differ materially from the Company's estimate.

### RECLASSIFICATION

Certain amounts included in the financial statements for the year ended December 31, 2005 have been reclassified to the presentation used by the Company in the year ended December 31, 2006.

### USE OF ESTIMATES IN PREPARING FINANCIAL STATEMENTS

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenue and expenses during the reporting period. Critical accounting policies requiring the use of estimates are revenue recognition for software products with multiple deliverables, allowance for doubtful accounts, goodwill, intangibles other than goodwill, which are associated with its continuing operations, impairment charges, convertible instruments, freestanding derivatives, and share based payments.

### FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts reported in the balance sheet for cash, accounts receivable, accounts payable accrued expenses, advances from stockholders and all note obligations classified as current liabilities approximate their fair values based on the short-term maturity of these instruments.

### PREFERRED STOCK

The Company applies the guidance enumerated in SFAS No. 150 "Accounting for

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Certain Financial Instruments with Characteristics of both Liabilities and Equity" and EITF Topic D-98 "Classification and Measurement of Redeemable Securities," when determining the classification and measurement of preferred stock. Preferred shares subject to mandatory redemption (if any) are classified as liability instruments and are measured at fair value in accordance with SFAS 150. All other issuances of preferred stock are subject to the classification and measurement principles of EITF Topic D-98. Accordingly the Company classifies conditionally redeemable preferred shares (if any), which includes preferred shares that feature redemption rights that are either within the control of the holder or subject to redemption upon the occurrence of uncertain events not solely within the Company's control, as temporary equity. At all other times, the Company classifies its preferred shares in stockholders' equity.

The Company's preferred shares do not feature any redemption rights within the holders control or conditional redemption features not within the Company's control as of December 31, 2006. Accordingly all issuances of preferred stock are presented as a component of stockholders equity.

### CONVERTIBLE INSTRUMENTS

The Company evaluates and accounts for conversion options embedded in its convertible instruments in accordance with SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133") and EITF 00-19 "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" ("EITF 00-19").

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SFAS 133 generally provides three criteria that, if met, require companies to bifurcate conversion options from their host instruments and account for them as free standing derivative financial instruments in accordance with EITF 00-19. These three criteria include circumstances in which (a) the economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract, (b) the hybrid instrument that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur and (c) a separate instrument with the same terms as the embedded derivative instrument would be considered a derivative instrument subject to the requirements of SFAS 133. SFAS 133 and EITF 00-19 also provide an exception to this rule when the host instrument is deemed to be conventional (as that term is described in the implementation guidance to SFAS 133 and further clarified in EITF 05-2 "The Meaning of "Conventional Convertible Debt Instrument" in Issue No. 00-19).

The Company accounts for convertible instruments (when it has determined that the embedded conversion options should not be bifurcated from their host instruments) in accordance with the provisions of EITF 98-5 "Accounting for Convertible Securities with Beneficial Conversion Features," ("EITF 98-5") and EITF 00-27 "Application of EITF 98-5 to Certain Convertible Instruments." Accordingly, the Company records when necessary discounts to convertible notes for the intrinsic value of conversion options embedded in debt instruments based upon the differences between the fair value of the underlying common stock at the commitment date of the note transaction and the effective conversion price embedded in the note. Debt discounts under these arrangements are amortized over the term of the related debt to their earliest date of redemption. The Company also records when necessary deemed dividends for the intrinsic value of conversion options embedded in preferred shares based upon the differences

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between the fair value of the underlying common stock at the commitment date of the note transaction and the effective conversion price embedded in the note.

The Company evaluated the conversion option embedded in its convertible instruments during each of the reporting periods presented and has determined, in accordance with the provisions of these statements, that it does not meet the criteria requiring bifurcation of these instruments.

The Company determined that the conversion option embedded in its Series A Convertible Preferred Stock, par value \$0.01 per share ("Series A Preferred"), is not a free standing derivative in accordance with the implementation guidance provided in paragraph 61 (1) of Appendix A to SFAS 133.

The Company determined that the conversion option embedded in its Series B Convertible Preferred Stock, par value \$0.01 per share ("Series B Preferred"), is not a free standing derivative in accordance with the implementation guidance provided in paragraph 61 (1) of Appendix A to SFAS 133.

The characteristics of common stock that is issuable upon a holder's exercise of conversion options embedded in the Company's preferred shares are deemed to be clearly and closely related to the characteristics of the preferred shares (as that term is clarified in paragraph 61 (1) of the implementation guidance included in Appendix A of SFAS 133). The Company recorded \$5,583,490 of deemed dividends during the year ended December 31, 2006 because the effective conversion prices of the preferred shares were less than the commitment date fair values of the Company's common stock at their respective dates of issuance and/or modification.

### COMMON STOCK PURCHASE WARRANTS AND OTHER DERIVATIVE FINANCIAL INSTRUMENTS

The Company accounts for the issuance of common stock purchase warrants and other free standing derivative financial instruments in accordance with the provisions of EITF 00-19. The Company performs classification assessments of its derivative financial instruments at each balance sheet date as required under EITF 00-19. Based on the provisions of EITF 00-19, the Company classifies as equity any contracts that (i) require physical settlement or net-share settlement or (ii) gives the Company a choice of net-cash settlement or settlement in its own shares (physical settlement or net-share settlement). The Company classifies as assets or liabilities any contracts that (i) require net-cash settlement (including a requirement to net cash settle the contract if an event occurs and if that event is outside the control of the Company) or (ii) gives the counterparty a choice of net-cash settlement or settlement in shares (physical settlement or net-share settlement). The Company has determined that its derivative financial instruments, which consist of common stock purchase warrants, are equity instruments since they do not provide any cash settlement alternatives outside of the Company's control.

### STOCK BASED COMPENSATION

Prior to January 1, 2006, the Company accounted for employee stock based compensation in accordance with

Accounting Principles Board ("APB") Opinion No. 25 "Accounting for Stock Issued to Employees." The Company applied the proforma disclosure requirements of SFAS No. 123 "Accounting for Stock-Based Compensation."

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Effective January 1, 2006, the Company adopted SFAS No. 123R "Share Based Payment." This statement is a revision of SFAS Statement No. 123, and supersedes APB Opinion No. 25, and its related implementation guidance. SFAS 123R addresses all forms of share based payment ("SBP") awards including shares issued under employee stock purchase plans, stock options, restricted stock and stock appreciation rights. Under SFAS 123R, SBP awards result in a cost that is measured at fair value on the awards' grant date, based on the estimated number of awards that are expected to vest. The Company adopted the modified prospective method with respect to accounting for its transition to SFAS 123(R) and measured unrecognized compensation cost as described in Note 19. Accordingly, the Company recognized in salaries and related expense in the statement of operations, \$360,795 for the fair value of employee stock options expected to vest during the year ended December 31, 2006.

The Company has reclassified certain components of its stockholders' equity section to reflect the elimination of deferred compensation arising from unvested share-based compensation pursuant to the requirements of Staff Accounting Bulletin No. 107, regarding Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment." This deferred compensation was previously recorded as an increase to additional paid-in capital with a corresponding reduction to stockholders' equity for such deferred compensation. This reclassification has no effect on net income or total stockholders' equity as previously reported. The Company will record an increase to additional paid-in capital with corresponding charges to operations as the share-based payments vest.

For the year ended December 31, 2005, the Company applied APB Opinion No. 25, "Accounting for Stock Issued to Employees." As required under SFAS No. 148, "Accounting for Stock-based Compensation - Transition and Disclosure," the following table presents pro-forma net income and basic and diluted earnings per share as if the fair value-based method had been applied to all awards during that period.

|  | YEAR ENDED<br>DECEMBER 31,<br>2005<br>----- |
|--|---|
| Net Loss, as reported .....  | \$(44,446,151)                              |
| (+) Stock-based compensation cost reflected in the<br>financial statements ..... | 22,500                                      |
| (-) Stock-based employee compensation cost, under fair<br>value accounting ..... | (440,753)<br>-----                          |
| Pro-forma net loss under fair value method .....                                 | \$(44,864,404)<br>=====                     |
| <br>   |   |
| Net loss per share - basic and diluted, as reported .....                        | \$ (22.78)                                  |
| Net loss per share - basic and diluted, proforma .....                           | \$ (22.99)                                  |

The fair value of all awards was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions: risk free interest rate: 3.10% to 3.83%; expected dividend yield: 0%; expected option life: 9 months to 4 years; volatility: 125%.

### NON-EMPLOYEE STOCK BASED COMPENSATION

The Company accounts for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force (EITF) Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to



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Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services," which requires that such equity instruments are recorded at their fair value on the measurement date. The measurement of stock-based compensation is subject to periodic adjustment as the underlying equity instrument vests. Non-employee stock-based compensation charges are amortized over the vesting period. Stock based compensation expense to non employees for service amount to \$163,120 for the year ended December 31, 2006 including \$63,120 for the fair value of 50,000 stock options with an exercise price of \$2.40 per share which were fully vested upon grant and have a life of 3 years and 50,000 shares of common stock with a an aggregate fair value of \$100,000.

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### INCOME TAXES

The Company accounts for income taxes under SFAS No. 109, "Accounting for Income Taxes." SFAS No. 109 requires the recognition of deferred tax assets and liabilities for both the expected impact of differences between the financial statements and tax basis of assets and liabilities and for the expected future tax benefit to be derived from tax loss and tax credit carry forwards. SFAS No. 109 additionally requires a valuation allowance to be established when it is more likely than not that all or a portion of deferred tax assets will not be realized. Furthermore, SFAS No. 109 provides that it is difficult to conclude that a valuation allowance is not needed when there is negative evidence such as cumulative losses in recent years. Therefore, cumulative losses weigh heavily in the overall assessment. Accordingly the Company has recorded a full valuation allowance against its net deferred tax assets. In addition, the Company expects to provide a full valuation allowance on future tax benefits until it can sustain a level of profitability that demonstrates its ability to utilize the assets, or other significant positive evidence arises that suggests its ability to utilize such assets. The future realization of a portion of the reserved deferred tax assets related to tax benefits associated with the exercise of stock options, if and when realized, will not result in a tax benefit in the consolidated statement of operations, but rather will result in an increase in additional paid in capital. The Company will continue to re-assess its reserves on deferred income tax assets in future periods on a quarterly basis.

### NET LOSS PER SHARE

Basic net loss per common share is computed by dividing net loss by the weighted-average number of common shares outstanding during the period. Diluted net loss per common share also includes common stock equivalents outstanding during the period if dilutive. Diluted net loss per common share, if required, would be computed by dividing net loss by the weighted-average number of common shares outstanding without an assumed increase in common shares outstanding for common stock equivalents; as such common stock equivalents are anti-dilutive.

Net loss per common share excludes the following outstanding options and warrants as their effect would be anti-dilutive:

|  | December 31, |         |
|--|--------------|---------|
|  | 2006         | 2005    |
| Options .....                              | 492,635      | 388,000 |
| Warrants .....                             | 4,472,590    | 993,779 |
| Series A Convertible Preferred stock ..... | 5,356,138    | --      |
| Series B Convertible Preferred stock ..... | 4,820,417    | --      |
| Convertible Notes .....                    | 66,557       | --      |

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|            |           |
|------------|-----------|
| -----      | -----     |
| 15,208,337 | 1,381,779 |
| =====      | =====     |

### RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 150." SFAS No. 155 (a) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (b) clarifies that certain instruments are not subject to the requirements of SFAS 133, (c) establishes a requirement to evaluate interests in securitized financial assets to identify interests that may contain an embedded derivative requiring bifurcation, (d) clarifies what may be an embedded derivative for certain concentrations of credit risk and (e) amends SFAS 140 to eliminate certain prohibitions related to derivatives on a qualifying special-purpose entity. SFAS 155 is applicable to new or modified financial instruments in fiscal years beginning after September 15, 2006, though the provisions related to fair value accounting for hybrid financial instruments can also be applied to existing instruments. Early adoption, as of the beginning of an entity's fiscal year, is also permitted, provided interim financial statements have not yet been issued. The Company is currently evaluating the potential impact, if any, that the adoption of SFAS 155 will have on its consolidated financial statements.

In March 2006, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 156, Accounting for Servicing of Financial Assets (SFAS No. 156). SFAS No. 156 amends SFAS No. 140 "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," to require all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. SFAS No. 156 also permits servicers to subsequently measure each separate class of servicing assets and liabilities at fair value rather than at the

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lower of cost or market. For those companies that elect to measure their servicing assets and liabilities at fair value, SFAS No. 156 requires the difference between the carrying value and fair value at the date of adoption to be recognized as a cumulative effect adjustment to retained earnings as of the beginning of the fiscal year in which the election is made. SFAS No. 156 is effective for the first fiscal year beginning after September 15, 2006. The Company is currently evaluating the potential impact, if any, that the adoption of SFAS 156 will have on its consolidated financial statements.

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Interpretation is effective for fiscal years beginning after December 15, 2006. The Company has not yet completed its analysis of the impact this Interpretation will have on its financial condition, results of operations, cash flows or disclosures.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements ("SFAS 157"). This Standard defines fair value, establishes a framework for measuring fair value in generally accepted

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accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The adoption of SFAS 157 is not expected to have a material impact on the Company's financial position, results of operations or cash flows.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin ("SAB") 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB 108"). SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year's financial statements are materially misstated. SAB 108 is effective for the first fiscal year ending after November 15, 2006. The adoption of SAB 108 did not impact the Company's financial statements.

In November 2006, the EITF reached a final consensus in EITF Issue 06-6 "Debtor's Accounting for a Modification (or Exchange) of Convertible Debt Instruments" ("EITF 06-6"). EITF 06-6 addresses the modification of a convertible debt instrument that changes the fair value of an embedded conversion option and the subsequent recognition of interest expense for the associated debt instrument when the modification does not result in a debt extinguishment pursuant to EITF 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments." The consensus should be applied to modifications or exchanges of debt instruments occurring in interim or annual periods beginning after November 29, 2006. The Company does not expect the adoption of EITF 06-6 to have a material impact on its consolidated financial position, results of operations or cash flows.

In November 2006, the FASB ratified EITF Issue No. 06-7, Issuer's Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities ("EITF 06-7"). At the time of issuance, an embedded conversion option in a convertible debt instrument may be required to be bifurcated from the debt instrument and accounted for separately by the issuer as a derivative under FAS 133, based on the application of EITF 00-19. Subsequent to the issuance of the convertible debt, facts may change and cause the embedded conversion option to no longer meet the conditions for separate accounting as a derivative instrument, such as when the bifurcated instrument meets the conditions of Issue 00-19 to be classified in stockholders' equity. Under EITF 06-7, when an embedded conversion option previously accounted for as a derivative under FAS 133 no longer meets the bifurcation criteria under that standard, an issuer shall disclose a description of the principal changes causing the embedded conversion option to no longer require bifurcation under FAS 133 and the amount of the liability for the conversion option reclassified to stockholders' equity. EITF 06-7 should be applied to all previously bifurcated conversion options in convertible debt instruments that no longer meet the bifurcation criteria in FAS 133 in interim or annual periods beginning after December 15, 2006, regardless of whether the debt instrument was entered into prior or subsequent to the effective date of EITF 06-7. Earlier application of EITF 06-7 is permitted in periods for which financial statements have not yet been issued. The Company is currently evaluating the impact of this guidance on its consolidated financial position, results of operations or cash flows.

In December 2006, the FASB issued FSP EITF 00-19-2, "Accounting for Registration Payment Arrangements." FSP EITF 00-19-2 addresses an issuer's accounting for registration payment arrangements. This pronouncement specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument,

should be separately recognized and accounted for as a contingency in accordance with SFAS 5 "Accounting for Contingencies." FSP EITF 00-19-2 amending previous standards relating to rights agreements became effective on December 21, 2006 with respect to arrangements entered into or modified beginning on such date and for the first fiscal year beginning after December 15, 2006 with respect to those arrangements entered into prior to December 21, 2006. The Company is in the process of evaluating the impact of the adoption of this statement on the Company's results of operations and financial condition.

In February 2007, the FASB issued SFAS 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS 159"). SFAS 159 provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company is in the process of evaluating the impact of the adoption of this statement on the Company's results of operations and financial condition.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on the consolidated financial statements upon adoption.

#### NOTE 5 - BUSINESS COMBINATIONS

##### MERGER WITH COMPLETE SECURITY SOLUTIONS, INC.

On February 25, 2005, pursuant to the filing of an Agreement and Plan of Merger, the Company's merger with Complete Security Solutions, Inc. ("CSSI") became effective. In connection with the CSSI merger, the Company issued 250,000 shares of common stock in exchange for the outstanding shares of the common stock of CSSI, and subordinated promissory notes in the aggregate principal amount of \$4,500,000 (the "Subordinated Notes") and warrants to purchase 75,000 shares of common stock ("Purchase Warrants") in exchange for the outstanding shares of the preferred stock of CSSI. The Purchase Warrants have a term of 5 years and an exercise price of \$0.70 per share. The Subordinated Notes and Purchase Warrants were issued to Apex Investment Fund V, L.P. ("Apex"), The Northwestern Mutual Life Insurance Company ("Northwestern"), and Advanced Equities Venture Partners I, L.P. ("Advanced Equities").

The Company did not redeem the Subordinated Notes on their extended due date of August 24, 2005 and, as a result, the notes became automatically convertible into 0.128 shares of common stock for each \$1 of principal then outstanding in accordance with the original note agreement. Accordingly, the Company recorded a charge of \$4,500,000 during the year ended December 31, 2005 based upon the intrinsic value of this conversion option measured at the original issuance date of the note. The Subordinated Notes remained outstanding subsequent to the date of their maturity but were ultimately surrendered as payment for 5,625,000 shares of Series A-1 Preferred Stock under the creditor and claimant liabilities restructuring program in March 2006 (Note 18). The Company has agreed to file with the SEC, a registration statement for the resale of the restricted shares of the Company's common stock issuable upon exercise of the conversion option that would be issued in this transaction, on a best efforts basis.

The Company has agreed to register the resale of the 250,000 shares of common

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stock issued to the holders of the outstanding common stock of CSSI and the 75,000 shares of common stock issuable upon the exercise of the warrants issued to the holders of the outstanding preferred stock of CSSI at such time as the Company next files a registration statement with the Securities and Exchange Commission ("SEC") on a best efforts basis.

### MERGER WITH LUCIDLINE, INC.

On February 25, 2005, pursuant to the filing of an Agreement and Plan of Merger, the Company's merger with LucidLine, Inc. ("LucidLine") became effective. In connection with the LucidLine merger, the Company issued 146,667 shares of common stock and \$200,000 of cash, in exchange for all of the outstanding shares of LucidLine's common stock. The Company has agreed to register the resale of the shares of common stock issued to the holders of the outstanding common stock of LucidLine at such time as the Company next files a registration statement with the SEC on a best efforts basis.

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### MERGER WITH ENTELAGENT SOFTWARE CORP.

On February 24, 2005, the Company entered into a definitive Amended and Restated Supplemental Agreement pursuant to which ESC Acquisition, Inc., a California corporation and wholly-owned subsidiary of Patron ("Entelagent Mergerco") would merge with and into Entelagent Software Corp., a California corporation ("Entelagent"), with Entelagent surviving the merger as a wholly-owned subsidiary of the Company. On March 30, 2005, pursuant to the filing of an Amended and Restated Agreement and Plan of Merger, the Company's merger with Entelagent became effective.

In connection with the Entelagent Merger, the Company issued 100,000 shares of the Company's common stock in exchange for all of the outstanding shares of the capital stock of Entelagent. In addition, pursuant to the terms of the Amended and Restated Supplemental Agreement, the Company also agreed to (i) issue to certain officers, directors, stockholders and creditors of Entelagent, in consideration of amounts owed by Entelagent to such parties, promissory notes in the aggregate principal amount of \$2,640,000, with interest payable thereon at a rate of 8% per annum and maturing one year after the completion of the merger and (ii) pay and satisfy \$1,388,000 in outstanding liabilities of Entelagent. The Company placed \$1,388,000 of the proceeds it received from the Interim Bridge Financing I financing transaction completed on February 28, 2005 in a reserve account established to assist the Company in the payment of such liabilities.

### BUSINESS COMBINATION ACCOUNTING

The Company accounted for its acquisitions of CSSI, LucidLine and Entelagent using the purchase method of accounting prescribed under SFAS 141 "Business Combinations."

The following table provides a breakdown of the purchase price including the fair value of purchase consideration issued to the sellers of the acquired business and direct transaction expenses incurred by the Company in connection with consummating these transactions:

| CSSI  | LUCIDLINE | ENTELAGENT | TOTAL |
|-------|-----------|------------|-------|
| ----- | -----     | -----      | ----- |

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|                               |              |              |              |              |
|-------------------------------|--------------|--------------|--------------|--------------|
| Cash .....                    | \$ --        | \$ 200,000   | \$ --        | \$ 200,000   |
| Common Stock .....            | 6,375,000    | 3,740,000    | 2,550,000    | 12,665,000   |
| Subordinated promissory notes | 4,500,000    | --           | --           | 4,500,000    |
| Common stock warrants .....   | 1,912,500    | --           | --           | 1,912,500    |
| Transaction expenses .....    | 398,128      | 154,611      | 359,894      | 912,633      |
|                               | -----        | -----        | -----        | -----        |
| Total Purchase Price .....    | \$13,185,628 | \$ 4,094,611 | \$ 2,909,894 | \$20,190,133 |
|                               | =====        | =====        | =====        | =====        |

The fair value of common stock issued to the sellers as purchase consideration was determined in accordance with the provisions of EITF 99-12 "Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination." The fair value of subordinated notes issued to the sellers as purchase consideration is considered to be equal to their principal amounts due to the short-term maturity of those instruments. The Company calculated the fair value of common stock purchase warrants issued to the sellers as purchase consideration using the Black-Scholes option-pricing model with the following assumptions: fair value of common stock \$25.50; risk-free interest rate of 3.55%; expected dividend yield of zero percent; expected warrant life of five years; and current volatility of 125%.

Transaction expenses, which include legal fees and transaction advisory services directly related to the acquisitions amount to \$912,633. Such fees include \$657,633 paid in cash and \$255,000 for the fair value of 300,000 common stock purchase warrants issued to Laidlaw & Company UK Ltd. ("Laidlaw") in its capacity as a transaction advisor.

PURCHASE PRICE ALLOCATION

Under business combination accounting, the total purchase price was allocated to CSSI's and LucidLine's net tangible and identifiable intangible assets based on their estimated fair values as of February 25, 2005. The total purchase price allocation for Entelagent's net tangible and identifiable intangible assets was based on their estimated fair values as of March 30, 2005. The allocation of the purchase price for these three acquisitions is set forth below. The excess of the purchase price over the net tangible and identifiable intangible assets was recorded as goodwill.

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|                                    | CSSI       | LUCIDLINE | ENTEAGENT   | TOTAL       |
|------------------------------------|------------|-----------|-------------|-------------|
|                                    | -----      | -----     | -----       | -----       |
| Fair value of tangible assets:     |            |           |             |             |
| Total current assets .....         | \$ 584,377 | \$ 34,825 | \$ 125,606  | \$ 744,808  |
| Total tangible assets .....        | 3,321,066  | 95,825    | 137,606     | 3,554,507   |
| Liabilities assumed:               |            |           |             |             |
| Total current liabilities .....    | (533,022)  | (861,505) | (7,063,459) | (8,457,986) |
| Total liabilities assumed .....    | (533,022)  | (963,965) | (7,408,789) | (8,905,776) |
|                                    | -----      | -----     | -----       | -----       |
| Net tangible assets acquired ..... | 2,788,044  | (868,140) | (7,271,183) | (5,351,279) |
| Value of excess allocated to:      |            |           |             |             |
| Developed technology .....         | 670,000    | --        | 1,900,000   | 2,570,000   |

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|                                     |               |              |              |           |
|-------------------------------------|---------------|--------------|--------------|-----------|
| Customer relationships .....        | 180,000       | --           | --           | 180       |
| Trademarks and tradenames .....     | 55,000        | --           | 106,000      | 161       |
| In-process research and development | 190,000       | --           | --           | 190       |
| Goodwill .....                      | 9,302,584     | 4,962,751    | 8,175,077    | 22,440    |
|                                     | -----         | -----        | -----        | -----     |
| Purchase Price .....                | \$ 13,185,628 | \$ 4,094,611 | \$ 2,909,894 | \$ 20,190 |
|                                     | =====         | =====        | =====        | =====     |

The purchase price allocation was based upon a valuation study performed by an independent outside appraisal firm. The Company, in formulating the allocation, considered its intention for future use of the acquired assets, analyses of the historical financial performance of each of the acquired businesses and estimates of future performance of each acquired businesses' products and services. The Company made certain adjustments during the year ended December 31, 2005 to its original purchase price allocation as a result of (a) having negotiated settlements of certain liabilities that it assumed in its business combination with Entelagent, (b) having completed the audits of the acquired businesses and (c) the reevaluation of the carrying amounts of certain accounts receivable balances recorded in purchase accounting.

### PROFORMA FINANCIAL INFORMATION

The unaudited financial information in the table below summarizes the combined results of operations of the Company and CSSI, LucidLine and Entelagent, on a proforma basis, as if the companies had been combined as of January 1, 2005.

The unaudited proforma financial information for the year ended December 31, 2005 combines the historical results for the Company for the year ended December 31, 2005 and the historical results for CSSI and LucidLine for the period from January 1, 2005 to February 24, 2005 and the historical results for Entelagent for the period from January 1, 2005 to March 30, 2005.

|   | 2005         |
|---|--------------|
|   | -----        |
| Total revenues .....  | \$ 800,710   |
| Net loss .....  | (46,152,799) |
| Weighted average shares outstanding on a proforma basis ..... | 2,034,098    |
| Proforma net loss per share, basic and diluted .....          | \$ (22.69)   |

The proforma financial information is presented for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisitions of these three companies had taken place at the beginning of each of the periods presented.

Additionally, the Company sold LucidLine in April 2006 for \$50,000 and discontinued the operations of the PolicyBridge software application business acquired from Entelagent Software Corp. in December 2006.

### NOTE 6 - IMPAIRMENT OF GOODWILL

The Company recorded \$22,440,412 of goodwill in connection with its acquisitions of CSSI, LucidLine and Entelagent (Note 5). The amount of goodwill that the Company recorded in connection with these acquisitions was determined by comparing the aggregate amounts of the respective purchase prices plus related

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transaction costs to the fair values of the net tangible and identifiable intangible assets acquired for each of the businesses described in Note 5.

The Company performed its annual impairment test of goodwill at its designated valuation date of December 31, 2005 in accordance with SFAS 142. As a result of these tests, the Company determined that the recoverable amount of goodwill with respect to its business amounted to \$9,510,716. Accordingly, the Company recorded a goodwill impairment charge in the amount of \$12,929,696 for the year ended December 31, 2005. The valuation was performed by an outside specialist using a weighted average discounted cash flows modeling approach.

The Company performed its annual impairment test of goodwill at its designated valuation date of December 31, 2006 in accordance with SFAS 142. As a result of these tests, the Company determined that the recoverable amount of goodwill with respect to its business amounted to \$9,300,000. Accordingly, the Company recorded a goodwill impairment charge in the amount of \$210,716 for the year ended December 31, 2006.

The valuation was performed by an outside specialist using a weighted average discounted cash flows modeling approach. Making estimates about the carrying value of goodwill requires management to exercise significant judgment. It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements, which management considered in formulating its estimate could change in the near term due to one or more future confirming events. Accordingly, the actual results regarding estimates of the carrying value of these intangibles could differ materially from the Company's estimates.

### NOTE 7 - PROPERTY AND EQUIPMENT

|                                | USEFUL LIFE  | DECEMBER 31,<br>2006 |
|--------------------------------|--------------|----------------------|
|                                | -----        | -----                |
| Computers                      | 2 to 3 years | \$ 239,029           |
| Furniture and fixtures         | 3 to 5 years | 31,962               |
| Leasehold improvements         | 5 years      | 4,490                |
|                                |              | -----                |
| sub-total                      |              | 275,481              |
| less: accumulated depreciation |              | (100,690)            |
|                                |              | -----                |
| Property and equipment, net    |              | \$ 174,791           |
|                                |              | =====                |

Depreciation expense amounted to \$70,375 and \$38,993 for the years ended December 31, 2006 and 2005, respectively.

### NOTE 8 - CAPITALIZED SOFTWARE

In December 2006, the Company made the decision to focus its business on its FormStream software products and to place its PolicyBridge business up for sale. Because of this decision, \$596,636 of capitalized software identified with the PolicyBridge business have been expensed as a loss from discontinued operations in the year ended December 31, 2006.

Capitalized software development costs are as follows:

|                             |    |          |
|-----------------------------|----|----------|
| Beginning of the year ..... | \$ | 172,130  |
| Capitalized .....           |    | 281,372  |
| Amortization .....          |    | (38,942) |



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Balance at December 31, 2006

-----  
\$ 414,560  
=====

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The Company classifies amortization of developed technology as a component of cost of sales. Amortization expense amounted to \$97,693 and \$192,300 for the years ended December 31, 2006 and 2005, respectively.

AMORTIZATION OF CAPITALIZED SOFTWARE

The amortization of capitalized software will result in the following additional expense by year:

| YEARS ENDED DECEMBER 31: | SOFTWARE<br>AMORTIZATION |
|--------------------------|--------------------------|
| -----                    | -----                    |
| 2007                     | \$ 79,877                |
| 2008                     | 97,035                   |
| 2009                     | 97,035                   |
| 2010                     | 65,365                   |
| 2011                     | 58,092                   |
| 2012                     | 17,156                   |
|                          | -----                    |
|                          | \$ 414,560               |
|                          | =====                    |

NOTE 9 - AMORTIZABLE INTANGIBLE ASSETS

In December 2006, the Company made the decision to focus its business on its FormStream software products and to place its PolicyBridge business up for sale. Because of this decision, \$61,834 of intangible assets identified with the PolicyBridge business have been expensed as a loss from discontinued operations in the year ended December 31, 2006.

The Company performed an analysis for the recoverability of its amortizable intangible assets used in its continuing operations in accordance with SFAS 144. The Company performed this analysis by estimating the future cash flows expected to result from the use of these assets, which principally include software products. Since the estimated undiscounted cash flows were greater than the carrying value of the related assets, it was determined that no impairment charge should be recognized.

The components of intangible assets as of December 31, 2006 are set forth in the following table:

|  | DECEMBER 31,<br>2006 |
|--|----------------------|
|  | -----                |
| Customer relationships .....             | \$ 180,000           |
| Trademarks and tradenames .....          | 55,000               |
|  | -----                |
|  | 235,000              |
| less: accumulated amortization .....     | (107,710)            |
|  | -----                |
| Amortizable intangible assets, net ..... | \$ 127,290           |
|  | =====                |

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### AMORTIZATION OF INTANGIBLE ASSETS

The amortization of intangible assets will result in the following additional expense by year:

| YEARS ENDED DECEMBER 31: | INTANGIBLE<br>AMORTIZATION |
|--------------------------|----------------------------|
| 2007                     | \$ 58,750                  |
| 2008                     | 58,750                     |
| 2009                     | 9,790                      |
|                          | \$ 127,290                 |
|                          | =====                      |

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### NOTE 10 - ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

Accrued expenses and other current liabilities consist of the following:

|  | DECEMBER 31,<br>2006 |
|--|----------------------|
| Payroll and payroll related expenses .....         | \$ 582,224           |
| Accrued interest .....                             | 629,331              |
| Reserve for preacquisition tax contingencies ..... | 336,828              |
| Other current liabilities .....                    | 210,049              |
| Accrued registration penalty .....                 | 90,488               |
| Expense reimbursement payable .....                | 9,958                |
|  | \$ 1,858,878         |
|  | =====                |

### NOTE 11 - DEMAND NOTES PAYABLE

Through December 31, 2004, the Company borrowed an aggregate amount of \$695,000 from several unrelated parties. At December 31, 2006, all of the notes were settled in the creditor and claimant liabilities restructuring. Interest expense on the notes amounted to \$22,462 and \$69,500 for the year ended December 31, 2006 and 2005, respectively.

The remaining demand note at December 31, 2006, which amounts to \$312,557, is payable to Lok Technology and is secured by Entelagent's accounts receivable. Accounts receivable of former Entelagent customers amounted to \$43,430 at December 31, 2006 and is included in Assets of Discontinued Operations. The note bears interest at 15% per annum. Interest on this demand note amounted to \$46,884 for the year ended December 31, 2006 and \$35,163 for year ended December 31, 2005. As described in Note 17, on May 4, 2006, the Company became aware of a complaint that Lok Technologies, Inc. had filed in the Superior Court of California, County of Santa Clara on or about March 30, 2006 against the Company, Entelagent Software Corp. and unnamed defendants.

### NOTE 12 - BRIDGE NOTES PAYABLE

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### INTERIM BRIDGE FINANCING I

On February 28, 2005, the Company completed a \$3,500,000 financing (the "Interim Bridge Financing I") through the issuance of 10% Senior Convertible Promissory Notes (the "Bridge I Notes") and warrants to purchase up to 58,348 shares of the Company's common stock ("Bridge I Warrants"). The warrants have a term of 5 years and an exercise price of \$1.62 per share. The aggregate fair value of the Bridge I Warrants amounts to \$1,487,500. Prior to final maturity, the Bridge I Notes would have been convertible into securities that would be issuable at the first closing of a subsequent financing by the Company, for such number of offered securities that could be purchased for the principal amount being converted. The Company did not complete a financing transaction prior to the final maturity date of these notes. The Bridge I Notes had an initial term of 120 days (due on June 28, 2005) with interest at a contractual rate of 10% per annum and featured an option for the Company to extend the term for an additional 60 days to August 27, 2005.

In accordance with APB 14, "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants," the Company allocated \$2,456,140 of the proceeds to the Bridge I Notes and \$1,043,860 of proceeds to the Bridge I Warrants. The difference between the carrying amount of the Bridge I Notes and their contractual redemption amount was accreted as interest expense to June 28, 2005, their earliest date of redemption.

On June 28, 2005, the Company elected to extend the contractual maturity date of the Bridge I Notes for an additional 60 days to August 27, 2005, which caused the contractual interest rate to increase to 12% per annum. In addition, the Company was required to issue the 58,348 additional warrants (the "Bridge I Extension Warrants") to purchase such number of shares of common stock equal to 1/60 of a share for each \$1.00 of principal amount outstanding. The Bridge I Extension Warrants have a term of 5 years and an exercise price of \$1.62 per share. The Bridge I Extension Warrants have a fair value of \$822,500. Assumptions relating to the estimated fair value of these

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warrants are as follows: fair value of common stock of \$19.50; risk-free interest rate of 4.25%; expected dividend yield zero percent; expected warrant life of three years; and current volatility of 125%.

The Company did not redeem the Bridge I Notes on August 27, 2005 and, as a result, the notes automatically became convertible into 0.128 shares of common stock for each \$1 of principal then outstanding in accordance with the original note agreement. The Bridge I Notes remained outstanding subsequent to the date of their maturity but were ultimately surrendered as payment for Series A-1 Preferred stock as described below. Accordingly, the Company recorded a charge of \$3,500,000 in 2005 based upon the intrinsic value of this conversion option measured at the original issuance date of the note in accordance with EITF 00-27, which is included in interest in the accompanying statement of operations for the year ended December 31, 2005.

Contractual interest expense on the Bridge I Notes amounted to \$133,238 and \$326,164 for the year ended December 31, 2006 and 2005, respectively, and is included as a component of interest expense in the accompanying statement of operations.

As of December 31, 2006, \$3,180,025 of the Bridge I Notes were surrendered as payment for 3,975,031 shares of Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 18). With the surrender of

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the Bridge I Notes in payment for Series A-1 Preferred stock under the creditor and claimant liabilities restructuring, conversion options associated with the surrendered Bridge I Notes are no longer exercisable and have been cancelled. As of December 31, 2006, \$319,975 of Bridge I notes remain outstanding.

### INTERIM BRIDGE FINANCING II

On June 6, 2005, the Company completed a \$2,543,000 financing (the "Interim Bridge Financing II") through the issuance of (i) 10% Junior Convertible Promissory Notes (the "Bridge II Notes") and (ii) warrants to purchase up to 42,388 shares of common stock (the "Bridge II Warrants"). The warrants have a term of 5 years and an exercise price of \$1.74 per share. The aggregate fair value of the Bridge II Warrants amounts to \$673,895. Prior to maturity, the Junior Convertible Promissory Notes would have been convertible into the securities offered by the Company at the first closing of a subsequent financing for the Company, for such number of offered securities as could be purchased for the principal amount being converted. The Company did not complete a financing transaction prior to the final maturity date of the notes. The Bridge II Notes had an initial term of 120 days (due on October 4, 2005) with interest at 10% per annum and featured an option for the Company to extend the term for an additional 60 days to December 2, 2005.

In accordance with APB 14, the Company allocated \$2,010,277 of the proceeds to the Bridge II Notes and \$532,723 of proceeds to the Bridge II Warrants. The difference between the carrying amount of the Bridge II Notes and their contractual redemption amount is being accreted as interest expense to October 3, 2005, their earliest date of redemption.

On October 4, 2005, the Company elected to extend the maturity date of the Bridge II Notes for an additional 60 days to December 2, 2005 which caused the contractual interest rate would increase to 12% per annum. In addition, the Company was required to issue 42,388 additional warrants (the "Bridge II Extension Warrants"). The Bridge II Extension Warrants, feature a term of 5 years and an exercise price of \$1.74 per share. The Bridge II Extension Warrants have a fair value of \$65,388. Assumptions relating to the estimated fair value of these warrants are as follows: fair value of common stock \$2.40; risk-free interest rate of 3.10%; expected dividend yield zero percent; expected warrant life of five years; and current volatility of 125%.

The Company did not redeem the Bridge II Notes on December 2, 2005 and, as a result, the notes automatically became convertible into 0.128 shares of common stock for each \$1 of principal then outstanding in accordance with the original note agreement. The Bridge II Notes remained outstanding subsequent to the date of their maturity but were ultimately surrendered as payment for Series A-1 Preferred stock as described below. Accordingly, the Company recorded a charge of \$2,543,000 based upon the intrinsic value of this conversion option measured at the original issuance date of the note in accordance with EITF 00-27, which is included in interest in the accompanying statement of operations for the year ended December 31, 2005.

Contractual interest expense on the Bridge II Notes amounted to \$123,244 and \$171,434 for the year ended December 31, 2006 and 2005, respectively and is included as a component of interest expense in the accompanying statement of operations.

As of December 31, 2006, \$2,343,000 of the Bridge II Notes were surrendered as payment for 2,928,750 shares of Series A-1 Preferred stock as part of the

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creditor and claimant liabilities restructuring (Note 18). With the surrender of the Bridge II Notes in payment for Series A-1 Preferred stock under the creditor and claimant liabilities restructuring, the conversion options associated with the surrendered Bridge II Notes are no longer exercisable and have been cancelled. As of December 31, 2006, \$200,000 of the Bridge II Notes remain outstanding.

### INTERIM BRIDGE FINANCING III

Beginning on July 1, 2005, and continuing through December 31, 2005, the Company completed, through 12 separate fundings, a \$5,234,000 financing (the "Interim Bridge Financing III") through the issuance of (i) 10% Junior Convertible Promissory Notes (the "Bridge III Notes") and (ii) warrants to purchase up to 87,235 shares of common stock (the "Bridge III Warrants"). The warrants have a term of 5 years and an exercise price of \$1.74 per share. Prior to maturity, the Junior Convertible Promissory Notes would have been convertible into the securities offered by the Company at the first closing of a subsequent financing for the Company, for such number of offered securities as could be purchased for the principal amount being converted. The Company did not complete a financing transaction prior to the final maturity date of the notes.

In accordance with APB 14, the Company allocated \$4,646,405 of the proceeds to the Bridge III Notes and \$587,595 of proceeds to the Bridge III Warrants. The difference between the carrying amount of the Bridge III Notes and their contractual redemption amount was being accreted as interest expense to various dates from November 1, 2005, their earliest date of redemption. Accretion of the aforementioned discount amounted to \$20,909 and \$566,686 for the years ended December 31, 2006 and 2005, respectively and are included as a component of interest expense in the accompanying statements of operations.

The Bridge III Notes had an initial term of 120 days (due on various dates beginning October 28, 2005) with interest at 10% per annum and feature an option for the Company to extend the term for an additional 60 days to various dates beginning December 28, 2005. Upon the extension of the maturity date of the Bridge III Notes, the contractual interest rate increased to 12% per annum, and the Company was required to issue warrants (the "Bridge III Extension Warrants") to purchase such number of shares of the Company's common stock equal to 1/60th of a share for each \$1.00 of principal then outstanding. The Bridge III Extension Warrants, issued upon extension of the maturity date of the Junior Convertible Promissory Notes, feature a term of 5 years and an exercise price of \$1.74 per share. In addition, any Bridge III Notes not paid in full on or before their extended maturity date, become automatically convertible into 0.128 shares of the Company's common stock for each \$1.00 of principal then outstanding.

Beginning on October 29, 2005, the Company elected to extend the contractual maturity date of \$2,400,000 of Bridge III Notes for an additional 60 days to various dates beginning December 28, 2005, which caused the contractual interest rate to increase to 12% per annum. Accordingly, the Company was required to issue 40,000 additional warrants with a fair value of \$67,537 during the year ended December 31, 2005 and an additional 39,917 warrants (together, the Bridge III Extension Warrants") with a fair value of \$48,149 during the year ended December 31, 2006. The Bridge III Extension Warrants have a term of five years and an exercise price of \$1.74 per share. Assumptions relating to the estimated fair value of these warrants are as follows: fair value of common stock \$1.95 to \$2.40; risk-free interest rate of 3.10% to 3.44%; expected dividend yield zero percent; expected warrant life of three years; and current volatility of 125%.

The aggregate fair value of the warrants was recorded as interest expense in the accompanying statement of operations for the year ended December 31, 2006. The fair value of the Bridge III Extension Warrants was amortized over the respective 60 day extension periods. Amortization of the aforementioned values amount to \$59,106 and \$56,860 for the years ended December 31, 2005 and December

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31, 2006, respectively and is included as a component of interest expense in the accompanying statements of operations.

During the year ended December 31, 2005, the Company did not redeem \$1,850,000 of Bridge III Notes with contractual maturity dates occurring through December 31, 2005. As a result, these notes became automatically convertible into 0.128 shares of common stock for each \$1 of principal then outstanding in accordance with the original note agreement. These Bridge III Notes remained outstanding subsequent to the date of their maturity but were ultimately surrendered as payment for Series A-1 Preferred Stock as described below. Accordingly, the Company recorded a charge of \$1,850,000 during the year ended December 31, 2005 based upon the intrinsic value of this conversion option measured at the original issuance date of the notes in accordance with EITF 00-27. The charge was recorded as interest expense in the accompanying statement of operations for the year ended December 31, 2005.

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The Company also did not redeem \$550,000 of Bridge III Notes with contractual maturity dates that occurred through March 27, 2006. As a result, these Bridge III Notes became automatically convertible into 0.128 shares of common stock for each \$1 of principal then outstanding in accordance with the original note agreement. These Bridge III Notes remained outstanding subsequent to the date of their maturity but were surrendered as payment for Series A-1 Preferred stock as described below. Accordingly, the Company recorded a charge of \$192,000, in the three months ended March 31, 2006, based upon the intrinsic value of this conversion option measured at the original issuance date of the notes in accordance with EITF 00-27. The charge was recorded as interest expense in the accompanying statement of operations for the year ended December 31, 2006.

As of December 31, 2006, all of the Bridge III Notes were surrendered as payment for 6,542,500 shares of Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 18).

Contractual interest expense on the Bridge III Notes amounted to \$153,036 and \$172,816 for the years ended December 31, 2006 and 2005, respectively, and is included as a component of interest expense in the accompanying statement of operations.

The Company sold these securities to Apex, Northwestern, and Advanced Equities. Funding for the Bridge III Notes included the conversion of \$1,650,000 of stockholder advances made during the period March 30, 2005 to June 30, 2005 into Bridge III Notes.

### 2006 BRIDGE NOTES

On January 18, 2006, the Company completed a financing of approximately \$540,000 in additional gross funds (the "2006 Bridge Note Financing") through the issuance of Subordinated Convertible Promissory Notes (the "2006 Bridge Notes") in the amount of \$720,001. The 2006 Bridge Note agreement provided for these notes to automatically convert into the same securities (consisting of shares of Series A Preferred Stock and warrants to purchase shares of the Company's common stock) offered by the Company in connection with its Series A Preferred Financing (Note 18). On March 27, 2006 (the date of the first closing of the Series A Preferred Financing), the 2006 Bridge Notes were converted into 7.2 Units in the Series A Preferred Financing described below. The \$180,000 difference between the gross proceeds received upon the original issuance of the notes and the redemption amount was recorded as interest expense during the year ended December 31, 2006.

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Additionally, the Company paid Laidlaw & Company (UK) Ltd. (Laidlaw), as placement agent in the transaction, a fee of \$54,000 in conjunction with the 2006 Bridge Note Financing. This fee was fully amortized and recognized as interest expense during the year ended December 31, 2006.

### INTERIM BRIDGE FINANCING IV

Beginning on July 18, 2006 and continuing through September 15, 2006, the Company obtained interim financing ("Interim Bridge Financing IV") totaling \$1,000,000 from Apex. This Interim Bridge Financing IV automatically converted into securities (consisting of shares of Series B Preferred Stock and warrants to purchase shares of the Company's common stock) offered by the Company in connection with its Series B Preferred Financing (see Note 19). On October 13, 2006, (the date of the first closing of the Series B Preferred Financing), the Interim Bridge Financing IV was converted into 10 Units in the Series B Preferred Financing described in Note 19 below.

### NOTE 13 - RELATED PARTY TRANSACTIONS

#### LIABILITIES DUE TO FORMER CHAIRMAN AND OFFICERS/STOCKHOLDERS

The Company's former non-executive chairman surrendered \$254,152 of liabilities due to him by the Company for expense reimbursements and other working capital advances made to the Company as payment for Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 18).

A former officer of the Company surrendered \$1,180,991 of liabilities due for expense reimbursements, payroll and various other loans and advances made to the Company as payment for Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 18). A portion of these liabilities were previously classified as notes payable to creditors of acquired business.

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#### CONSULTING AGREEMENT PAYABLE

On June 8, 2005, the Company negotiated a settlement regarding a consulting agreement payable with a related party. The terms of the settlement agreement terminated the prior agreement and reduced the remaining payments due under the contract to \$150,000 including a \$50,000 payment that was made upon the execution of the agreement and two additional \$50,000 payments including one to be made upon the completion of a follow-on-financing by the Company and one not later than September 30, 2005. The \$150,000 reduction in payments was recorded as a reduction of general and administrative expense during the year ended December 31, 2005. Additionally, the settlement agreement terminated an obligation for the Company to issue 3,334 shares of unrestricted stock. The stock issuable under this commitment was recorded in 2004 as common stock issued in lieu of cash for services in the amount of \$78,900. The rescission of the stock issuable under this arrangement resulted in an additional reduction of \$78,900 in general and administrative expenses during the year ended December, 31, 2005.

The payment due on September 30, 2005 was not made by the Company. The \$100,000 balance due under this arrangement has been surrendered as payment for Series A-1 Preferred stock under the creditor and claimant liabilities restructuring described in Note 18.

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### NOTES PAYABLE (TO CREDITORS OF ACQUIRED BUSINESS)

The notes issued to creditors of Entelagent (in connection with the acquisition described in Note 5) include \$554,202 that is payable to related parties for settlements of accrued payroll, notes payable and other payables that remain outstanding at December 31, 2006. The original amount of these notes amounted to \$2,602,913. Aggregate interest expense on these notes amounted to \$90,184 and \$155,959 for the years ended December 31, 2006 and 2005, respectively.

During the year ended December 31, 2006, \$1,795,930 of the notes payable to creditors of acquired business were surrendered as payment for Series A-1 Preferred stock under the creditor and claimant liabilities restructuring (Note 18). As of December 31, 2006, \$799,982 of the notes payable remain outstanding.

### NOTE 14 - DEFERRED REVENUE

Deferred revenue at December 31, 2006 includes (1) \$59,674 for the fair value of remaining service obligations on maintenance and support contracts and (2) \$104,621 for contracts on which the revenue recognition is deferred until contract deliverables have been completed.

### NOTE 15 - SETTLEMENT WITH PATRICK J. ALLIN, FORMER CHIEF EXECUTIVE OFFICER

On June 6, 2005, the Company entered into a settlement of certain employment and indemnification related claims brought by Patrick J. Allin, ("Mr. Allin") the Company's former Chief Executive Officer and former member of its Board of Directors, against the Company during the year ended December 31, 2004. The Settlement Agreement and Mutual Release dated June 2, 2005, among the Company, Mr. Allin and The Allin Dynastic Trust, called for the Company to pay to Mr. Allin, in settlement of all claims, an aggregate payment of \$1,150,000 payable in an initial installment upon execution of the Settlement Agreement and Mutual Release and (ii) \$950,000 payable in cash and/or a promissory note upon the consummation of a follow-on-financing by the Company. The Company accrued an aggregate of \$933,493 in amounts repayable to Mr. Allin up through the date of his termination in February 2004. The difference between the amounts accrued and the cash settlement, which difference amounts to \$216,507, was recorded in general and administrative expense in the quarter ended March 31, 2004. The amount payable to Mr. Allin under this provision of the settlement, totaling \$1,130,022, was presented net of the \$200,000 payment that was made upon the execution of the agreement and includes \$48,522 of interest and \$130,500 of penalties accrued during the year ended December 31, 2005.

Pursuant to the Settlement Agreement and Mutual Release, the Company also agreed to purchase from Mr. Allin and The Allin Dynastic Trust an aggregate of 133,334 shares of the Company's common stock as follows: (i) 66,667 shares (the "Initial Shares") through the issuance of 8% promissory notes in the aggregate principal amount of One Million Six Hundred Thousand Dollars (\$1,600,000) and (ii) 66,667 shares (the "Remainder Shares") through a cash payment from the proceeds of a follow-on-financing by the Company, at a price per share equal to the lesser of (a) \$15.00 per share or (b) 90% of the issue price or conversion price, as the case may be, of the security issued in a

follow-on-financing, provided however that in the event that 90% of the issue price or conversion price, as the case may be, of the security issued in the follow-on-financing is less than \$15.00 per share, Mr. Allin and/or The Allin



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Dynastic Trust may, at their option, decline to sell any or all of the Remainder Shares to the Company.

As of December 31, 2005, the fair value of the Company's common stock was \$1.50 per share, which resulted in a reduction of the charge for the intrinsic value of the put right associated with the Remainder Shares granted on June 6, 2005 to \$0. Such reduction is presented as a change in the intrinsic value of put right in the accompanying statement of operations for the year ended December 31, 2005.

Effective January 1, 2006, the Company and Mr. Allin and the Allin Dynastic Trust entered into Stock Subscription Agreement and Mutual Release agreements (the "Series A-1 Agreements") to settle all claims under the creditor and claimant liabilities restructuring (Note 18). The settlement resulted in the release of all claims and the reversal of \$2,600,000 of obligations to purchase common stock from Mr. Allin and the Allin Dynastic Trust. These liabilities were reclassified to stockholders' equity since Mr. Allin and the Allin Dynastic Trust retained the shares that were subject to the Company's repurchase obligation. In addition, the Company issued an aggregate of 2,500,000 Shares of Series A-1 Preferred stock with a fair value of \$1,500,000 to Mr. Allin and the Allin Dynastic Trust in settlement of \$1,317,089 of liabilities that were payable in cash. Accordingly, the Company recorded a \$182,911 loss on this settlement based on the difference between the fair value of the Series A-1 Preferred shares and the liabilities payable in cash.

### NOTE 16 - ACCOMMODATION AGREEMENT

In November 2002, the Company entered into a financing arrangement with a third party financial institution (the "Lender"), pursuant to which the Company would borrow \$950,000 under a note to be collateralized by the pledge of 31,667 shares of registered stock from five different stockholders. In connection with this arrangement, the Company executed a series of Accommodation Agreements with these stockholders wherein each stockholder pledged their shares in return for the right to the return of the pledged shares, or replacement shares in the event of foreclosure, and one additional share of common stock for every four shares pledged as compensation. The Company received approximately \$450,000 of proceeds under the note and provided the Lender the pledged shares. No additional proceeds were provided by the Lender. The Company accounted for the Lender's failure to fund the facility and return the pledged shares as a foreclosure on the loan collateral and recorded a \$1,047,728 loss during the year ended December 31, 2002. In 2003, the Company issued 40,000 replacement shares to the five stockholders for which the Company recorded an additional loss of \$2,210,272 during the year ended December 31, 2003 for the difference between the loss the Company recorded upon the Lender's foreclosure of the collateral and the aggregate fair value of the replacement shares.

The Accommodation Agreements provided for the Company to pay a penalty in the event of its failure to cause the replacement shares to be registered on or before March 31, 2003. As a result, the Company recorded stock based penalties for the fair value of 15,000 shares per quarter through December 31, 2005. The total stock-based penalties associated with the Accommodation Agreements from April 2003 to December 31, 2005 amounted to \$3,318,975. An aggregate of 165,000 shares were issuable through December 31, 2005 under the stock-based penalties associated with the Accommodation Agreements.

Additionally, the accommodating stockholders had filed, in October 2005, a complaint against the Company in the Circuit Court of the Fifteenth Judicial Circuit in and for Palm Beach County, Florida, alleging breach of certain accommodation agreements between the plaintiffs and the Company and were seeking damages in an amount not less than \$14,000,000, plus interest and reasonable attorneys' fees and costs. In November 2005, a default judgment was entered

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against the Company in this matter. On March 27, 2006, the Company entered into an agreement to release and resolve all outstanding claims between itself and the accommodating stockholders as part of the creditor and claimant liabilities restructuring (Note 18).

Under the terms of the settlement agreement, the Company issued 3,000,000 shares of its Series A-1 Preferred stock to the accommodating stockholders, plus \$125,090 in cash for legal fees, in lieu of the 165,000 shares of common stock that were issuable to the stockholders under the penalty agreement. The Company recorded a \$2,228,090 loss reserve at December 31, 2005 with respect to this settlement, which represents the difference between \$2,400,000 for the fair value of 3,000,000 Series A-1 shares issued in the settlement plus \$125,090 in cash less the settlement date fair of the common stock that was issuable under the penalty arrangement. The Company reclassified the \$2,400,000 liability payable in stock to stockholders equity upon the issuance of the Series A-1 shares on March 27, 2006.

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### STOCK PLEDGE ARRANGEMENT

In April 2004, a stockholder of the Company entered into a one-year stock loan financing arrangement ("Stock Financing Facility") with a third party financial institution (the "Lender I"), pursuant to which such stockholder committed to obtain financing for the Company under a credit facility collateralized by the pledge of 22,834 shares of registered stock (the "Pledged Stock") that was pledged by a second stockholder (the "Pledging Stockholder"). In connection with this arrangement, the Company executed an accommodation agreement with the Pledging Stockholder committing to issue 22,834 shares of restricted stock (the "Replacement Stock") on April 2, 2005 (the "Termination Date") in the event of a loss of the Pledged Stock, plus a premium of 6,850 shares (the "Premium Shares") for entering into the agreement. The Company also agreed to register 10,000 shares of restricted stock held by the Pledging Stockholder (the "Held Stock") within thirty days of the agreement and to use its best efforts to register with the SEC, both the Replacement Stock and Premium Stock within 12 months from their date of issue.

The Company received \$40,012 of funds but was unable to recover the Pledged Stock on the Termination Date. In addition, due to a delay in registering all of the shares under this arrangement, the Company entered into a secondary agreement with the Pledging Stockholder providing for: (1) the immediate issuance of the Replacement Shares and Premium Shares; (2) registration of the Replacement Shares, Premium Shares and Held Stock; (3) the retroactive accrual of a penalty from May 2, 2004 through the date the registration statement is filed payable in such number of shares that is equal to 15% of the Held Stock (prorated for each fraction of a year); and (4) the accrual of an additional penalty from April 2, 2005 through the date the registration statement is filed equal to 15% of the Replacement Stock and Premium Stock (prorated for each fraction of a year).

The Company recorded a charge of \$406,205 for the fair value of the Replacement Stock and Premium Stock (29,684 shares) issued to the Pledging Stockholder under this arrangement. Such charge, net of \$40,012 of advances received, is presented as a loss on collateralized financing arrangement in the accompanying statement of operations. The Company also recorded charges of \$8,560 and \$81,928 during the year ended December 31, 2006 and 2005, respectively for the fair value of 4,452 and 4,353 shares issuable during the year ended December 31, 2006 and 2005, respectively to the Pledging Stockholder as penalties for the delays in registering the stock. The charges associated with the penalties are included in

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stock based penalties under loss on collateralized financing arrangement in the accompanying statements of operations.

### NOTE 17 - COMMITMENTS AND CONTINGENCIES

#### LEGAL PROCEEDINGS

Effective January 1, 2006, the Company and Mr. Allin, former Company Chief Executive Officer, and the Allin Dynastic Trust entered into Stock Subscription Agreement and Mutual Release agreements (the "Series A-1 Agreements") to settle all claims, including claims related to the settlement agreement entered into in 2005 which settled certain employment and indemnification related claims brought against the Company in 2004, under the creditor and claimant liabilities restructuring (Note 18). The settlement resulted in the release of all claims and the reversal of \$2,600,000 of obligations to purchase common stock from Mr. Allin and the Allin Dynastic Trust. These liabilities were reclassified to stockholders' equity since Mr. Allin and the Allin Dynastic Trust retained the shares that were subject to the Company's repurchase obligation. In addition, the Company issued an aggregate of 2,500,000 Shares of Series A-1 Preferred stock with a fair value of \$1,500,000 to Mr. Allin and the Allin Dynastic Trust in settlement of \$1,317,089 of liabilities that were payable in cash. Accordingly, the Company recorded a \$182,911 loss on this settlement based on the difference between the fair value of the Series A-1 Preferred shares and the liabilities payable in cash.

Sherleigh Associates Inc. Profit Sharing Plan ("Sherleigh") filed a complaint against the Company, Mr. Allin, former Chief Executive Officer of the Company, and Robert E. Yaw, the Company's non-executive Chairman, on February 3, 2004, in the United States District Court for the Southern District of New York (the "Court") alleging common law fraud. On April 24, 2006, the Company and Sherleigh Associates Inc. Profit Sharing Plan entered into a final and binding settlement of all claims as part of the creditor and claimant liabilities restructuring (Note 18).

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On January 5, 2006, Mark P. Gertz, Trustee in bankruptcy for Arter & Hadden, LLP, filed an Adversary Complaint for Recovery of Assets of the Estate in the United States Bankruptcy Court Northern District of Ohio Eastern Division, against the Company as successor in merger to Entelagent. Mr. Gertz seeks \$32,278 plus interest accruing at the statutory rate since July 15, 2003 for services rendered by Arter & Hadden, LLP to Entelagent. On September 11, 2006, the Company entered into a settlement and release agreement with Mark P. Gertz, Trustee in bankruptcy for Arter & Hadden, LLP which calls for the payment of \$32,500 in 13 installments of \$2,500.

On May 4, 2006, Patron became aware that Lok Technologies, Inc. had filed a complaint on or about March 30, 2006 against the Company, Entelagent Software Corp. and unnamed defendants in the Superior Court of California, County of Santa Clara alleging breach of contract, breach of duty of good faith and fair dealing and unjust enrichment and seeking damages, interest, disgorgement of any unjust enrichment, attorneys fees and cost. Prior to receipt of this notice of litigation, the Company had recorded a note payable of approximately \$320,000 plus accrued interest of \$159,432. The trial date is currently set for June 2007. The Company believes that it has defenses to these claims. The Company cannot provide any assurance that the ultimate settlement of this claim will not have a material adverse affect on its financial condition.

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The Company, from time to time, is involved in disputes arising in the ordinary course of its business. The Company does not believe that any such disputes are likely to have any material impact on the Company's financial position and results of operations.

The Company was previously subject to an investigation by the SEC. On February 1, 2007, the Securities and Exchange Commission issued a letter to the Company indicating that the SEC's investigation of the Company has been terminated and that no enforcement action has been recommended to the Commission.

### LEASE AGREEMENT

On August 24, 2005, the Company entered into an office lease agreement for 4,876 square feet of space for its office in Boulder, Colorado. The lease commences on October 1, 2005 and has a term of fifty-four months including a six-month lease abatement. The minimum rental payments, beginning April 2006, amount to \$4,063 per month. In addition, the Company was required to make a \$19,995 security deposit at the inception of the lease.

Future minimum rental payments, excluding the Company pro-rata share of maintenance and operating charges under this arrangement are as follows:

| For the year ended December 31, |            |
|---------------------------------|------------|
| -----                           |            |
| 2007                            | \$ 48,760  |
| 2008                            | 48,760     |
| 2009                            | 48,760     |
| 2010                            | 12,190     |
|                                 | -----      |
| Total                           | \$ 158,470 |
|                                 | =====      |

### BRADEN WAVERLEY, CHIEF EXECUTIVE OFFICER - EMPLOYMENT AGREEMENT

On February 17, 2006, the Company entered into an employment agreement (the "Waverley Agreement") with Braden Waverley ("Waverley"), to serve as the Company's Chief Operating Officer. Mr. Waverley became the Company's Chief Executive Officer on January 18, 2007 and the terms of the Waverley Agreement remain in force. The term of the Waverley Agreement is one year with automatic one-year renewal unless Mr. Waverley is provided with written notice of non-renewal 90 days prior to expiration of the current term of the Waverley Agreement. The Waverley Agreement provides for a base salary of \$200,000 per year. The Waverley Agreement provides for a performance bonus determined in accordance with revenue milestones established by the Board of Directors on a quarterly basis. Mr. Waverley is eligible to receive a bonus of up to 75% of base salary for each quarter that the Company achieves the agreed upon revenue milestones. The bonus milestones were not met during the year ended December 31, 2006. Additionally, the Waverley Agreement provides for the grant of stock options in an amount representing an aggregate 3.5% of the outstanding shares of Company common stock on the date of grant ("Waverley Initial Grant"). The Waverley Initial Grant is for 73,371 shares at an exercise price of \$1.65 per share. These options have a term of 10 years and vest 20% on the date of grant and 1/48th of the balance on the last day of each month for the next 48 months following the effective date of this agreement (Note 20).

### BRETT NEWBOLD, PRESIDENT AND CHIEF TECHNOLOGY OFFICER - EMPLOYMENT AGREEMENT

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On February 28, 2005, the Company entered into an employment agreement with Brett Newbold ("Mr. Newbold") in connection with Mr. Newbold's employment for a one-year term, subject to automatic renewal, commencing on February 28, 2005, as President and Chief Technology Officer. Mr. Newbold will receive a minimum annual base salary of \$190,000 during each fiscal year of the agreement, subject to adjustment on an annual basis by the Board. In the event that his employment is terminated, Mr. Newbold shall continue to receive his base salary and shall be entitled to continued participation in our executive benefit plans for a period of six (6) months. Mr. Newbold is eligible to receive (i) an annual bonus of 50% of his annual base salary if certain financial performance measures are attained and (ii) such discretionary bonuses as may be authorized by the Board from time to time for executive employees. The bonus milestones were not met during the year ended December 31, 2006. Mr. Newbold also is eligible to participate in stock option and other employee benefit plans of the Company that may be in effect from time to time.

Mr. Newbold's employment agreement will terminate on the expiration of the agreement's term, his death, or delivery of written notice of termination by the Company to Mr. Newbold if he were to suffer a permanent disability rendering him unable to perform his duties and obligations under the agreement for 90 days in any 12-month period. The Company can terminate Mr. Newbold's employment by delivery of written notice of such termination "for cause" or "without cause" (as such terms are defined in his employment agreement to Mr. Newbold. Mr. Newbold can terminate his employment by delivery of written notice of termination "for good reason" (as defined in his employment agreement) to the Company. Mr. Newbold agrees not to compete with the Company or solicit certain of its employees or clients for a period of two years after the termination of his employment.

### MARTIN T. JOHNSON, CHIEF FINANCIAL OFFICER - EMPLOYMENT AGREEMENT

On February 17, 2006, the Company entered into an employment agreement (the "Johnson Agreement") with Martin T. Johnson ("Johnson"), the Company's Chief Financial Officer. The term of the Johnson Agreement is one year with automatic one-year renewal unless Mr. Johnson is provided with written notice of non-renewal 90 days prior to expiration of the current term of the Johnson Agreement. The Johnson Agreement provides for a base salary of \$180,000 per year. The Johnson Agreement provides for a performance bonus determined in accordance with revenue milestones established by the board of directors on a quarterly basis. Mr. Johnson is eligible to receive a bonus of up to 50% of base salary for each quarter that the Company achieves the agreed upon revenue milestones. The bonus milestones were not met during the year ended December 31, 2006. Additionally, the Johnson Agreement provides for the grant of stock options in an amount representing an aggregate 1.25% of the outstanding shares of the Company's common stock on the date of grant ("Johnson Initial Grant"). The Johnson Initial Grant is for 26,204 shares at an exercise price of \$1.65 per share. These options have a term of 10 years and vest 20% on the date of grant and 1/48th of the balance on the last day of each month for the next 48 months following the effective date of this agreement (Note 20).

### ROBERT CROSS - BONUS ARRANGEMENT

On March 7, 2006, the board of directors, in executive session without Mr. Robert Cross ("Mr. Cross"), the Company's then Chief Executive Officer, being present, approved a bonus arrangement ("Bonus Arrangement") for Mr. Cross. The Bonus Arrangement provided for (i) a cash bonus equal to \$200,000, grossed up for taxes (the "Cash Bonus"), (ii) the Cash Bonus would be payable only after agreement has been reached with creditors holding the applicable percentage of the Company's creditor obligations agree to convert their obligations under the creditor and claimant liabilities restructuring (Note 18) and when the funding escrow established by Laidlaw under the Series A Preferred Financing transaction

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has been released (the "Eligibility Date"), and (iii) 50% of the Cash Bonus would be paid on the Eligibility Date, and the other 50% would be paid in ten equal monthly installments beginning one month following the Eligibility Date. Mr. Cross would be granted a stock option in an amount representing an aggregate 2.5% of the outstanding shares of Company common stock following the completion of the Company's recapitalization under the creditor and claimant liabilities restructuring. The service conditions associated with Mr. Cross' employment as a result of this arrangement were modified to ensure that his employment with the Company would be extended beyond June 30, 2006 for an additional period of time sufficient for him to (i) complete the creditor and claimant liabilities restructuring, (ii) raise additional working capital and (iii) transition his position to a new Chief Executive Officer. The Company accrued the unpaid balance of the bonus at December 31, 2006, Mr. Cross' last date of payroll as CEO of the Company. The total amount of Mr. Cross' bonus is \$278,558 of which \$107,293 remained unpaid at December 31, 2006 and is included in accrued expenses in the accompanying balance sheet.

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### NOTE 18 - CREDITOR AND CLAIMANT LIABILITIES RESTRUCTURING

On January 12, 2006, the Company issued a Stock Subscription Agreement & Mutual Release ("the Original Release") to each creditor and claimant ("Subscriber") of the Company for purposes of entering into a final and binding settlement with respect to any and all claims, liabilities, demands, causes of action, costs, expenses, attorneys fees, damages, indemnities, and obligations of every kind and nature that the creditor and/or claimant may have with the Company ("Subscriber Claims"). Under terms of this agreement, the Company sold to the Subscriber and the Subscriber purchased from the Company shares ("Stock") of its Series A-1 Preferred stock at a price of \$0.80 per share. The aggregate purchase price was equivalent to the value of the Subscriber Claims being settled through this settlement and release. Subscriber was deemed to have paid for the Stock through the settlement and release of Subscriber Claims. Each share of Stock was automatically convertible into 1/3 share of the Company's common stock upon the effectiveness of an amendment to the Company's certificate of incorporation which provided for a sufficient number of authorized but unissued and unreserved shares of the Company's common stock to permit the conversion of all issued and outstanding shares of Series A-1 Preferred. The Company issued the Series A-1 Preferred shares following the final determination of the claims and acceptance by the Company of each claimant submitted Stock Subscription Agreement and Mutual Release through countersignature thereof.

The Original Release also provided that in the event that (a) a bona fide sale or (series of related sales) by the Company of equity interests in the Company in an amount equal to or in excess of \$3,000,000 or (b) any merger, consolidation, recapitalization, reclassification, reincorporation, reorganization, share exchange, sale of all or substantially all of the assets of the Company or comparable transaction, was not consummated on or before March 31, 2006 (the "Termination Date"), the Stock Subscription Agreement & Mutual Release would terminate and be null and void, the Series A-1 Preferred issued to Subscriber would be cancelled and the Subscriber Claims would remain in full force and effect on their terms. Each Subscriber agreed not to transfer or sell any portion of the Stock until the next business day after the Termination Date, subject to (i) an effective registration under the Securities Act or in a transaction which is otherwise in compliance with the Securities Act, (ii) an effective registration under any applicable state securities statute or in a transaction otherwise in compliance with any applicable state securities statute, and (iii) evidence of compliance with the applicable securities laws of other jurisdictions. As described below, the Company completed the sale of \$4.8

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million in equity securities under the Series A Preferred Financing on March 27, 2006 thereby eliminating the provision for automatic termination of this arrangement.

The Company has filed with the Securities and Exchange Commission on July 24, 2006 a registration statement ("Registration Statement") covering the resale of the underlying Stock and has agreed to use its best efforts to cause such Registration Statement to become effective as soon as practicable thereafter and in any event no later than 180 days from the date that the Company countersigns each Stock Subscription Agreement and Mutual Release. The Company shall keep the Registration Statement continuously effective under the Securities Act until the earlier of (i) the date when all shares of the Stock have been sold pursuant to the Registration Statement or an exemption from the registration requirements of the Securities Act, and (ii) two years from the effective date of the Registration Statement.

Through July 21, 2006, the Company issued additional Stock Subscription Agreements & Mutual Releases ("the Additional Release") to several creditors that had not signed the January 12, 2006 Original Release by April 30, 2006. The terms of the Additional Release were predominantly the same as the Original Release with the exception of the 120 day requirement for filing the Registration Statement.

On July 21, 2006, the Board of Directors authorized the completion of the Creditor and Claimant Liabilities Restructuring program. Under this program, claims totaling \$24,467,871 were settled for 36,993,054 shares of Series A-1 Preferred Stock. The Company recorded net gains with respect to all claims and liabilities settled under this program in the aggregate amount of \$1,853,055. The Series A-1 Preferred shares were automatically converted into 12,331,056 shares of the Company's common stock on July 31, 2006 following the Company's effectuation of a 1-for-30 reverse stock split.

The following table provides a summary of all claims settled by category with the (gain) loss recognized on the settlement:

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| Settlement Category                        | Series A-1<br>Stock Issued | Fair Value<br>of Stock | Claim Amount   | (Gain)<br>Loss |
|--|----------------------------|------------------------|----------------|----------------|
| General Creditors .....                    | 22,246,601                 | \$ 13,283,857          | \$(18,072,357) | \$ (4,         |
| Former Officer/Stockholder .....           | 1,549,526                  | 929,716                | (1,180,991)    | (              |
| Former Non-Executive Chairman .....        | 315,438                    | 252,350                | (254,152)      |                |
| Stockholders under Accommodation Agreement | 3,000,000                  | 2,400,000              | (2,400,000)    |                |
| Mr. Allin and the Allin Dynastic Trust ... | 2,500,000                  | 1,500,000              | (1,317,089)    |                |
| Other Claimants .....                      | 7,381,489                  | 4,248,893              | (1,243,282)    | 3,             |
|  | 36,993,054                 | \$ 22,614,816          | \$(24,467,871) | \$ (1,         |

The fair value of the Series A-1 shares issued in settlements reached prior to June 30, 2006 amounted to \$.60 per share, based on a comparison of the features of these shares to similar shares sold in private placement transactions to unrelated parties for cash and the trading price of the Company's shares at the time of the settlements. Series A-1 shares issued in settlements reached in July

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2006, which principally includes the Company's former non-executive chairman, were valued at \$0.80 per share commensurate with an increase in the trading price of the Company's common stock. These agreements effectuated a complete settlement of these debts, claims and liabilities and the mutual release of the parties with respect thereto.

The Company accounted for the extinguishment of liabilities payable to general creditors in accordance with SFAS 15 "Accounting by Debtors and Creditors for Troubled Debt Restructurings," due to the fact that the holders of these notes granted to Company concessions intended to alleviate its immediate liquidity constraints. These concessions that the creditors granted to the Company enabled it to (a) effectuate their settlement through an exchange of equity instead of a use of cash and (b) consummate a private placement of equity securities (Note 19) that resulted in an infusion of cash that was needed to sustain operations.

Claimants other than Mr. Allin and the Allin Dynastic Trust that participated in the settlement include certain parties that were previously engaged in litigation with the Company including the Sherleigh Associates Profit Sharing Plan to which the Company issued 2,312,500 shares for a settlement loss of \$1,387,500, Richard Linting to whom the Company issued 1,777,261 shares for a settlement loss of approximately \$773,000 and the holders of the Marie Gaul claim to whom the Company issued 1,164,461 shares for a settlement loss of approximately \$698,000.

### OTHER LIABILITIES SETTLEMENTS

The Company also settled \$660,494 of other liabilities for \$28,140 in cash and a \$32,500 note during the year ended December 31, 2006 for which it recorded net gains in the amount of \$ 599,854.

### NOTE 19 - STOCKHOLDERS' EQUITY

#### AMENDMENT TO CERTIFICATE OF INCORPORATION AND AUTHORIZED SHARE CAPITAL

On March 1, 2006, the Company filed with the Delaware Secretary of State a Certificate of Designation of Preferences, Rights and Limitations of Series A Convertible Preferred Stock and Series A-1 Convertible Preferred Stock designating the rights, preferences and privileges of 2,160 shares of Series A Convertible Preferred Stock and 50,000,000 shares of Series A-1 Convertible Preferred Stock.

On October 12, 2006, the Company filed with the Delaware Secretary of State a Certificate of Designation of Preferences, Rights and Limitations of Series B Convertible Preferred Stock designating the rights, preferences and privileges of 2,000 shares of Series B Convertible Preferred Stock. The Certificate of Designation of Preferences, Rights and Limitations of Series B Convertible Preferred Stock was amended on January 24, 2007.

A description of each class of the Company's authorized capital stock following the most recent amendment to its Certificate of Incorporation is as follows:

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#### SERIES A PREFERRED STOCK

The Series A Preferred Stock has a stated value of \$5,000 per share and carries a dividend of 10% per annum with such dividend accruing on a cumulative basis. The dividend is payable only (i) at such time as declared payable by the Board



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of Directors of the Company or (ii) in the event of liquidation, as part of the liquidation preference amount ("Liquidation Preference Amount"). Cumulative dividends on the Series A Preferred, which have not been declared by the board of directors, amount to \$368,471 at December 31, 2006.

The Series A Preferred is convertible, at the option of the holder, into shares of the Company's common stock ("Conversion Shares") at an initial conversion price ("Initial Conversion Price") of \$2.40 per share based on the stated value of the Series A Preferred, subject to adjustment for stock splits, dividends, recapitalizations, reclassifications, payments made to Common Stock holders and other similar events and for issuances of additional securities at prices more favorable than the conversion price at the date of such issuance.

The Series A Preferred is mandatorily convertible into shares of the Company's common stock at the Initial Conversion Price, which is subject to adjustment as described above, on the date that: (i) there shall be an effective registration statement covering the resale of the Conversion Shares, (ii) the average closing price of the Company's common stock, for a period of 20 consecutive trading days is at least 250% of the then applicable Conversion Price, and (iii) the average daily trading volume of the Company's common stock for the same period is at least 8,334 shares.

The Series A Preferred Liquidation Preference Amount is equal to 125% of the sum of: (i) the stated value of any then unconverted shares of Series A Preferred and (ii) any accrued and unpaid dividends thereon. An event of liquidation means any liquidation, dissolution or winding up of the Company, whether voluntary or involuntary, as well as any change of control of the Company which includes the sale by the Company of either (x) substantially all its assets or (y) the portion of its assets which comprises its core business technology, products or services.

### SERIES A-1 PREFERRED STOCK

The Series A-1 Preferred Stock has a stated value of \$0.80 per share and carries a non-cumulative dividend of 5% per annum, with such dividend payable only (i) at such time as declared payable by the Board of Directors of the Company or (ii) in the event of liquidation, as part of the liquidation preference amount ("Series A-1 Liquidation Preference Amount"). The Series A-1 Liquidation Preference Amount is equal to the sum of: (i) the stated value of any then unconverted shares of Series A-1 Preferred and (ii) any accrued and unpaid dividends thereon. An event of liquidation means any liquidation, dissolution or winding up of the Company, whether voluntary or involuntary, as well as any change of control of the Company which includes the sale by the Company of either (x) substantially all its assets or (y) the portion of its assets which comprises its core business technology, products or services.

The Series A-1 Preferred is not convertible at the option of the holder. Each share of Series A-1 Preferred automatically converted into the Company's common stock, at a conversion price of \$2.40 per share based on the stated value of the Series A-1 Preferred, upon the effectiveness of the amendment to the Company's certificate of incorporation which provided for a sufficient number of authorized shares to permit the exercise or conversion of all issued and outstanding shares of Series A Preferred, Series A-1 Preferred and all options, warrants and other rights to acquire shares of the Company's common stock.

Through December 31, 2006, the Company has issued 36,993,054 shares of Series A-1 Preferred Stock which converted on July 31, 2006 upon the effectiveness of the amendment to the Company's Second Amended and Restated Certificate of Incorporation to affect a 1-for-30 reverse stock split, into 12,331,056 shares of the Company's newly split common stock.

### SERIES B PREFERRED STOCK

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We have designated 2,000 shares of preferred stock as Series B Preferred Stock. The Series B Preferred Stock has a stated value of \$5,000 per share, has no maturity date, carries a dividend of 10% per annum, with such dividend accruing on a cumulative basis and is payable only (i) at such time as declared payable by the board of directors or (ii) in the event of liquidation, as part of the liquidation preference amount ("Liquidation Preference Amount"). The Liquidation Preference Amount is equal to 125% of the sum of: (i) the stated value of any then unconverted shares of Series B Preferred Stock and (ii) any accrued and unpaid dividends thereon. An event of liquidation means any liquidation, dissolution or winding up of the Company, whether voluntary or involuntary, as well as any change of

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control of the Company which includes the sale by the Company of either (x) substantially all its assets or (y) the portion of its assets which comprises its core business technology, products or services. The Series B Preferred Stock is junior to the Series A Preferred Stock with respect to liquidation and dividend rights. Cumulative dividends on the Series B Preferred, which have not been declared by the board of directors, amount to \$77,448 at December 31, 2006.

The Series B Preferred Stock is convertible, at the option of the holder, into shares of Common Stock ("Conversion Shares") at an initial conversion price ("Initial Conversion Price") of \$0.82 based on the stated value of the Series B Preferred Stock, subject to adjustment for stock splits, dividends, recapitalizations, reclassifications, payments made to Common Stock holders and other similar events and for issuances of additional securities at prices more favorable than the conversion price at the date of such issuance. We are obligated to register the Conversion Shares within 90 days of completion of the issuance of the Series B Preferred Stock.

The Series B Preferred Stock is mandatorily convertible at the then applicable conversion price ("Conversion Price") into shares of Common Stock at the then applicable Conversion Price on the date that: (i) there shall be an effective registration statement covering the resale of the Conversion Shares, (ii) the average closing price of Common Stock, for a period of 20 consecutive trading days is at least 250% of the then applicable Conversion Price, and (iii) the average daily trading volume of Common Stock for the same period is at least 8,334 shares.

The Series B Preferred Liquidation Preference Amount is equal to 125% of the sum of: (i) the stated value of any then unconverted shares of Series A Preferred and (ii) any accrued and unpaid dividends thereon. An event of liquidation means any liquidation, dissolution or winding up of the Company, whether voluntary or involuntary, as well as any change of control of the Company which includes the sale by the Company of either (x) substantially all its assets or (y) the portion of its assets which comprises its core business technology, products or services.

### PRIVATE PLACEMENTS OF CONVERTIBLE PREFERRED STOCKS

#### PRIVATE PLACEMENT OF SERIES A CONVERTIBLE PREFERRED STOCK AND WARRANTS

In January 2006, the Company initiated a proposed \$5,400,000 financing transaction (the "Series A Preferred Financing") which would, for each \$100,000 Unit purchased, result in the issuance of (i) 20 shares of Series A Preferred Stock and (ii) warrants ("Investor Warrants") to purchase 13,888.9 shares of the Company's common stock. The minimum amount of the Series A Preferred Financing

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was \$3,000,000 ("Minimum Amount") and the maximum amount was \$5,400,000. Apex agreed to purchase up to \$1,500,000 which would all be available to fund the Minimum Amount, provided however, in the event that the Series A Preferred Financing was over-subscribed as to the Minimum Amount, then for each \$1.00 of such over subscription up to \$250,000, the Apex funding commitment would be reduced on a dollar for dollar basis, down to a minimum amount of \$1,250,000. Additionally, holders of the 2006 Bridge Notes were mandatorily obligated to exchange their 2006 Bridge Notes for Units in the Series A Preferred Financing upon consummation of the Series A Preferred Financing at the face value of their 2006 Bridge Notes. The issuance of Units to the holders of 2006 Bridge Notes counted toward satisfying the Minimum Amount.

The Investor Warrants have a term of 5 years and an exercise price of \$1.85 per share. Each Investor Warrant entitles the holder thereof to purchase 13,888.9 shares of the Company's common stock (the "Warrant Shares"), subject to anti-dilution provisions similar to those of the conversion rights of the Series A Preferred. The Company was obligated to include the Conversion Shares and the Warrant Shares in the Registration Statement originally filed on July 24, 2006. The Conversion Shares and the Warrant Shares have piggyback registration rights.

In connection with the Series A Preferred Financing, the Company retained Laidlaw as its non-exclusive placement agent ("Series A Preferred Placement Agent"). Laidlaw received, in its role as Series A Preferred Placement Agent, (i) a cash fee equal to 10% of all gross proceeds, excluding the Apex proceeds, delivered at each Closing and (ii) a warrant (the "Agent Warrants") to purchase the Company's common stock equal to 10% times the sum of (x) the Conversion Shares to be issued upon conversion of the shares of Series A Preferred issued at each Closing and (y) the number of shares of the Company's common stock reserved for issuance upon the exercise of the Investor Warrants issued at each closing. The Agent Warrants have a term of 5 years and an exercise price of \$1.85 per share. Additionally, the Company paid the Series A Preferred Placement Agent a non-accountable expense allowance of \$25,000. The Agent Warrants have a fair value of \$274,393. Assumptions relating to the estimated fair value of these warrants are as follows: fair value of common stock of \$0.80; risk-free interest rate of 4.52%; expected dividend yield zero percent; expected warrant life of five years; and current volatility of 125%.

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On March 3, 2006, the investors in the Series A Preferred Financing agreed to a modification of the terms of this financing arrangement to waive the requirement for 100% completion of the creditor and claimant liabilities restructuring for release of the net proceeds of the Series A Preferred Financing in order to allow the Company to proceed with its business plan and to protect the investors in the Series A Preferred Financing. The modifications provided for the net proceeds of the Series A Preferred Financing to be deposited with an escrow agent whereby funds would be released to the Company to cover payroll, rent and other operating costs, including eligible payables not otherwise subject to the creditor and claimant liabilities restructuring, on a bi-monthly basis.

On March 27, 2006, the Company consummated the Series A Preferred Financing with the closing of funds totaling \$4,465,501, resulting in the issuance of 893 shares of Series A Preferred Stock and 620,233 common stock purchase warrants to the purchasers of the Series A Preferred Stock. This amount was comprised of \$720,001 associated with the conversion of the Bridge Notes, \$895,000 provided by Apex and \$2,850,500 from parties made available by the Series A Preferred Placement Agent. The Company also issued Agent Warrants to Laidlaw exercisable for 198,375 shares of common stock.. The Investor Warrants have a fair value of \$857,908. Assumptions relating to the estimated fair value of these warrants are

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as follows: fair value of common stock of \$1.71; risk-free interest rate of 4.52%; expected dividend yield zero percent; expected warrant life of five years; and current volatility of 125%.

On April 3, 2006, the Company consummated an additional closing of the Series A Preferred Financing with the closing of funds totaling \$355,000, resulting in the issuance of 71 shares of Series A Preferred Stock and 49,306 common stock purchase warrants. The Investor Warrants issued in this additional closing have a fair value of \$95,102. Assumptions relating to the estimated fair value of these warrants are as follows: risk-free interest rate of 4.52%; expected dividend yield zero percent; expected warrant life of five years; and current volatility of 125%.

The completion of the Series A Preferred Financing was conditioned upon, among other things, the Company's completion of the creditor and claimant liabilities restructuring in an amount and on terms satisfactory to the Placement Agent. In order to make these funds available to the Company in connection with the completion of the creditor and claimant liabilities restructuring, the Company, on March 27, 2006, entered into a post-closing restricted cash escrow agreement ("Post-Closing Escrow Agreement") with an escrow agent ("Escrow Agent"). As of March 27, 2006, the Escrow Agent was provided \$2,183,026 in net offering proceeds. The escrow agent held the funds and made periodic disbursements to the Company on or after the 15th of each calendar month and on or after the last day of each calendar month. The Company was required to provide a detailed schedule of the mid-month, month-end and maximum monthly disbursement amounts to substantiate its requests for a release of any funds. All funds were released to the Company from the escrow account as of June 15, 2006.

Pursuant to the Certificate of Designation for the Series A Preferred Stock, in the event that additional shares of common stock are issued or deemed to be issued at an effective price that is lower than the conversion price of the Series A Preferred Stock, the conversion price for the Series A Preferred Stock shall be reduced to the effective price of such issuance. On November 16, 2006, the Series B Preferred Financing was completed at a conversion price of \$0.82 per share as compared to the \$2.40 per share conversion price for the Series A Preferred Stock. Pursuant to the terms of the Certificate of Designation for the Series A Preferred Stock the conversion price of the Series A Preferred Stock was adjusted to \$0.90 per share. This change resulted in an additional 3,347,571 shares of Common Stock being reserved for issuance upon the conversion of the Series A Preferred Stock. In accordance with EITF 00-27, the Company recorded \$3,759,059 of deemed dividends since the conversion price was less than the commitment fair value of the Company's common stock at the time of the completion of the Series A Financing.

As of December 31, 2006, the 964 shares of Series A Preferred Stock outstanding are convertible, as described above, into 5,356,138 shares of Common Stock.

### PRIVATE PLACEMENT OF SERIES B CONVERTIBLE PREFERRED STOCK AND WARRANTS

On August 29, 2006, the Company initiated a proposed \$5,000,000 financing transaction (the "Series B Preferred Financing") which would, for each \$100,000 Unit purchased, result in the issuance of (i) 20 shares of Series B Preferred Stock and (ii) warrants ("Series B Investor Warrants") to purchase Company common stock in an amount equal to 50% of the Conversion Shares. The minimum amount of the Series B Preferred Financing is \$3,000,000 ("Series B Minimum Amount") and the maximum amount is \$5,000,000. Apex agreed to purchase up to \$1,000,000 all of which would be available to fund the Series B Minimum Amount, provided however, in the event that the Series B Preferred Financing was over-subscribed as to the Series B Minimum Amount, then for each \$1.00 of such over subscription up to \$2,000,000, the Apex funding commitment would be increased by \$0.333 to a maximum amount of \$1,666,667.

The Series B Investor Warrants have a term of 5 years and an exercise price of \$1.03 per share. Each Series B Investor Warrant entitles the holder thereof to purchase up to 50% of the Conversion Shares in Company's common stock (the "Series B Warrant Shares"), subject to anti-dilution provisions similar to those of the conversion rights of the Series B Preferred. The Conversion Shares and the Series B Warrant Shares have piggyback registration rights.

In connection with the Series B Preferred Financing, the Company retained Laidlaw as its non-exclusive placement agent ("Series B Preferred Placement Agent"). Laidlaw received, in its role as Series B Preferred Placement Agent, (i) a cash fee equal to 13% of all gross proceeds, excluding the Apex proceeds, delivered at each Closing and (ii) a warrant (the "Series B Agent Warrants") to purchase the Company's common stock equal to 10% times the sum of (x) the Conversion Shares to be issued upon conversion of the shares of Series B Preferred issued at each Closing and (y) the number of shares of the Company's common stock reserved for issuance upon the exercise of the Series B Investor Warrants issued at each closing. The Series B Agent Warrants have a term of 5 years and an exercise price of \$1.03 per share. Additionally, the Company paid \$32,750 of Laidlaw's legal expenses associated with the Series B Preferred Financing.

On October 13, 2006, the Company consummated the first closing of the Series B Preferred Financing through the sale of Units, at a per Unit price of \$100,000, consisting of (i) 20 shares of Series B Preferred Stock and (ii) Series B Investor Warrants to purchase shares of Common Stock in an amount equal to 50% of the shares issuable upon conversion of the Series B Preferred Stock, in the aggregate amount of \$3,082,716. This amount was comprised of \$1,027,572 provided by Apex and \$2,055,144 provided by parties made available by Laidlaw, the Series B Preferred Placement Agent. The first closing of the Series B Preferred Financing resulted in the issuance of 616.54 shares of Series B Preferred Stock with a conversion price of \$1.80 and Series B Investor Warrants to purchase 855,801 shares of Common Stock at an exercise price of \$2.40 per share. The Company paid Laidlaw a fee of \$280,484 and issued to Laidlaw Series B Agent Warrants to purchase 256,737 shares of Common Stock for its services as the Series B Preferred Placement Agent.

The Investor Warrants issued in the first closing of the Series B have an aggregate fair value of \$1,441,620. The Series B Agent Warrants issued in the first closing of the Series B have an aggregate fair value of \$432,787. Assumptions relating to the estimated fair value of these warrants are as follows: fair value of common stock \$2.00; risk-free interest rate of 4.77%; expected dividend yield zero percent; expected warrant life of five years; and current volatility of 125%.

The Company determined, based upon an allocation of the proceeds to the fair values of the Series B Preferred Stock and Series B Investor Warrants issued to the investors in this closing, that the effective conversion price embedded in the Series A Convertible Preferred Shares amounts \$1.23 per share. Accordingly, the Company recorded a deemed dividend in the amount of \$1,322,623 based upon the effective conversion price embedded in the preferred shares times the number of shares issuable upon conversion.

On November 16, 2006, the Company consummated the second closing of the Series B Preferred Financing through the sale of Units in the aggregate amount of \$870,000. This amount was comprised of \$290,000 provided by Apex and \$580,000 provided by parties made available by Laidlaw, the Series B Preferred Placement Agent. The second closing of the Series B Preferred Financing resulted in the

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issuance of 174 shares of Series B Preferred Stock with a conversion price of \$0.82 and Series B Investor Warrants to purchase 530,497 shares of Common Stock at an exercise price of \$1.03 per share. The Company paid Laidlaw a fee of \$72,085 and issued to Laidlaw Series B Agent Warrants to purchase 159,149 shares of Common Stock at an exercise price of \$1.03 per share for its services as the Series B Preferred Placement Agent. The Investor Warrants issued in this second closing of the Series B have an aggregate fair value of \$454,414. The Series B Agent Warrants issued in this second closing of the Series B have an aggregate fair value of \$137,524. Assumptions relating to the estimated fair value of these warrants are as follows: fair value of common stock \$1.01; risk-free interest rate of 4.96%; expected dividend yield zero percent; expected warrant life of five years; and current volatility of 125%.

The Company determined, based upon an allocation of the proceeds to the fair values of the Series B Preferred Stock and Series B Investor Warrants issued to the investors in this closing, that the effective conversion price embedded in the Series B Convertible Preferred Shares amounts \$0.54 per share. Accordingly, the Company recorded a deemed dividend in the amount of \$501,808 based upon the difference between the fair value of the Company's common stock and the effective conversion price embedded in the preferred shares times the number of shares issuable upon conversion.

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On November 16, 2006, in conjunction with the second closing of the Series B Preferred Financing at a per share conversion price of \$0.82 and an associated Series B Investor Warrant exercise price of \$1.03 per share, the conversion price of the Series B Preferred Stock issued in the first closing was adjusted to the \$0.82 per share value associated with the second closing and the warrant exercise price of the Series B Investor Warrants issued in conjunction with the first closing was adjusted to \$1.03 per share. An additional 1,023,924 Series B Investor Warrants were issued in conjunction with this change. Because of this change, the Company also issued to Laidlaw Series B Agent Warrants to purchase an additional 307,179 shares of Common Stock at an exercise price of \$1.03 for its services as the Series B Preferred Placement Agent. The Series B Investor Warrants issued in the first closing along with the additional warrants issued to the investors in the first Series B Preferred closing upon the revision of the conversion price of the Series B Preferred offering and the revision of the warrant exercise price have a fair value of \$1,209,596. The Series B Agent Warrants issued in the first closing along with the additional warrants issued because of the second closing revision of the conversion price of the Series B Preferred offering and the revision of the warrant exercise price have a fair value of \$387,177. Assumptions relating to the estimated fair value of these warrants are as follows: fair value of common stock \$1.01; risk-free interest rate of 4.96%; expected dividend yield zero percent; expected warrant life of five years; and current volatility of 125%.

The Company is obligated to register the shares of Common Stock issuable upon exercise of the Series B Investor Warrants and the Series B Agent Warrants and conversion of the Series B Preferred Stock within 90 days after the completion of the Series B Preferred Financing.

As of November 16, 2006, the 790.54 shares of Series B Preferred Stock outstanding are convertible into 4,820,417 shares of Common Stock.

### ADDITIONAL SHARES ISSUED UNDER ANTI-DILUTION PROVISION

Effective April 1, 2006, the Company issued 251,175 shares of common stock under the provisions of an anti-dilution agreement associated with private placements

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of common stock that occurred in March, August and September 2004.

### ISSUANCE OF COMMON STOCK PURCHASE WARRANTS

On January 28, 2006 the Company issued warrants for 20,000 shares at an adjusted exercise price of \$1.74 per share to Apex in connection with the Interim Bridge Financing III financing (Note 12). The aggregate fair value of these warrants amounted to \$20,316.

On February 13, 2006 the Company issued warrants for 6,000 shares at an adjusted exercise price of \$1.74 per share to Apex in connection with the Interim Bridge Financing III financing (Note 12). The aggregate fair value of these warrants amounted to \$6,634.

On February 21, 2006 the Company issued warrants for 1,250 shares at an adjusted exercise price of \$1.74 per share to Apex in connection with the Interim Bridge Financing III financing (Note 12). The aggregate fair value of these warrants amounted to \$1,382.

On March 1, 2006 the Company issued warrants for 6,417 shares at an adjusted exercise price of \$1.74 per share to Apex in connection with the Interim Bridge Financing III financing (Note 12). The aggregate fair value of these warrants amounted to \$10,029.

On March 17, 2006 the Company issued warrants for 3,750 shares at an adjusted exercise price of \$1.74 per share to Apex in connection with the Interim Bridge Financing III financing (Note 12). The aggregate fair value of these warrants amounted to \$5,861.

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On March 22, 2006 the Company issued warrants for 2,500 shares at an adjusted exercise price of \$1.74 per share to Apex in connection with the Interim Bridge Financing III financing (Note 12). The aggregate fair value of these warrants amounted to \$3,907.

On March 27, 2006 the Company issued warrants for 620,233 shares at a \$1.85 per share exercise price to the investors in the Series A Preferred Financing. Additionally, the Company issued 198,375 common stock purchase warrants at a \$1.85 per share exercise price to Laidlaw as placement agent in the Series A Preferred Financing.

On April 3, 2006 the Company issued warrants for 49,306 shares at a \$1.85 per share exercise price to Apex in connection with their investment in the Series A Preferred Financing.

On October 13, 2006 and November 16, 2006, the Company issued warrants totaling 1,879,725 shares at a \$1.03 per share exercise price to the investors in the Series B Preferred Financing in connection with the first closing of the Series B Preferred Financing.

On October 13, 2006 and November 16, 2006, the Company issued 563,913 common stock purchase warrants at a \$1.03 per share exercise price to Laidlaw as placement agent for the first closing in the Series B Preferred Financing.

On November 16, 2006, the Company issued warrants for 530,497 shares at a \$1.03 per share exercise price to the investors in the Series B Preferred Financing in connection with the second closing of the Series B Preferred Financing.

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On November 16, 2006, the Company issued 159,147 common stock purchase warrants at a \$1.03 per share exercise price to Laidlaw as placement agent for the second closing in the Series B Preferred Financing.

### NOTE 20 - SHARE-BASED PAYMENTS

#### ISSUANCE OF EMPLOYEE STOCK OPTIONS

During the year ended December 31, 2006, the Company issued stock options to employees to purchase 139,914 shares. These options include a grant on February 17, 2006, to purchase 73,371 shares at \$1.65 per share, with a fair value of \$96,850, to the Chief Operating Officer of the Company Mr. Braden Waverley, upon the signing of his employment agreement with the Company. Additionally, on February 17, 2006, the Company granted options to purchase 26,204 shares at \$1.65 per share, with a fair value of \$34,589, to Mr. Martin T. Johnson, the Company's Chief Financial Officer, upon the signing of his employment agreement with the Company.

These options have a term of 10 years and vest 20% on the date of grant and 1/48th of the balance on the last day of each month for the next 48 months following the effective date of the agreement. Assumptions relating to the estimated fair value of these stock options, which the Company is accounting for in accordance with SFAS 123(R) are as follows: fair value of common stock \$1.65; risk-free interest rate of 4.45%; expected dividend yield zero percent; expected option life of four years; and current volatility of 125%. On July 12, 2006, the Board of Directors approved the grant of 40,339 non-qualified stock options to 11 individuals. The exercise price for these options was \$1.35, the closing price for the Company's common stock on the date of grant, July 12, 2006.

The fair value of the unvested portion of stock options at December 31, 2006 is \$531,132 with a weighted-average remaining vesting period of 2.9 years.

#### SHARE-BASED COMPENSATION ARRANGEMENTS

The Company, since its inception has granted non-qualified stock options to various employees and non-employees at the discretion of the Board of Directors. Substantially all options granted to date have exercise prices equal to the fair value of underlying stock at the date of grant and terms of ten years. Vesting periods range from fully vested at the date of grant to four years.

#### 2006 PATRON SYSTEMS, INC. STOCK INCENTIVE PLAN

On July 21, 2006, the stockholders of the Company approved the 2006 Patron Systems, Inc. Stock Incentive Plan (the "2006 Stock Plan"). The 2006 Stock Plan provides for the granting of incentive stock options to employees and the granting of nonstatutory stock options to employees, non-employee directors, advisors, and consultants. The

2006 Stock Plan also provides for grants of restricted stock, stock appreciation rights and stock unit awards to employees, non-employee directors, advisors and consultants. The 2006 Stock Plan authorizes and reserves 5,600,000 shares for issuance of options that may be granted under plan.

In accordance with the 2006 Stock Plan, the stated exercise price shall not be less than 100% and 85% of the estimated fair market value of common stock on the date of grant for ISO's and NSO's, respectively, as determined by the Board of



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Directors at the date of grant. With respect to any 10% stockholder, the exercise price of an ISO or NSO shall not be less than 110% of the estimated fair market value per share on the date of grant.

Options issued under the 2006 Stock Plan have a term up to ten-years and generally become exercisable over a four-year period.

Shares subject to awards that expire unexercised or are forfeited or terminated will again become available for issuance under the 2006 Stock Plan. No participant in the 2006 Stock Plan can receive option grants, restricted shares, stock appreciation rights or stock units for more than 1,500,000 shares in the aggregate in any calendar year.

As of December 31, 2006, no options have been granted from the 2006 Stock Plan.

### NON-PLAN STOCK OPTION GRANTS

As described in Note 4, the fair value of all awards was estimated at the date of grant using the Black-Scholes option pricing model. Assumptions relating to the estimated fair value of stock options that the Company granted prior to January 1, 2006 that were accounted for and recorded under the intrinsic value method prescribed under APB 25 are also described in Note 4.

The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant. The Company has not paid dividends to date and does not expect to pay dividends in the foreseeable future due to its substantial accumulated deficit and limited capital resources. Accordingly, expected dividends yields are currently zero. Historical cancellations and forfeitures of stock options granted through December 31, 2004 have been insignificant. However, the Company's operations and the nature of its business changed substantially during 2005 with the acquisition of businesses and the recruitment of a new Chief Operating Officer in 2006. Accordingly, the Company considers more recent data relating to employee turnover rates to be indicative of future vesting. Based on available data, the Company has assumed that approximately 84% of outstanding options will vest annually. Unearned compensation relating to options granted through December 31, 2005 has been adjusted to reflect this assumption. The Company will prospectively monitor employee terminations, exercises and other factors that could affect its expectations relating to the vesting of options in future periods. The Company will adjust its assumptions relating to its expectations of future vesting and the terms of options at such times that additional data indicates that changes in these assumptions are necessary. Expected volatility is principally based on the historical volatility of the Company's stock.

A summary of option activity for the year ended December 31, 2006 is as follows:

| OPTIONS                                | SHARES   | WEIGHTED-<br>AVERAGE<br>EXERCISE<br>PRICE | WEIGHTED-<br>AVERAGE<br>REMAINING<br>CONTRACTUAL<br>TERM |
|--|----------|---|--|
| Outstanding at January 1, 2006 .....   | 428,022  | \$ 21.09                                  | 7.7 years  |
| Granted .....                          | 189,914  | \$ 1.78                                   | --   |
| Exercised .....                        | --       | --  | --   |
| Forfeited or expired .....             | (85,300) | \$ 7.74                                   | --   |
| Outstanding at December 31, 2006 ..... | 532,636  | \$ 16.34                                  | 6.5 years  |
| Exercisable at December 31, 2006 ..... | 400,312  | \$ 20.08                                  | 5.4 years  |

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At December 31, 2006, the aggregate intrinsic value of options outstanding and options exercisable, based on the December 29, 2006 closing price of the Company common stock (\$0.35 per share) amounted to \$2,000 and \$2,000, respectively. In addition the table includes 156,670 fully vested and non-forfeitable stock options outstanding that it issued to non-employees through December 31, 2005. As of December 31, 2006, these options have a weighted average exercise price of \$17.39, weighted average remaining contractual term of 6.1 years and an aggregate intrinsic value of \$0.

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The weighted-average grant-date fair value of the 189,914 stock options granted during the year ended December 31, 2006 amounted to \$1.26 per share. The Company granted 190,514 stock options with a weighted average grant-date fair value of \$7.85 per share or a total fair value of \$1,495,158 during the year ended December 31, 2005. There have also not been any exercises of stock options to date. The total fair value of options vested during the year ended December 31, 2006 amounted to \$397,277. Additionally, the Company did not capitalize the cost associated with stock based compensation.

Stock based compensation expense to non employees for services rendered during the year ended December 31, 2006 amount to \$163,120 including \$63,120 for the fair value of 50,000 stock options with an exercise price of \$2.40 per share which are fully vested and have a term of 3 years and 50,000 shares of common stock with an aggregate fair value of \$100,000. Assumptions relating to the estimated fair value of the stock options granted to non-employees during the year ended December 31, 2006 are as follows: Fair value of common stock of \$1.80, risk-free interest rate of 4.98%; expected dividend yield of zero percent; expected option life of three years; and current volatility of 125%. These options were recorded in accordance with measurement guidelines provided for under EITF 96-18.

Aggregate stock based compensation to employees and non employees amounted to \$523,915 for the year ended December 31, 2006.

Stock based compensation expense to non-employees amounted to \$1,239,083 during the year ended December 31, 2005, including \$708,750 relating to stock options and \$530,333 relating to issuances of common stock for services. All non-employee stock based compensation awards were accounted for in accordance with the provisions of EITF 96-18. Assumptions relating to the estimated fair value of the stock options granted to non-employees during the year ended December 31, 2005 are as follows: fair value of common stock of \$2.70; risk-free interest rate of 3.83%; expected dividend yield of zero percent; expected option life of 3 years; and current volatility of 125%.

### REVERSE STOCK SPLIT

On July 31, 2006, the Company effected an equity restructuring through a 1-for-30 reverse stock split of its common stock. The Company split adjusted both the exercise price and number of shares underlying its outstanding employee stock options in accordance with stock option agreement equity restructuring provisions, which include adjustments for stock splits. The Company applied the guidance specified in paragraph 54 and the related implementation guidance included in Appendix A of SFAS 123(R) to evaluate whether the equity restructuring and modification of awards resulted in an increase in the fair value of such awards and whether additional compensation cost should be recognized. In accordance with SFAS 123(R) awards that are modified in equity

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restructurings pursuant to existing anti-dilution provisions generally do not result in the recognition of additional compensation cost. The Company evaluated the effect of the reverse-split on the fair value of existing stock options before and after the equity restructuring in accordance with the equity restructuring guidelines. As a result, the Company determined that it is not required to record additional stock-based compensation cost.

### NOTE 21 - DISCONTINUED OPERATIONS

#### SALE OF LUCIDLINE

LucidLine, Inc. ("LucidLine") was a provider of bundled and branded high speed Internet access and synchronized remote data back-up, retrieval, and restoration services. The acquisition of LucidLine was intended to supply the Company with the expertise needed to establish a homeland security architecture, risk and vulnerability assessment evaluation services and the development and operation of the homeland security data center solutions originally contemplated in the business plan. The actual results were substantially different. The Company was unable to find any parties interested in its homeland security data center solutions, its risk and vulnerability assessment services and its homeland security architecture business. Additionally, LucidLine's commercial data backup and storage business was not growing sufficiently to cover the costs of operating the business.

Because of the Company's precarious financial position, the difficulty it was experiencing in finding parties interested in pursuing the concept of homeland security compliant data centers and the general lack of government funding for municipalities and counties to address homeland security focused IT infrastructure projects, the

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Company decided in the first quarter of 2006 to abandon its focus on the homeland security market portion of its business plan and to streamline its business to focus on enterprise level software and service solutions designed to help customers create, manage and apply complex rule sets that support business policies, enhance work flow processes, enforce regulatory compliance, and reduce the time, cost and overhead of electronic message management.

Having made this decision, the Company's management undertook a thorough review of all areas of its business, including the revenue, pricing, supplier contracts and all other aspects of the LucidLine business unit, in an attempt to further cost-reduce the already cost-reduced business which had approximately \$65,000 per month in negative cash flow. While this effort reduced the potential negative cash flow to approximately \$35,000 per month through additional cost reductions, price increases and improved contract management, this negative cash flow would still result in a substantial drain on the Company's very limited cash resources. On the basis of this analysis, the Company decided to sell the business to a party who would purchase LucidLine and assume LucidLine's customer and supplier contract commitments. Based on these factors, the Company undertook an effort to identify a prospective acquirer of this business. In March 2006, Walnut Valley, Inc. agreed to acquire the legal entity and all of LucidLine's customer and supplier contract commitments for a substantial discount from the price the Company paid in February 2005. As the Company had found no other interested buyers and would have incurred a cash cost to shutdown the business far in excess of \$50,000, the Company decided to sell the LucidLine business to Walnut Valley.

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On April 18, 2006, the Company entered into a Stock Purchase Agreement with Walnut Valley, Inc., pursuant to which the Company sold all of the outstanding shares of LucidLine to Walnut Valley, Inc. for aggregate consideration of \$50,000 consisting of a cash payment in the amount of \$25,000 and the issuance of a Promissory Note in the principal amount of \$25,000 by Walnut Valley in favor of the Company. The Company originally purchased LucidLine in February 2005 for \$3,940,000 including cash of \$200,000 and 146,667 shares of common stock with a fair value of \$3,740,000.

During the period from the acquisition of LucidLine on February 25, 2005 through December 31, 2005, LucidLine generated revenue of approximately \$227,000, incurred a net loss of approximately \$1.4 million and used net cash in operations of approximately \$1.4 million. For the period from January 1, 2006 to March 31, 2006, LucidLine generated revenue of approximately \$99,000, a net loss of approximately \$105,000 and used net cash in operations of approximately \$194,000. Additionally, the Company recognized a loss on disposal of \$75,920.

|                                | January 1, 2006<br>through<br>March 31, 2006<br>----- | February 25, 2005<br>through<br>December 31, 2005<br>----- |
|--------------------------------|---|--|
| Revenue .....                  | \$ 99,167   | \$ 227,494   |
| Cost of sales .....            | 91,601  | 698,397  |
|                                | -----   | -----  |
| Gross profit (loss) .....      | 7,566   | (470,903)  |
| Operating expenses .....       | 111,992   | 907,074  |
|                                | -----   | -----  |
| Loss from operations .....     | (104,426)   | (1,377,977)  |
| Other income/(expense) .....   | (538)   | (4,753)  |
|                                | -----   | -----  |
| Loss before income taxes ..... | (104,964)   | (1,382,730)  |
| Income taxes .....             | --  | --   |
|                                | -----   | -----  |
| Net loss .....                 | \$ (104,964)  | \$ (1,382,730)   |
|                                | =====   | =====  |

### POLICYBRIDGE CLASSIFICATION AS A DISCONTINUED OPERATION

During December 2006, the Company made an affirmative decision to exit and actively pursue a plan to sell its PolicyBridge software product business. As a result of this decision, the Company has classified its PolicyBridge software product business as a discontinued operation in its financial statements as of December 31, 2006 in accordance with SFAS 144.

During the period from the acquisition of the PolicyBridge product in the Entelagent acquisition on March 30, 2005 through December 31, 2006, PolicyBridge generated revenue of approximately \$547,000, incurred a net loss of approximately \$4.4 million and used net cash of over \$2.7 million. For the year ended December 31, 2006,

PolicyBridge generated revenue of approximately \$311,000, incurred a net loss of approximately \$1,932,000 and used net cash of approximately \$1.4 million. The net loss for the year ended December 31, 2006 includes \$719,636 associated with the write-off of the capitalized PolicyBridge software (Note 8), \$61,833

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associated with the write-off of the PolicyBridge intangible assets (Note 9) and \$210,716 associated with the impairment of the remaining Entelagent acquisition goodwill (Note 6).

|                                      | Year ended<br>December 31, 2006<br>----- | March 30, 2005<br>through<br>December 31, 2005<br>----- |
|--------------------------------------|--|---|
| Revenue .....                        | \$ 311,120                               | \$ 235,426  |
| Cost of sales .....                  | 11,520                                   | 77,132  |
|                                      | -----                                    | -----   |
| Gross profit (loss) .....            | 299,600                                  | 158,294   |
| Operating expenses .....             | 1,239,110                                | 1,259,889   |
| Write-off of intangible assets ..... | 781,470                                  | 1,147,125   |
| Goodwill impairment charge .....     | 210,716                                  | --  |
|                                      | -----                                    | -----   |
| Loss from operations .....           | (1,931,696)                              | (2,248,720)   |
| Other income/(expense) .....         | --                                       | (225,505)   |
|                                      | -----                                    | -----   |
| Loss before income taxes .....       | (1,931,696)                              | (2,474,225)   |
| Income taxes .....                   | --                                       | --  |
|                                      | -----                                    | -----   |
| Net loss .....                       | \$ (1,931,696)                           | \$ (2,474,225)  |
|                                      | =====                                    | =====   |

While management continues to search for a buyer of this business, the Company will continue to provide services under the existing maintenance and support agreements to its PolicyBridge customers.

### NOTE 22 - INCOME TAXES

At December 31, 2006, the Company has federal and state net operating loss carryforwards available to offset future taxable income, if any, of approximately \$31,000,000 expiring at various times through 2026. The Company's determination of the amount of its net operating loss carryforwards includes approximately \$11,000,000 associated with acquired business. The Company's net operating losses (including those of the acquired businesses) may be subject to substantial limitations due to the (a) "Change of Ownership" provisions under Section 382 of the Internal Revenue Code and similar state provisions and (b) delinquencies that the Company has experienced with respect to filing its income tax returns on a timely basis. Such limitations may result in the expiration of the net operating losses prior to their utilization.

The tax effects of significant temporary differences which give rise to the Company's deferred tax assets and liabilities are as follows:

|   | DECEMBER 31,<br>----- |               |
|---|-----------------------|---------------|
|   | 2006                  | 2005          |
|   | -----                 | -----         |
| Net operating loss carry forwards ..... | \$ 11,803,887         | \$ 10,000,908 |
| Start-up costs .....                    | 7,278,114             | 7,278,114     |
| Stock options .....                     | 2,687,527             | 2,530,339     |
| Accrued compensation and expenses ..... | 2,602,755             | 2,447,333     |
| Goodwill impairment .....               | 4,794,331             | 4,794,331     |
| Intangible impairment .....             | 632,383               | 632,383       |
|   | -----                 | -----         |
|   | 29,798,997            | 27,683,408    |

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|                              |              |              |
|------------------------------|--------------|--------------|
| Valuation allowance .....    | (29,798,997) | (27,683,408) |
|                              | -----        | -----        |
| Net deferred tax asset ..... | \$ --        | \$ --        |
|                              | =====        | =====        |

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The increase in the Company's deferred tax assets during the year ended December 31, 2006 includes the effects of deferred tax assets associated with the net operating losses of acquired business. The Company fully reserves for deferred tax assets recorded in purchase accounting. The deferred tax assets and subsequent valuation allowance recorded in purchase accounting were accompanied by a corresponding decrease and increase, respectively, in goodwill at the time the purchase price allocation was recorded. The Company's recorded income benefit, net of the change in the valuation allowance for each of the period presented, is as follows:

|                                     | YEARS ENDED DECEMBER 31, |             |
|-------------------------------------|--------------------------|-------------|
|                                     | 2006                     | 2005        |
|                                     | -----                    | -----       |
| Current                             |                          |             |
| Federal .....                       | \$ --                    | \$ --       |
| State .....                         | --                       | --          |
|                                     | -----                    | -----       |
|                                     | --                       | --          |
| Deferred                            |                          |             |
| Federal .....                       | (1,851,425)              | (8,720,828) |
| State .....                         | (264,163)                | (1,244,297) |
|                                     | -----                    | -----       |
|                                     | (2,115,588)              | (9,965,125) |
| Change in valuation allowance ..... | 2,115,588                | 9,965,125   |
|                                     | -----                    | -----       |
|                                     | \$ --                    | \$ --       |
|                                     | =====                    | =====       |

Pursuant to SFAS No. 109 "Accounting for Income Taxes," management has evaluated the recoverability of the deferred income tax assets and the level of the valuation allowance required with respect to such deferred income tax assets. After considering all available facts, the Company fully reserved for its deferred tax assets because it is more likely than not that their benefit will not be realized in future periods. The Company will continue to evaluate its deferred tax assets to determine whether any changes in circumstances could affect the realization of their future benefit. If it is determined in future periods that portions of the Company's deferred income tax assets satisfies the realization standard of SFAS No. 109, the valuation allowance will be reduced accordingly.

A reconciliation of the expected Federal statutory rate of 34% to the Company's actual rate as reported for each of the periods presented is as follows:

|                               | YEARS ENDED DECEMBER 31, |       |
|-------------------------------|--------------------------|-------|
|                               | 2006                     | 2005  |
|                               | -----                    | ----- |
| Expected statutory rate ..... | (34)%                    | (34)% |
| State income tax rate, net of |                          |       |

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|                                 |        |        |
|---------------------------------|--------|--------|
| Federal benefit .....           | (3) %  | (3) %  |
| Permanent Difference:           |        |        |
| Non-cash interest charges ..... | 4 %    | 15 %   |
|                                 | -----  | -----  |
|                                 | (33) % | (22) % |
| Valuation allowance .....       | 33 %   | 22 %   |
|                                 | -----  | -----  |
|                                 | --     | --     |
|                                 | =====  | =====  |

### NOTE 23 - MAJOR CUSTOMERS

During the year ended December 31, 2006, the Company's top four customers accounted for 25%, 18%, 18% and 13% of net revenues. During the year ended December 31, 2005, the Company's top three customers accounted for 27%, 23% and 17% of net revenues.

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The four largest customers in accounts receivable at December 31, 2006 are 24%, 19%, 21% and 20% of accounts receivable.

### NOTE 24 - RESTATEMENT OF FINANCIAL STATEMENTS FOR INTERIM PERIODS DURING THE YEAR ENDED DECEMBER 31, 2006

The Company, while undergoing the audit of its consolidated financial statements for the year ended December 31, 2006, became aware of possible misstatements in its unaudited condensed consolidated interim financial statements filed with the Securities and Exchange Commission during the year ended December 31, 2006. On March 6, 2007, the Company's Board of Directors determined that certain amounts reported in its unaudited condensed consolidated interim financial statements for the quarters ended March 31, 2006, and June 30, 2006, and for the six months ended June 30, 2006 and nine months ended September 30, 2006 needed to be restated as described below.

The specific errors that came to management's attention relate to the Company's accounting for certain transactions that occurred during the quarter ended March 31, 2006 and the quarter ended June 30, 2006. Upon review of these transactions, Company management discovered that the accounting for these transactions resulted in a \$2,408,250 overstatement of its loss for the quarterly period ended March 31, 2006 and a \$593,765 overstatement of its loss for the quarterly period ended June 30, 2006, which also resulted in an overstatement of the year to date losses in the six and nine month periods ended June 30, 2006 and September 30, 2006, respectively.

Specifically, the Company recorded for the three months ended March 31, 2006, (1) a net loss of \$858,213 on the settlement of various liabilities under its creditor and claimant liabilities restructuring program when it should have recorded a net gain of approximately \$906,987, (2) excess non-cash interest of \$358,000 with respect to a conversion option that became effective under two of its Interim Bridge Financing III notes and (3) charged, as interest expense, a \$285,050 fee paid to the placement agent in its Series A Preferred stock financing transaction that should have been recorded as a reduction of the offering proceeds. For the three months ended June 30, 2006, the company recorded a net gain of \$371,616 on the settlement of various liabilities under its creditor and claimant liabilities restructuring program when it should have recorded a net gain of approximately \$965,381. The nature of the adjustments

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required in the creditor and claimant liabilities restructuring in the quarters ended March 31, 2006 and June 30, 2006, relate to an overvaluation of the Series A-1 preferred shares issued in the exchange offer offset by gains on the extinguishment of liabilities that originated in connection with obligations to issue or repurchase stock.

The effect of the restatement on the Company's previously issued unaudited condensed consolidated interim financial statements is as follows:

|  | Three Months<br>ended<br>March 31, 2006 |                 | Three Months<br>ended<br>June 30, 2006 |                 | Six M<br>en<br>June 3     |
|--|---|-----------------|--|-----------------|---------------------------|
|  | As Previously<br>Reported               | As<br>Restated  | As Previously<br>Reported              | As<br>Restated  | As Previously<br>Reported |
| Loss/(Gain)<br>associated<br>with settlement<br>agreements ..... | \$ 858,213                              | \$ (906,987)    | \$ (371,616)                           | \$ (965,381)    | \$ 486,597                |
| Interest expense   | \$ (1,615,514)                          | \$ (972,464)    | \$ (88,421)                            | \$ (88,421)     | \$ (1,703,935)            |
| Net loss from<br>continuing<br>operations .....                  | \$ (4,400,074)                          | \$ (1,991,824)  | \$ (1,420,313)                         | \$ (826,548)    | \$ (5,715,425)            |
| Net loss<br>available to<br>common<br>stockholders ...           | \$ (4,400,074)                          | \$ (1,991,824)  | \$ (1,621,017)                         | \$ (1,027,252)  | \$ (6,021,091)            |
| Net loss per<br>share-<br>continuing<br>operations .....         | \$ (2.06)                               | \$ (0.91)       | \$ (0.71)                              | \$ (0.44)       | \$ (2.75)                 |
| Net loss per<br>share - total ..                                 | \$ (2.11)                               | \$ (0.96)       | \$ (0.75)                              | \$ (0.47)       | \$ (2.83)                 |
| Additional paid<br>in capital .....                              | \$ 93,922,101                           | \$ 91,513,851   | \$ 97,792,968                          | \$ 94,790,953   | \$ 97,792,968             |
| Accumulated<br>Deficit .....                                     | \$ (88,788,101)                         | \$ (86,379,851) | \$ (90,409,118)                        | \$ (87,407,103) | \$ (90,409,118)           |

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| Nine Months<br>ended<br>September 30, 2006 |                |
|--|----------------|
| As Previously<br>Reported                  | As<br>Restated |



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|  |                 |                 |
|--|-----------------|-----------------|
| Loss/(Gain)<br>associated<br>with settlement<br>agreements ..... | \$ (93,944)     | \$ (2,452,909)  |
| Interest expense   | \$ (1,768,499)  | \$ (1,125,449)  |
| Net loss from<br>continuing<br>operations .....                  | \$ (6,872,302)  | \$ (3,870,287)  |
| Net loss<br>available to<br>common<br>stockholders ...           | \$ (7,300,152)  | \$ (4,298,137)  |
| Net loss per<br>share-<br>continuing<br>operations .....         | \$ (1.44)       | \$ (0.83)       |
| Net loss per<br>share - total ..                                 | \$ (1.48)       | \$ (0.87)       |
| Additional paid<br>in capital .....                              | \$ 97,468,961   | \$ 94,466,946   |
| Accumulated<br>Deficit .....                                     | \$ (91,688,179) | \$ (88,686,164) |

A) For the quarter ended March 31, 2006, a reduction in the net loss of \$2,408,250 (\$1.15 per share) and a corresponding reduction in accumulated deficit of \$2,408,250 and a reduction of additional paid in capital of \$2,408,250.

B) For the quarter ended June 30, 2006, a reduction in the net loss of \$593,765 (\$0.27 per share) and a corresponding reduction in accumulated deficit of \$593,765 and a reduction of additional paid in capital of \$593,765.

C) For the six months ended June 30, 2006, a reduction in the net loss of \$3,002,015 (\$1.41 per share) and a corresponding reduction in accumulated deficit of \$3,002,015 and a reduction of additional paid in capital of \$3,002,015.

D) For the nine months ended September 30, 2006, a reduction in the net loss of \$3,002,015 (\$0.61 per share) and a corresponding reduction in accumulated deficit of \$3,002,015 and a reduction of additional paid in capital of \$3,002,015.

NOTE 25 - SUBSEQUENT EVENTS

MANAGEMENT CHANGES

On January 18, 2007, the board of directors of the Company approved the resignation of Mr. Robert Cross as Chief Executive Officer of the Company, elected Mr. Robert Cross to chairman of the board of directors of the Company and elected Mr. Braden Waverley, the Company's current Chief Operating Officer,

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to the position of Chief Executive Officer of the Company.

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### ISSUANCE OF EMPLOYEE STOCK OPTIONS

On January 24, 2007, the board of directors approved the grant of stock options under the 2006 Patron Systems, Inc. Stock Incentive Plan (the "2006 Stock Plan"). A total of 5,270,553 stock options were granted at an exercise price of \$0.40 per share (the closing price of the Company's common stock on January 24, 2007). These options have a term of 10 years. The total fair value of this stock option grant is \$1,705,918. Assumptions relating to the estimated fair value of these options are as follows: fair value of common stock \$0.40; risk-free interest rate of 5.00%; expected dividend yield zero percent; expected option life of four years; and current volatility of 125%. Included in this stock option grant were stock option grants to Mr. Brett Newbold, the Company's President and Chief Technology Officer in the amount of 100,000 shares at an exercise price of \$0.40 per shares and a grant to Ms. Heidi Newton, the Company's Vice President-Finance and Administration in the amount of 140,000 shares with an exercise price of \$0.40 per share.

### STOCK OPTION GRANT TO MR. BRADEN WAVERLEY

Included in the January 24, 2007 stock option grant, the Company issued to Braden Waverley, the Company's Chief Executive Officer, an option granted under the Plan to purchase 1,500,000 shares of the Company's common stock at an exercise price of \$0.40 per share and an option granted outside of the Plan to purchase 547,121 shares of the Company's common stock at an exercise price of \$0.40 per share. Each option has a term of 10 years and vests with respect to 20% on the date of grant and 1/48th of the balance on the last day of each month for the 48 months following the date of grant until fully vested. Each option expires on January 23, 2017. The Company and Mr. Waverley have agreed, pursuant to an amendment dated January 24, 2007, of that certain Employment Agreement dated February 17, 2006 between the Company and Mr. Waverley, that these options were issued in lieu of a grant that was intended to be made under the terms of the Employment Agreement as an antidilutive grant, following the Company's completion of its recapitalization under the creditor and claimant liabilities restructuring program and the effectiveness of a registration statement for the resale of such shares so that Mr. Waverley would retain options to purchase up to 3.5% of the Company's fully diluted common stock. Mr. Waverley's Employment Agreement also provided for the grant of an additional option to purchase that number of shares of the Company's common stock representing an aggregate of 3.5% of the outstanding shares of the Company's common stock on a fully-diluted basis upon Mr. Waverley's appointment as the Company's Chief Executive Officer.

### STOCK OPTION GRANT TO MR. MARTIN T. JOHNSON

Included in the January 24, 2007 stock option grant, the Company issued to Martin T. Johnson, the Company's Chief Financial Officer, an option under the Plan to purchase 731,114 shares of the Company's common stock at an exercise price of \$0.40 per share. The option has a term of 10 years and vests with respect to 20% on the date of grant and 1/48th of the balance on the last day of each month for the 48 months following the date of grant until fully vested. The option expires on January 23, 2017. The Company and Mr. Johnson have agreed, pursuant to an amendment dated January 24, 2007, of that certain Employment Agreement dated February 17, 2006 between the Company and Mr. Johnson, that these options were issued in lieu of a grant that was intended to be made under the terms of the Employment Agreement as an antidilutive grant, following the Company's completion of its recapitalization under the creditor and claimant

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liabilities restructuring program and the effectiveness of a registration statement for the resale of such shares so that Mr. Johnson would retain options to purchase up to 1.25% of the Company's fully diluted common stock.

### STOCK OPTION GRANT TO MR. ROBERT CROSS

Included in the January 24, 2007 stock option grant, the Company issued to Robert Cross, the Company's chairman of the board of directors, an option under the Plan to purchase 757,318 shares of the Company's common stock at an exercise price of \$0.40 per share. The option has a term of 10 years and vests with respect to 20% on the date of grant and 1/48th of the balance on the last day of each month for the 48 months following the date of grant until fully vested. The option expires on January 23, 2017. The Company and Mr. Cross have agreed that these options were issued in lieu of a grant (approved by the board of directors on March 7, 2006) that was intended to be made to Mr. Cross following the Company's completion of its recapitalization under the creditor and claimant liabilities restructuring program and the effectiveness of a registration statement for the resale of such shares so that Mr. Cross would retain options to purchase 2.5% of the Company's fully diluted common stock.

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### STOCK OPTION GRANT TO MR. GEORGE MIDDLEMAS

Included in the January 24, 2007 stock option grant, the Company issued to George Middlemas, a director of the Company, an option under the Plan to purchase 50,000 shares of the Company's common stock at an exercise price of \$0.40 per share. The option has a term of 10 years and vests fully at the next annual meeting of stockholders.

### ADJUSTMENT OF SERIES A PREFERRED CONVERSION PRICE

On January 24, 2007, the Company issued 5,270,553 stock options under the Patron Systems Inc. 2006 Stock Incentive Plan. These options have an exercise price of \$0.40 per share. This issuance has resulted in the adjustment of the Series A Preferred conversion price to \$0.40 per share and has resulted in an additional 6,695,116 shares of Common Stock being reserved for issuance upon the conversion of the Series A Preferred Stock. The fair value of these additional conversion shares is \$2,295,562. Assumptions relating to the estimated fair value of these additional conversion shares are as follows: Fair value of common stock \$0.40, risk-free interest rate of 5.0%; expected dividend yield of zero percent; expected option life of five years; and current volatility of 125%.

### 2007 BRIDGE NOTES

On February 20, 2007, the Company, in consideration of funds advanced in the aggregate amount of \$200,000, issued a secured convertible promissory note (the "2007 Bridge Note") to Apex in the principal amount of \$200,000, and issued a common stock purchase warrant for 200,000 shares at an exercise price of \$1.00 per share. The common stock purchase warrants have a term of five (5) years. The Company's obligations under the 2007 Bridge Note is secured by liens on all assets of the Company pursuant to a Security Agreement entered into by the Company and Apex on February 20, 2007 (the "Security Agreement"). The aggregate amounts (principal and any accrued interest) under the 2007 Bridge Note are payable to Apex on demand with simple interest accruing on any unpaid principal amount at a rate of nine (9) percent per annum. At the option of Apex, the 2007 Bridge Note is convertible into shares of the Company's common stock at any time, in an amount equal to the quotient of the amounts being converted under the 2007 Bridge Notes divided by the offering price per share associated with

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any offering of equity securities made by the Company, or in an amount equal to the quotient of the amounts being converted by the fair value of such shares. The Security Agreement terminates upon the full satisfaction of the Company's obligations under the 2007 Bridge Note or upon the conversion of the 2007 Bridge Note.

On March 2, 2007, March 19, 2007 and March 27, 2007, the Company was advanced an additional \$100,000, \$160,000 and \$165,000 respectively. These advances will result in the granting of common stock purchase warrants in the amount of 100,000 shares at an exercise price of \$1.25 associated with the March 2, 2007 advance, 160,000 shares at an exercise price of \$1.14 associated with the March 19, 2007 advance and 165,000 shares at an exercise price of \$1.25 per share associated with the March 27, 2007 advance. These common stock purchase warrants have a term of 5 years.

PART III

ITEM 13. EXHIBITS

See attached Exhibit Index.

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SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the Company caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PATRON SYSTEMS, INC.

By: /S/ BRADEN WAVERLEY

-----  
 Braden Waverley

Its: Chief Executive Officer

Date: May 21, 2007

| SIGNATURE   | TITLE  | DATE         |
|---|--|--------------|
| -----   | -----  | -----        |
| /S/ BRADEN WAVERLEY<br>-----<br>Braden Waverley     | Chief Executive Officer<br>& Director  | May 21, 2007 |
| /S/ MARTIN T. JOHNSON<br>-----<br>Martin T. Johnson | Chief Financial Officer  | May 21, 2007 |
| /S/ HEIDI B. NEWTON<br>-----<br>Heidi B. Newton     | Vice President-Finance and<br>and Administration<br>(Principal Accounting Officer) | May 21, 2007 |
| *<br>-----<br>Robert Cross                          | Chairman of the Board  | May 21, 2007 |

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\*

Director

May 21, 2007

-----  
George Middlemas

\* /S/ HEIDI NEWTON

-----  
Heidi Newton, Attorney-in-Fact

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EXHIBIT INDEX

| EXHIBIT<br>NUMBER | DESCRIPTION OF EXHIBIT   |
|-------------------|--|
| 2.1               | Agreement and Plan of Merger dated as of November 24, 2002, among Patron Systems, Inc., ESC Acquisition, Inc. and Entelagent Software Corp. Incorporated by reference to Exhibit 2.3 to the Current Report on Form 8-K filed November 27, 2002.                    |
| 2.2               | Supplemental Agreement dated as of November 24, 2002, among Patron Systems, Inc., ESC Acquisition, Inc. and Entelagent Software Corp. Incorporated by reference to Exhibit 2.4 to the Current Report on Form 8-K filed November 27, 2002.                          |
| 2.3               | Agreement and Plan of Merger dated as of March 26, 2003, between Patron Systems, Inc. and Patron Holdings, Inc. Incorporated by reference to Exhibit A to the Definitive Information Statement on Schedule 14C filed on March 7, 2003.                             |
| 2.4               | Supplemental Agreement dated February 24, 2005, among Patron Systems, Inc., LL Acquisition I Corp. and LucidLine, Inc. Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K filed March 2, 2005.  |
| 2.5               | Agreement and Plan of Merger dated February 24, 2005, among Patron Systems, Inc., LL Acquisition I Corp. and LucidLine, Inc. Incorporated by reference to Exhibit 10.3 to the Current Report on Form 8-K filed March 2, 2005.                                      |
| 2.6               | Supplemental Agreement dated February 24, 2005, among Patron Systems, Inc., CSSI Acquisition Co. I, Inc. and Complete Security Solutions, Inc. Incorporated by reference to Exhibit 10.5 to the Current Report on Form 8-K filed March 2, 2005.                    |
| 2.7               | Agreement and Plan of Merger dated February 24, 2005, among Patron Systems, Inc., CSSI Acquisition Co. I, Inc. and Complete Security Solutions, Inc. Incorporated by reference to Exhibit 10.6 to the Current Report on Form 8-K filed March 2, 2005.              |
| 2.8               | Amended and Restated Supplemental Agreement dated as of February 24, 2005, by and among Patron Systems, Inc., ESC Acquisition, Inc. and Entelagent Software Corp. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed March 2, 2005. |
| 2.9               | Amended and Restated Agreement and Plan of Merger dated March 30, 2005,  |

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by and among Patron Systems Inc., ESC Acquisition, Inc. and Entelagent Software Corp. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed April 5, 2005.

- 3.1.1 Second Amended and Restated Certificate of Incorporation of Patron Systems, Inc. dated as of March 7, 2003. Incorporated by reference to Exhibit B to the Definitive Information Statement on Schedule 14C filed on March 7, 2003.
- 3.1.2 Certificate of Designation of Preferences, Rights and Limitations of Series A Convertible Preferred Stock and Series A-1 Convertible Preferred Stock of Patron Systems, Inc. dated as of March 1, 2006. Incorporated by reference to Exhibit 3.1 to the Current Report on Form 8-K filed on March 31, 2006.
- 3.2 Amended and Restated By-laws of Patron Systems, Inc., dated as of March 7, 2003. Incorporated by reference to Exhibit C to the Definitive Information Statement on Schedule 14C filed with the SEC on March 7, 2003.
- 10.1 Registration Rights Agreement dated February 24, 2005, among Patron Systems, Inc. and each of the former LucidLine, Inc. shareholders signatory thereto. Incorporated by reference to Exhibit 10.4 to the Current Report on Form 8-K filed March 2, 2005.
- 10.2 Registration Rights Agreement dated February 24, 2005, among Patron Systems, Inc. and each of the former Complete Security Solutions, Inc. stockholders signatory thereto. Incorporated by reference to Exhibit 10.7 to the Current Report on Form 8-K filed March 2, 2005.

EX-1

| EXHIBIT<br>NUMBER | DESCRIPTION OF EXHIBIT   |
|-------------------|--|
| 10.3              | Form of Subordinated Promissory Note issued to the former preferred stockholders of Complete Security Solutions, Inc. Incorporated by reference to Exhibit 10.8 to the Current Report on Form 8-K filed March 2, 2005.                                   |
| 10.4              | Form of Common Stock Purchase Warrant issued by Patron Systems, Inc. in favor of the former preferred stockholders of Complete Security Solutions, Inc. Incorporated by reference to Exhibit 10.9 to the Current Report on Form 8-K filed March 2, 2005. |
| 10.5              | Form of Subscription Agreement dated February 28, 2005, among Patron Systems, Inc. and each of the investors in Interim Bridge Financing I. Incorporated by reference to Exhibit 10.10 to the Current Report on Form 8-K filed March 2, 2005.            |
| 10.6              | Registration Rights Agreement dated February 28, 2005, among Patron Systems, Inc. and each of the investors in Interim Bridge Financing I. Incorporated by reference to Exhibit 10.11 to the Current Report on Form 8-K filed March 2, 2005.             |
| 10.7              | Form of 10% Senior Convertible Promissory Note issued by Patron Systems, Inc. in favor of investors in Interim Bridge Financing I. Incorporated by reference to Exhibit 10.12 to the Current Report on   |

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Form 8-K filed March 2, 2005.

- 10.8 Form of Common Stock Purchase Warrant issued by Patron Systems, Inc. in favor of investors in Interim Bridge Financing I. Incorporated by reference to Exhibit 10.13 to the Current Report on Form 8-K filed March 2, 2005.
- 10.9 Registration Rights Agreement dated February 28, 2005, among Patron Systems, Inc. and Laidlaw & Company (UK) Ltd. Incorporated by reference to Exhibit 10.14 to the Current Report on Form 8-K filed March 2, 2005.
- 10.10 Form of Common Stock Purchase Warrant issued by Patron Systems, Inc. in favor of Laidlaw & Company (UK) Ltd. in connection with placement agent services. Incorporated by reference to Exhibit 10.15 to the Current Report on Form 8-K filed March 2, 2005.
- 10.11 Form of Common Stock Purchase Warrant issued by Patron Systems, Inc. in favor of Laidlaw & Company (UK) Ltd in connection with advisory services. Incorporated by reference to Exhibit 10.16 to the Current Report on Form 8-K filed March 2, 2005.
- 10.12 Executive Employment Agreement dated February 28, 2005, between Brett Newbold and Patron Systems, Inc. Incorporated by reference to Exhibit 10.12 to the Annual Report on Form 10-KSB filed April 3, 2006.\*
- 10.13 Executive Employment Agreement dated February 28, 2005, between J. William Hammon and Patron Systems, Inc. Incorporated by reference to Exhibit 10.13 to the Annual Report on Form 10-KSB filed April 3, 2006.\*
- 10.14 Registration Rights Agreement dated March 30, 2005, among Patron Systems, Inc. and each of the former Entelagent Software Corp. shareholders signatory thereto. Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K filed April 5, 2005.
- 10.15 Form of Promissory Note issued to certain creditors of Entelagent Software Corp. Incorporated by reference to Exhibit 10.3 to the Current Report on Form 8-K filed April 5, 2005.
- 10.16 Settlement Agreement and Mutual Release dated June 2, 2005, among Patrick J. Allin, The Allin Dynastic Trust and Patron Systems, Inc. Incorporated by reference to Exhibit 10.16 to the Annual Report on Form 10-KSB filed April 3, 2006.
- 10.17 Form of Subscription Agreement between Patron Systems, Inc. and each of the investors in Interim Bridge Financing II. Incorporated by reference to Exhibit 10.3 to the Quarterly Report on Form 10-QSB filed August 22, 2005.

EX-2

| EXHIBIT<br>NUMBER | DESCRIPTION OF EXHIBIT   |
|-------------------|--|
| 10.18             | Registration Rights Agreement among Patron Systems, Inc. and each of the investors in Interim Bridge Financing II. Incorporated by reference to Exhibit 10.18 to the Annual Report on Form 10-KSB filed April 3, 2006. |

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- 10.19 Form of 10% Junior Convertible Promissory Note issued by Patron Systems, Inc. in favor of investors in Interim Bridge Financing II. Incorporated by reference to Exhibit 10.19 to the Annual Report on Form 10-KSB filed April 3, 2006.
- 10.20 Form of Common Stock Purchase Warrant issued by Patron Systems, Inc. in favor of the Placement Agent for, and investors in, Interim Bridge Financing II. Incorporated by reference to Exhibit 10.20 to the Annual Report on Form 10-KSB filed April 3, 2006.
- 10.21 Option Agreement dated July 1, 2005, between Robert Cross and Patron Systems, Inc. Incorporated by reference to Exhibit 10.1 to the Quarterly Report on Form 10-QSB filed August 22, 2005.\*
- 10.22 Employment Agreement dated July 1, 2005, between Robert Cross and Patron Systems, Inc. Incorporated by reference to Exhibit 10.2 to the Quarterly Report on Form 10-QSB filed August 22, 2005.\*
- 10.23 Form of Subscription Agreement between Patron Systems, Inc. and each of the investors in Interim Bridge Financing III. Incorporated by reference to Exhibit 10.23 to the Annual Report on Form 10-KSB filed April 3, 2006.
- 10.24 Registration Rights Agreement among Patron Systems, Inc. and each of the investors in Interim Bridge Financing III. Incorporated by reference to Exhibit 10.24 to the Annual Report on Form 10-KSB filed April 3, 2006.
- 10.25 Form of 10% Junior Convertible Promissory Note issued by Patron Systems, Inc. in favor of each of the investors in Interim Bridge Financing III. Incorporated by reference to Exhibit 10.25 to the Annual Report on Form 10-KSB filed April 3, 2006.
- 10.26 Form of Common Stock Purchase Warrant issued by Patron Systems, Inc. in favor of each of the investors in, Interim Bridge Financing III. Incorporated by reference to Exhibit 10.26 to the Annual Report on Form 10-KSB filed April 3, 2006.
- 10.27 Lease Agreement dated August 31, 2005, between Flatiron Boulder Office, Inc. and Patron Systems, Inc. Incorporated by reference to Exhibit 10.1 to the Quarterly Report on Form 10-QSB filed November 21, 2005.
- 10.28 Employment Agreement dated February 17, 2006, between Patron Systems, Inc. and Braden Waverley. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed February 23, 2006.
- 10.29 Employment Agreement dated February 17, 2006, between Patron Systems, Inc. and Martin Johnson. Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K filed February 23, 2006.
- 10.30 Option Agreement dated February 17, 2006, between Patron Systems, Inc. and Braden Waverley. Incorporated by reference to Exhibit 10.3 to the Current Report on Form 8-K filed February 23, 2006.
- 10.31 Option Agreement dated February 17, 2006, between Patron Systems, Inc. and Martin Johnson. Incorporated by reference to Exhibit 10.4 to the Current Report on Form 8-K filed February 23, 2006.
- 10.32 Form of Subscription Agreement between Patron Systems, Inc. and each of the purchasers of shares of the Series A Preferred Stock of Patron Systems, Inc. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on March 31, 2006.



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- 10.33 Form of Common Stock Purchase Warrant issued by Patron Systems, Inc. in favor of each of the purchasers of shares of the Series A Preferred Stock of Patron Systems, Inc. Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K filed on March 31, 2006.

EX-3

| EXHIBIT<br>NUMBER | DESCRIPTION OF EXHIBIT  |
|-------------------|---|
| 10.34             | Registration Rights Agreement dated March 27, 2006, among Patron Systems, Inc. and each of the purchasers of shares of the Series A Preferred Stock of Patron Systems, Inc. Incorporated by reference to Exhibit 10.3 to the Current Report on Form 8-K filed on March 31, 2006.  |
| 10.35             | Form of Stock Subscription Agreement and Mutual Release issued by Patron Systems, Inc. in favor of each of the Creditors and/or Claimants exchanging claims for shares of the Series A-1 Preferred Stock of Patron Systems, Inc. Incorporated by reference to Exhibit 10.4 to the Current Report on Form 8-K filed on March 31, 2006. |
| 10.36             | Post Closing Escrow Agreement dated March 27, 2006, between Stubbs Alderton & Markiles, LLP and Patron Systems, Inc. Incorporated by reference to Exhibit 10.5 to the Current Report on Form 8-K filed on March 31, 2006.   |
| 10.37             | Form of Subscription Agreement between Patron Systems, Inc. and each of the purchasers of shares of the Series B Preferred Stock of Patron Systems, Inc. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on October 17, 2006.   |
| 10.38             | Form of Common Stock Purchase Warrant issued by Patron Systems, Inc. in favor of each of the placement agent and the purchasers of shares of the Series B Preferred Stock of Patron Systems, Inc. Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K filed on October 17, 2006.                              |
| 10.39             | Registration Rights Agreement dated October 12, 2006, among Patron Systems, Inc., Laidlaw & Company (UK) Ltd. and each of the purchasers of shares of the Series B Preferred Stock of Patron Systems, Inc. Incorporated by reference to Exhibit 10.3 to the Current Report on Form 8-K filed on October 17, 2006.                     |
| 10.40             | First Amendment to Executive Employment Agreement dated February 17, 2006, entered into on January 24, 2007, between Patron Systems, Inc. and Braden Waverley.* Previously filed with the Form 10-KSB.  |
| 10.41             | First Amendment to Executive Employment Agreement dated February 17, 2006, entered into on January 24, 2007, between Patron Systems, Inc. and Martin T. Johnson.* Previously filed with the Form 10-KSB.  |
| 10.42             | Secured Convertible Promissory note dated February 20, 2007, issued by Patron Systems, Inc. in favor of Apex Investment Fund V, L.P. Previously filed with the Form 10-KSB.   |
| 10.43             | Security Agreement dated February 20, 2007, between Patron Systems, Inc. and Apex Investment Fund V, L.P. Previously filed with the Form  |

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10-KSB.

- 10.44 Form of Warrant issued by Patron Systems, Inc. in favor of Apex Investment Fund V, L.P. Previously filed with the Form 10-KSB.
- 24.1 Power of Attorney. Previously filed with the Form 10-KSB.
- 31.1 Certification of Principal Executive Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Principal Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Indicates a management contract or compensatory plan.

EX-4