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

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

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

(Mark One)
[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2006

[_] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the transition period from _____ to _____

COMMISSION FILE NUMBER 0-25675

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

DELAWARE	74-3055158
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(IRS EMPLOYER IDENTIFICATION NO.)
5775 FLATIRON PARKWAY, SUITE 230 BOULDER, CO	80301
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)	(ZIP CODE)

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

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 [X] No [_]

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 14,462,260 shares of common stock outstanding as of November 13, 2006.

Transitional Small Business Disclosure Format (Check one): Yes [_] No [X]

PATRON SYSTEMS, INC.

FORM 10-QSB/A QUARTERLY REPORT

TABLE OF CONTENTS

PART I - FINANCIAL INFORMATION PAGE

ITEM 1. FINANCIAL STATEMENTS 4

Condensed Consolidated Balance Sheet at September 30, 2006 (unaudited)..... 4
Condensed Consolidated Statements of Operations for the Three and
Nine Months Ended September 30, 2006 (unaudited)..... 5
Condensed Consolidated Statement of Stockholders' (Deficiency)
Equity for the Nine Months Ended September 30, 2006 (unaudited)..... 6
Condensed Consolidated Statements of Cash Flows for the
Nine Months Ended September 30, 2006 and September 30, 2005 (unaudited).... 7
Notes to Condensed Consolidated Financial Statements (unaudited)..... 8

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL
CONDITION AND RESULTS OF OPERATIONS..... 37

PART II - OTHER INFORMATION

ITEM 6. EXHIBITS.....51

SIGNATURES..... 52

EXPLANATORY NOTE

Patron Systems, Inc. is filing this Amendment No. 1 to its Quarterly Report on Form 10-QSB (the "Form 10-QSB") for the quarterly period ended September 30, 2006 filed with the Securities and Exchange Commission on November 14, 2006. This filing amends and restates our previously reported financial statements for the nine months ended September 30, 2006 to reflect the determination by the Company that, during the three months ended March 31, 2006, it had recorded 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. For the nine months ended September 30, 2006, the Company recorded 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. The nature of the adjustments required in the creditor and claimant liabilities restructuring 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.

This Amendment No. 1 amends and restates the following items of our Form 10-QSB as described above: (i) Part I, Item 1 - Financial Statements; (ii) Part I, Item 2 - Management's Discussion and Analysis of Result of Operations and Financial Condition; and (iii) Part II, Item 6 - Exhibits.

All information in our Form 10-QSB, as amended by this Amendment No. 1, speaks as to the date of the original filing of our Form 10-QSB 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 initial filing of our Form 10-QSB.

FORWARD LOOKING STATEMENTS

The following discussion and explanations should be read in conjunction with the financial statements and related notes contained elsewhere in this Form 10-QSB/A. Certain statements made in this discussion are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements can be identified by terminology such as "may," "will," "should," "expects," "intends," "anticipates," "believes," "estimates," "predicts," or "continue" or the negative of these terms or other comparable terminology. Because forward-looking statements involve risks and uncertainties, there are important factors that could cause actual results to differ materially from those expressed or implied by these forward-looking statements. Although Patron Systems believes that expectations reflected in the forward-looking statements are reasonable, it cannot guarantee future results, performance or achievements. Moreover, neither Patron Systems nor any other person assumes responsibility for the accuracy and completeness of these forward-looking statements. Patron Systems is under no duty to update any forward-looking statements after the date of this report to conform such statements to actual results.

PART I - FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

PATRON SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEET
(unaudited)

ASSETS	SEPTEMBER 30, 2006 (As Restated)
Current Assets	
Cash	$ 60,156
Accounts receivable, net	222,722
Other current assets	58,004
Total current assets	340,882
Property and equipment, net	193,543
Intangible assets, net	1,436,767
Goodwill	9,510,716
Total assets	$ 11,481,908
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current Liabilities	
Accounts payable	$ 659,030

Accrued payroll and related expenses	551,930
Accrued interest	592,179
Demand note payable	312,556
Bridge notes payable	1,519,975
Notes payable (to creditors of acquired business, including $554,202 to related parties)	799,982
Expense reimbursements due to officers and stockholders	4,458
Other current liabilities	555,043
Accrued registration rights penalty	90,488
Deferred revenue	223,880
Total current liabilities	5,309,521
Commitments and contingencies	
Stockholders' Equity	
Preferred stock, par value $0.01 per share, 75,000,000 shares authorized, Series A convertible: 2,160 shares authorized; 964 shares issued and outstanding	10
liquidation preference of $6,334,337	
Series A-1 convertible: 50,000,000 shares authorized; no shares outstanding	--
Common stock, par value $0.01 per share, 150,000,000 shares authorized, 14,462,260 shares issued and outstanding	144,627
Additional paid-in capital	94,466,946
Deferred compensation	--
Accumulated deficit	(88,439,196)
Total stockholders' equity	6,172,387
Total liabilities and stockholders' equity	$ 11,481,908

See notes to condensed consolidated financial statements.

PATRON SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	NINE MONTHS ENDED SEPTEMBER 30,		THREE SEP
	2006 (AS RESTATED)	2005	2006
Revenue	$ 857,570	$ 184,300	$ 276,82
Cost of Sales			
Cost of products/services	39,580	2,003	9,68
Amortization of technology	99,980	280,855	44,93
Total cost of sales	139,560	282,858	54,61

Gross profit (loss)	718,010	(98,558)	222,20
Operating Expenses			
Salaries and related expenses	3,700,443	2,306,118	1,252,25
Consulting expense (non-employee stock based compensation)	--	1,239,083	--
Professional fees	1,105,500	932,250	219,60
General and administrative	1,011,459	1,251,659	389,88
Amortization of intangibles	92,440	69,691	30,81
Stock based penalties under accomodation agreements	--	745,500	--
Stock based penalty under collateralized financing arrangement	8,560	78,247	3,31
Loss on intrinsic value of put right	--	(300,000)	--
Loss on collateralized financing arrangement	--	366,193	--
Loss/(gain) associated with settlement agreements	(2,452,909)	(343,571)	(580,54
Total operating expenses	3,465,493	6,345,170	1,315,32
Operating loss	(2,747,483)	(6,443,728)	(1,093,12
Other Income (Expense)			
Interest income	2,770	19,250	80
Loss on sale of property and equipment	(125)	(544)	--
Interest expense	(1,125,449)	(12,355,249)	(64,56
Total other income (expense)	(1,122,804)	(12,336,543)	(63,75
Loss from continuing operations before income taxes	(3,870,287)	(18,780,271)	(1,156,87
Income taxes	--	--	--
Loss from continuing operations	(3,870,287)	(18,780,271)	(1,156,87
Loss from discontinued operations	(104,962)	(1,129,751)	--
Loss on disposal of discontinued operations	(75,920)	--	--
	(180,882)	(1,129,751)	--
Net loss	(4,051,169)	(19,910,022)	(1,156,87
Preferred stock dividend	(246,968)	--	(122,18
Net loss available to common stockholders	$ (4,298,137)	$(19,910,022)	$ (1,279,06
Net Loss Per Share - Basic and Diluted			
- Continuing operations	$ (0.83)	$ (9.84)	$ (0.1
- Discontinued operations	(0.04)	(0.59)	--
- Total Net Loss per share available to common stockholders	$ (0.87)	$ (10.43)	$ (0.1
Weighted Average Number of Shares Outstanding - Basic and diluted	4,945,846	1,909,483	10,490,54

See notes to condensed consolidated financial statements.

PATRON SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' (DEFICIENCY) EQUITY
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006
(UNAUDITED)

	SHARES OF SERIES A PREFERRED STOCK	PAR VALUE SERIES A PREFERRED STOCK	SHARES OF SERIES A-1 PREFERRED STOCK
Balance - December 31, 2005	--	$ --	--
Reclassification of deferred compensation upon adoption of FAS 123 (R)	--	--	--
Issuance of Series A Preferred Stock to investors	964	10	--
Issuance of warrants in connection with bridge loan extension - extension warrants	--	--	--
Conversion option penalty incurred upon default of Bridge Financing III	--	--	--
Cancellation of stock repurchase obligations due to former officer	--	--	--
Issuance of Series A-1 Preferred stock in settlement of debt	--	--	36,993,054
Issuance of shares in connection with anti-dilution provision	--	--	--
Amortization of deferred compensation	--	--	--
Conversion of Preferred Series A-1 to common stock	--	--	(36,993,054)
Net Loss	--	--	--
BALANCE - SEPTEMBER 30, 2006 (AS RESTATED)	964	$ 10	--

	PAR VALUE COMMON STOCK	ADDITIONAL PAID IN CAPITAL (AS RESTATED)	DEFERRED COMPENSATIO
Balance - December 31, 2005	$ 19,787	$ 65,601,272	$ (7,50
Reclassification of deferred compensation upon adoption of FAS 123 (R)	--	(7,500)	7,50
Issuance of Series A Preferred Stock to investors	--	4,535,440	--
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	--
Cancellation of stock repurchase obligations due to former officer	--	1,300,000	--
Issuance of Series A-1 Preferred stock in settlement of debt	(983)	22,245,869	--

Issuance of shares in connection with anti-dilution provision	2,512	(2,512)	--
Amortization of deferred compensation	--	307,629	--
Conversion of Preferred Series A-1 to common stock	123,311	246,619	--
Net Loss	--	--	--
BALANCE - SEPTEMBER 30, 2006 (AS RESTATED)	$ 144,627	$ 94,466,946	$ --

	TOTAL (AS RESTATED)
Balance - December 31, 2005	$(20,066,968)
Reclassification of deferred compensation upon adoption of FAS 123 (R)	(7,500)
Issuance of Series A Preferred Stock to investors	4,535,450
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
Cancellation of stock repurchase obligations due to former officer	2,600,000
Issuance of Series A-1 Preferred stock in settlement of debt	22,614,816
Issuance of shares in connection with anti-dilution provision	--
Amortization of deferred compensation	307,629
Conversion of Preferred Series A-1 to common stock	--
Net Loss	(4,051,169)
BALANCE - SEPTEMBER 30, 2006 (AS RESTATED)	$ 6,172,387

See notes to condensed consolidated financial statements.

PATRON SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	NINE MONTHS ENDED SEPTEMBER 30,	
	2006 (As Restated)	2005
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss from continuing operations	$ (3,870,287)	$(18,780,271)

Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	236,845	367,974
Stock based compensation	307,629	1,239,083
Non-cash interest expense	543,439	1,927,374
Amortization of deferred financing charges	--	1,825,606
Stock options issued to Chief Executive Officer	--	16,000
Penalty warrants issued to bridge note holders	--	8,000,000
Gain associated with settlement agreements	(2,452,909)	(389,103)
Accrued registration penalty	8,560	--
Loss on disposition of discontinued operations	75,920	--
Loss on sale of fixed assets	125	--
Reduction in intrinsic value of put right	--	(300,000)
Stock based penalty under accomodation agreements	--	823,747
Gain on settlement of consulting agreement payable	--	(228,900)
Loss on collateralized financing arrangement	--	366,194
Non-cash increase in notes payable to former officer	--	17,399
Non-cash interest income	--	(19,250)
Changes in assets and liabilities:		
Restricted cash escrowed to settle liabilities assumed	511,691	(517,003)
Prepaid expenses	--	51,487
Accounts receivable	1,422	(32,634)
Other current assets	18,636	(95,682)
Accounts payable	(222,911)	(320,797)
Accrued interest	581,137	12,202
Deferred revenue	(108,201)	65,267
Accrued payroll and payroll related expenses	24,366	(1,043,209)
Other current liabilities	(157,401)	394,267
Consulting agreements payable	--	(50,000)
Expense reimbursements due to officers and stockholders	(32,335)	(30,521)
Loss on sale of property and equipment	--	544
Other accrued expenses	--	(3,413)
Total adjustments	(663,987)	12,076,632
NET CASH USED IN CONTINUING OPERATIONS	(4,534,274)	(6,703,639)
NET CASH USED IN DISCONTINUED OPERATIONS	(197,882)	(1,077,769)
NET CASH USED IN OPERATING ACTIVITIES	(4,732,156)	(7,781,408)
CASH FLOWS USED IN INVESTING ACTIVITIES		
Cash payments in purchase business combinations	--	(857,633)
Cash acquired in purchase business combinations	--	406,834
Purchase and development of technology	(396,428)	(92,547)
Proceeds from sale of fixed assets	1,755	1,500
Purchase of fixed assets	(133,559)	(43,608)
NET CASH USED IN CONTINUING INVESTING ACTIVITIES	(528,232)	(585,454)
NET CASH USED IN DISCONTINUED INVESTING ACTIVITIES	(78,920)	(14,284)
NET CASH USED IN INVESTING ACTIVITIES	(607,152)	(599,738)
CASH FLOWS FROM FINANCING ACTIVITIES		
Expenses repaid to officers and stockholders	--	(273,536)

Payments on settlement of accommodation agreements ...	(125,000)	--
Deferred financing costs	(54,000)	(627,739)
Proceed from issuance of Series A Preferred Stock	4,355,451	--
Repayments of amounts due under settlement with former officer	--	(200,000)
Proceeds from issuance of bridge notes	1,000,000	7,100,000
Repayments of notes payable	(7,001)	--
Proceeds from disposition of discontinued operations	50,000	--
Proceeds received in connection with financing settlement	180,000	--
Proceeds from issuance of notes, less fees	--	2,543,000
Repayments of advances from stockholders	--	(32,774)
NET CASH PROVIDED BY CONTINUING FINANCING ACTIVITIES	5,399,450	8,508,951
NET CASH USED BY DISCONTINUED FINANCING ACTIVITIES	--	(93,483)
NET CASH PROVIDED BY FINANCING ACTIVITIES	5,399,450	8,415,468
NET INCREASE IN CASH	60,142	34,322
CASH, beginning of period	14	45,901
CASH, end of period	$ 60,156	$ 80,223
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for:		
Interest	$ 285,091	$ 527,231
Supplemental non-cash investing and finanical activity		
Current tangible assets acquired	$ --	$ 300,911
Non-current tangible assets acquired		2,756,470
Current liabilities assumed with acquisitions		(8,379,271)
Non-current liabilities assumed with acquisitions		(439,126)
Intangible assets acquired		3,101,000
Goodwill recognized on purchase business combinations		22,433,752
Non-cash consideration		(19,332,500)
Cash acquired in purchase business combinations		416,397
Cash paid to acquire businesses	$ --	$ 857,633
Liabilities and claims settled in exchange for Series A-1 Preferred Stock	$ 24,467,871	

See notes to condensed consolidated financial statements.

PATRON SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
SEPTEMBER 30, 2006

NOTE 1 - BASIS OF INTERIM FINANCIAL STATEMENT PRESENTATION

The accompanying unaudited Condensed Consolidated Financial Statements of Patron Systems, Inc. and subsidiaries (the "Company," "Patron," "we," "us," or "our") have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-QSB. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows for all periods presented have been made. The results of operations for the three-month and nine-month periods ended September 30, 2006 are not necessarily indicative of the operating results that may be expected for the entire year ending December 31, 2006.

This Form 10-QSB/A should be read in conjunction with the Company's 10-KSB for the year ended December 31, 2005.

NOTE 2 - THE COMPANY

ORGANIZATION AND DESCRIPTION OF BUSINESS

Patron Systems, Inc. ("Systems") is a Delaware corporation formed in April 2002 to provide comprehensive, end-to-end information security solutions to global corporations and government institutions.

Pursuant to an Amended and Restated Share Exchange Agreement dated October 11, 2002, Combined Professional Services ("CPS"), Systems and the stockholders of Systems consummated a share exchange ("Share Exchange"). As a result of the Share Exchange, the former stockholders of Systems became the majority stockholders of CPS. Accordingly, Systems became the accounting acquirer of CPS and the exchange was accounted for as a reverse merger and recapitalization of Systems. CPS subsequently merged with Systems, with Systems surviving the merger. The combined entity continued to use the name Patron Systems, Inc.

ANNUAL MEETING OF STOCKHOLDERS

On July 20, 2006, the Company held its annual meeting of stockholders. The stockholders approved the election of three directors: Mr. Robert Cross to serve until the annual meeting of stockholders in 2007; Mr. Braden Waverley to serve until the annual meeting of stockholders in 2008; and Mr. George Middlemas to serve until the annual meeting of stockholders in 2009. Additionally, the stockholders approved the three other proposals made as part of the 2006 proxy statement including the adoption of the Patron Systems, Inc. 2006 Stock Incentive Plan which provides for the grant of up to 5.6 million shares of common stock underlying stock options and other awards under the plan and the approval of an amendment to the Second Amended and Restated Certificate of Incorporation, as amended, to provide for a 1-for-30 reverse stock split of the Company's issued and outstanding common stock.

REVERSE STOCK SPLIT AND AMENDMENT TO CERTIFICATE OF INCORPORATION

On July 20, 2006, the Company's stockholders approved an amendment to its Second

Amended and Restated Certificate of Incorporation, as amended, to provide for a 1-for-30 reverse stock split of our issued and outstanding Common Stock. Effective July 31,2006, the Company's Second Amended and Restated Certificate of Incorporation, as amended, to provide for a 1-for-30 reverse stock split of our issued and outstanding Common Stock was declared effective. All share information included in the accompanying financial statements and notes thereto give retroactive effect to the reverse split.

CONSOLIDATION OF SUBSIDIARIES

Effective September 19, 2006, we merged our wholly-owned subsidiaries Entelagent, CSSI and PILEC into our 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 3 - RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS

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. 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 was recorded.

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 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:

	Nine Months ended September 30, 2006	
	As Previously Reported	As Restated
Loss/(Gain) associated with settlement agreements	$ (93,944)	$ (2,452,909)
Interest expense	$ (1,768,499)	$ (1,125,449)
Net loss from continuing operations	$ (6,872,302)	$ (3,870,287)
Net loss available to common stockholders	$ (7,300,152)	$ (4,298,137)
Net loss per share- continuing operations	$ (1.44)	$ (0.83)
Net loss per share - total	$ (1.48)	$ (0.87)
Additional paid in capital	$ 97,468,961	$ 94,466,946
Accumulated Deficit	$(91,688,179)	$(88,439,196)

NOTE 4 - LIQUIDITY AND FINANCIAL CONDITION

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. The Company incurred a net loss of $4,051,169 for the nine months ended September 30, 2006, which includes an aggregate of $1,172,518 of non-cash charges including the conversion option cost for bridge note and subordinated note holders, non-cash interest expense, the amortization of deferred compensation and the charge for stock option based compensation. These non-cash charges are offset by a non-cash gain of $2,452,909 associated with the settlement of outstanding liabilities, claims and litigation for Series A-1 Preferred stock. The Company used net cash in its operating activities of $4,732,156 during the nine months ended September 30, 2006. The Company's working capital deficiency at September 30, 2006 amounted to $4,968,639 and the Company is continuing to experience shortages in working capital. The Company is also involved in litigation and is being investigated by the Securities and Exchange Commission with respect to certain of its press releases and its use of form S-8 to register shares of common stock issued to certain consultants (Note 16). The Company cannot provide any assurance that the outcome of these matters will not have a material adverse affect on its ability to sustain the business. These matters raise substantial doubt about the Company's ability to continue as a going concern. The accompanying financial statements do not include any adjustments that may result from the outcome of this uncertainty.

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's ability to successfully market its software products, grow revenue and generate cash flows of certain businesses it acquired in 2005 is critical to the realization of its business plan. The Company raised $5,640,501 of gross proceeds ($5,301,451 net proceeds after the payment of certain transaction expenses) in financing transactions during the nine months ended September 30, 2006. The Company used $4,732,156 of these proceeds to fund its operations and a net of $607,152 in investing activities. On January 12, 2006, the Company offered its creditors and claimants an agreement to receive Series A-1 Preferred Stock, par value $0.01 per share ("Series A-1 Preferred") for amounts owed to the holders of the Company's indebtedness (including lenders, past-due trade accounts, and employees, consultants and other service providers with claims for fees, wages or expenses) (Note 17). On July 21, 2006, the Company's Board of Directors approved the completion of the creditor and claimant liabilities restructuring. A total of $24,467,871 of debts, liabilities and other claims were settled by the issuance of Series A-1 Preferred Stock. In addition, through July 21, 2006, the Company settled $660,493 in claims for $28,140 in cash and a $32,500 note. The Company is currently unable to provide assurance that the acceptance of the claims settlement will actually improve the Company's ability to fund the further development of its business plan or improve its operations.

On July 12, 2006, the Board of Directors ratified, approved and adopted the indemnification and escrow agreements that the Company has entered into with its legal counsel, Stubbs, Alderton & Markiles, LLP. Accordingly, cash that was previously held in escrow for general working capital purposes, including the repayment of outstanding obligations, under the Company's merger agreement with Entelagent and the Series A Preferred Stock Financing documents was used to fund general operating activities.

The Company is currently in the process of attempting to raise additional capital and has taken certain steps to conserve its liquidity while it continues to integrate the businesses acquired in 2005. Although management believes that the Company has access to capital resources, the Company has not secured any commitments for additional financing at this time nor can the Company provide any assurance that it will be successful in its efforts to raise additional capital and/or successfully execute its business plan.

NOTE 5 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Entelagent Software Corporation, Complete Security Solutions, Inc. and PILEC Disbursement Company, which were merged into the Company on September 19, 2006. The accounts of LucidLine, Inc. have been included in discontinued operations through April 18, 2006, the date on which LucidLine was sold (Note 20). All significant inter-company transactions have been eliminated.

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 September 30, 2006 the uninsured bank cash balances were $0. 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) services, which include internet access, back-up, retrieval and restoration services and 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 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.

BUSINESS COMBINATIONS

In accordance with business combination accounting, the Company allocated the purchase price of acquired companies to the tangible and intangible assets acquired, liabilities assumed, as well as in-process research and development based on their estimated fair values. The Company engaged a third-party appraisal firm to assist management in determining the fair values of certain assets acquired and liabilities assumed. Such a valuation requires management to make significant estimates and assumptions, especially with respect to intangible assets.

Management makes estimates of fair value based upon assumptions believed to be reasonable. These estimates are based on historical experience and information obtained from the management of the acquired companies. Critical estimates in valuing certain of the intangible assets include but are not limited to: future expected cash flows from license sales, maintenance agreements, customer contracts and acquired developed technologies; expected costs to develop the in-process research and development into commercially viable products; the acquired company's brand awareness and market position, as well as assumptions about the period of time the acquired brand will continue to be used in the combined company's product portfolio; and discount rates. These estimates are inherently uncertain and unpredictable. Assumptions may be incomplete or inaccurate, and unanticipated events and circumstances may occur which may affect the accuracy or validity of such assumptions, estimates or actual results.

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 and determines 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.

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

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 and/or goodwill impairment for each reporting unit. The Company recorded goodwill in connection with the Company's acquisitions described in Note 6 amounting to

$22,440,412. The Company's annual impairment review

of goodwill resulted in goodwill impairment charges totaling $12,929,696 for the year ended December 31, 2005 (Note 6) resulting in $9,510,716 in goodwill at September 30, 2006.

LONG LIVED ASSETS

The Company periodically reviews the carrying values of its long lived 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, which principally consist of amortizable intangibles from acquired businesses, resulted in an impairment charge of $1,705,455 for the year ended December 31, 2005 (Note 9). Amortizable intangible assets continue to be amortized over their estimated useful lives. The Company evaluated the carrying amounts of its goodwill and intangible assets as of September 30, 2006 and determined that impairment charges are not necessary.

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.

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 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 September 30, 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").

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 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 (l) of Appendix A to SFAS 133.

STOCK BASED COMPENSATION

Prior to January 1, 2006, the Company accounted for employee stock transactions 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."

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, $307,629 and $62,705 for the fair value of stock options expected to vest during the nine and three month periods ended September 30, 2006, respectively.

In the current quarter we have reclassified certain components of our 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 as the share-based payments vest.

For the nine and three months ended September 30, 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.

	NINE MONTHS ENDED SEPTEMBER 30, 2005	THREE MONTHS ENDED SEPTEMBER 30, 2005
Net Loss, as reported	$ (19,910,022)	$ (12,677,722)
Stock-based employee compensation cost, under fair value accounting	(375,000)	(225,000)
Pro-forma net loss under fair value method	$ (20,285,022)	$ (12,902,722)
Net loss per share - basic and diluted, as reported	$ (10.43)	$ (6.18)
Net loss per share - basic and diluted, proforma	$ (10.62)	$ (6.29)

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 fee interest rate: 3.44% to 4.05%; expected dividend yield: 0%; expected option life: 3 to 4 years; volatility: 87% to 125%.

COMMON STOCK PURCHASE WARRANTS

The Company accounts for the issuance of common stock purchase warrants issued with registration rights in accordance with the provisions of EITF 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."

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) give the counterparty a choice of net-cash settlement or settlement in shares (physical settlement or net-share settlement).

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 the establishment of a valuation allowance to reflect the likelihood of realization of deferred tax assets.

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.

As a result of the consummation of the Share Exchange described in Note 2, the Company included 40,001 stock options with an exercise price of $0.30 per share that it issued to certain employees during 2002 in its calculation of weighted-average number of common shares outstanding for all periods presented.

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

	SEPTEMBER 30	
	2006	2005
Options	463,970	373,020
Warrants	1,339,306	321,852
Series A Preferred Stock	2,008,567	--
Series A-1 Preferred Stock	12,331,018	--
Convertible Notes	66,557	--

16,209,418	694,872

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Non-monetary Assets" (SFAS 153). SFAS 153 amends APB Opinion No. 29 to eliminate the exception for non-monetary exchanges of similar productive assets and replaces it with a general exception for exchanges of non-monetary assets that do not have commercial substance. A non-monetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The provisions of SFAS 153 are effective for non-monetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Earlier application is permitted for non-monetary asset exchanges occurring in fiscal periods beginning after December 16, 2004. The provisions of this statement are intended be applied prospectively. The adoption of this pronouncement did not have a material effect on the Company's financial statements.

In May 2005, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 154, "Accounting Changes and Error Corrections-a replacement of APB Opinion No. 20 and FASB Statement No. 3" ("SFAS 154"). This Statement replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed.

APB Opinion No. 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. This Statement requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. When it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented, this Statement requires that the new accounting principle be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable and that a corresponding adjustment be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period rather than being reported in an income statement. When it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods, this Statement requires that the new accounting principle be applied as if it were adopted prospectively from the earliest date practicable. This Statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of this pronouncement did not have a material effect on the Company's financial statements.

On June 29, 2005, the EITF ratified Issue No. 05-2, "The Meaning of 'Conventional Convertible Debt Instrument' in EITF Issue No. 00-19, `Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock.'" EITF Issue 05-2 provides guidance on determining whether a convertible debt instrument is "conventional" for the purpose of determining when an issuer is required to bifurcate a conversion option that is embedded in convertible debt in accordance with SFAS 133. Issue No. 05-2 is effective for new instruments entered into and instruments modified in reporting periods

beginning after June 29, 2005. The adoption of this pronouncement did not have a material effect on the Company's financial statements.

In September 2005, the EITF ratified Issue No. 05-4, "The Effect of a Liquidated Damages Clause on a Freestanding Financial Instrument Subject to EITF Issue No. 00-19, 'Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock.'" EITF 05-4 provides guidance to issuers as to how to account for registration rights agreements that require an issuer to use its "best efforts" to file a registration statement for the resale of equity instruments and have it declared effective by the end of a specified grace period and, if applicable, maintain the effectiveness of the registration statement for a period of time or pay a liquidated damage penalty to the investor. The Company is currently in the process of evaluating the effect that the adoption of this pronouncement may have on its financial statements.

In September 2005, the FASB ratified the Emerging Issues Task Force's ("EITF") Issue No. 05-7, "Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues," which addresses whether a modification to a conversion option that changes its fair value affects the recognition of interest expense for the associated debt instrument after the modification and whether a borrower should recognize a beneficial conversion feature, not a debt extinguishment if a debt modification increases the intrinsic value of the debt (for example, the modification reduces the conversion price of the debt). This issue is effective for future modifications of debt instruments beginning in the first interim or annual reporting period beginning after December 15, 2005. The adoption of this pronouncement did not have a material effect on the Company's financial statements.

In September 2005, the FASB also ratified the EITF's Issue No. 05-8, "Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature," which discusses whether the issuance of convertible debt with a beneficial conversion feature results in a basis difference arising from the intrinsic value of the beneficial conversion feature on the commitment date (which is recorded in the stockholders' equity for book purposes, but as a liability for income tax purposes), and, if so, whether that basis difference is a temporary difference under FASB Statement No. 109, "Accounting for Income Taxes." This Issue should be applied by retrospective application pursuant to Statement 154 to all instruments with a beneficial conversion feature accounted for under Issue 00-27 included in financial statements for reporting periods beginning after December 15, 2005. The adoption of this pronouncement did not have a material effect on the Company's financial statements.

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. We are currently evaluating the potential impact, if any, that the adoption of SFAS 155 will have on our 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 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. We are currently evaluating the potential impact, if any, that the adoption of SFAS 156 will have on our consolidated financial statements.

In July 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. We have not yet completed our analysis of the impact this Interpretation will have on our 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 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.

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 6 - BUSINESS COMBINATIONS

On February 25, 2005, the Company acquired Complete Security Solutions, Inc. ("CSSI") and LucidLine, Inc. ("LucidLine") in separate merger transactions. Additionally, on March 30, 2005, the Company acquired Entelagent Software Corp. ("Entelagent") in a merger transaction. The Company accounted for these business combinations in accordance with the provisions of SFAS 141 "Accounting for Business Combinations."

In connection with these three merger transactions, the Company paid, $200,000

in cash, 496,667 shares of common stock with a fair market value of $12,665,000, subordinated promissory notes in the aggregate principal amount of $4,500,000, warrants to purchase up to 75,001 shares of common stock which were valued at $1,912,500. Direct expenses incurred by the Company to complete these transactions amounted to $912,663. The total purchase price for the three companies amounted to $20,190,133.

The allocation of the purchase price was based upon a valuation study performed by an independent outside appraisal firm. The purchase price allocation resulted in the allocation of $3,101,000 to intangible assets, including $2,570,000 to developed technology and $190,000 to in-process research and development. Additionally, the purchase price allocation resulted in the allocation of $22,440,412 to goodwill.

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. Additionally, after reevaluating the resources available to the Company, the strategic direction of the business as well as the revised business plans and financial projections, the Company, during the quarter ended December 31, 2005, recorded a $1,705,455 charge for the impairment of the developed technology assets acquired in the CSSI and Entelagent acquisitions. The remaining amount of goodwill and intangible assets is presented net of such impairment charges recorded during the year ended December 31, 2005. There have been no new developments since December 31, 2005 which would give rise to an impairment charge.

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, Inc. As a result, LucidLine has been treated as a discontinued operation in these financial statements (Note 20).

NOTE 7 - OTHER CURRENT ASSETS

Other current assets consist of the following:

	SEPTEMBER 30, 2006
Prepaid expenses	$ 27,365
Deposits	30,639
Other current assets	$ 58,004

NOTE 8 - PROPERTY AND EQUIPMENT

	SEPTEMBER 30, 2006
Computers	$ 234,136
Furniture and fixtures	31,962
Leasehold improvements	4,490
sub-total	270,588
less: accumulated depreciation	(77,045)

Property and equipment, net	$ 193,543

Depreciation expense amounted to $44,425 and $25,491 for the nine months ended September 30, 2006 and 2005, respectively.

NOTE 9 - INTANGIBLE ASSETS

The components of intangible assets as of September 30, 2006 are set forth in the following table:

	SEPTEMBER 30, 2006
Developed technology	$ 2,570,000
Customer relationships	180,000
Trademarks and tradenames	161,000
In-process research and development	920,815
	3,831,815
Amortization and impairment charge	(2,395,048)
Intangible assets, net	$ 1,436,767

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

YEARS ENDED DECEMBER 31,	INTANGIBLE AMORTIZATION
2006	$ 85,398
2007	367,070
2008	379,501
2009	310,666
2010	180,016
2011	101,686
2012	12,430
	$ 1,436,767

During the year ended December 31, 2005, the Company recorded a $1,705,455 charge for the impairment of the developed technology assets acquired in the CSSI and Entelagent acquisitions (Note 6).

The Company classifies amortization of developed technology as a component of cost of sales and amortization of customer relationship and trademarks and tradenames as a component of general and administrative expense. Amortization expense amounted to $192,420 and $342,483 for the nine months ended September 30, 2006 and 2005, respectively. Included in these amounts is $99,980 and $272,792 for the nine months ended September 30, 2006 and 2005, respectively, which is classified as cost of sales.

NOTE 10 - DEMAND NOTES PAYABLE

Through December 31, 2004, the Company borrowed an aggregate amount of $695,000 from several unrelated parties. At September 30, 2006, all of the notes were settled in the creditor and claimant liabilities restructuring. Interest expense on the notes amounted to $20,750 and $52,125 for the nine months ended September 30, 2006 and 2005, respectively.

The remaining demand note at September 30, 2006, which amounts to $312,556, is payable to Lok Technology and is secured by Entelagent's accounts receivable, which approximate $86,000 and $106,000 at September 30, 2006 and 2005, respectively. The note bears interest at 15% per annum. Interest on this demand note amounted to $35,163 for the nine months ended September 30, 2006 and $23,442 for nine months ended September 30, 2005. As described in Note 16, 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.

As of September 30, 2006, $743,500 of the Demand Notes have been surrendered as payment for Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 17).

NOTE 11 - BRIDGE NOTES PAYABLE

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 $21.00 per share. The aggregate fair value of the Bridge I Warrants amounts to $1,487,500. Prior to final maturity, the Bridge I Notes may be converted 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 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 $21.00 per share. The Bridge I Extension Warrants have a fair value of $822,500. Assumptions relating to the estimated fair value of these 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. 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. The Company has filed with the SEC on July 24, 2006 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.

Contractual interest expense on the Bridge I Notes amounted to $123,665 and $204,167 for the nine months ended September 30, 2006 and 2005, respectively, and is included as a component of interest expense in the accompanying statement of operations.

As of September 30, 2006, $3,180,025 of the Bridge I Notes were surrendered as payment for Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 17). With the surrender of 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 September 30, 2006, $319,975 of Bridge I notes remain outstanding. The registration statement filed on July 24, 2006 includes the resale of the 40,957 restricted shares of the Company's common stock issuable upon the exercise of the conversion option associated with the Bridge I Notes.

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 42,384 shares of common stock (the "Bridge II Warrants"). The warrants have a term of 5 years and an exercise price of $18.00 per share. The aggregate fair value of the Bridge II Warrants amounts to $673,895. Prior to maturity, the Junior Convertible Promissory Notes may be converted 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.

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.

The Bridge II Notes have an initial term of 120 days (due on various dates beginning October 3, 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 2, 2005. Upon the extension of the maturity date of the Bridge II Notes, the contractual interest rate would increase to 12% per annum, and the Company would be required to issue warrants (the "Bridge II 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 II Extension Warrants, issuable upon extension of the maturity date of the Junior Convertible Promissory notes, feature a term of 5 years and an exercise price of $18.00 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%. In addition, if the Bridge II Notes are not paid in

full on or before the extended maturity date, each note becomes convertible into ..128 shares of the Company's common stock for each $1.00 of principal then outstanding. The intrinsic value of this conversion option measured at the issuance date of the notes amounts to $2,543,000 and would be recognized as interest expense in accordance with EITF 00-27. The Company has agreed to file with the SEC, a registration statement for the resale of the restricted shares of its common stock issuable upon exercise of the conversion option that would be issuable in this transaction, on a best efforts basis.

The Company sold these securities to seven accredited investors introduced by Laidlaw, placement agent in the Interim Bridge Financing II. The Company incurred $386,027 of fees in connection with this transaction including a cash fee of $305,160 and $80,867 for the fair value of warrants to purchase 4,243 shares of the Company's common stock at an exercise price of $18.00 per share.

The Company elected to extend the due dates of these notes by an additional 60 days to various dates beginning December 2, 2005. In addition, the Company was required to issue Bridge II Extension Warrants to purchase 42,388 shares of the Company's common stock. The Bridge II Extension Warrants have at term of 5 years and an exercise price of $18.00 per share.

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. 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.
The Company has filed with the SEC on July 24, 2006 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.

Contractual interest expense on the Bridge II Notes amounted to $117,261 and $84,767 for the nine months ended September 30, 2006 and 2005, respectively and is included as a component of interest expense in the accompanying statement of operations.

As of September 30, 2006, $2,343,000 of the Bridge II Notes were surrendered as payment for Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 17). 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 September 30, 2006, $200,000 of the Bridge II Notes remain outstanding. The registration statement filed on July 24, 2006 includes the resale of the 25,600 restricted shares of the Company's common stock issuable upon the exercise of the conversion option associated with the Bridge II Notes.

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 $18.00 per share. Prior to maturity, the Junior Convertible Promissory Notes may be converted 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.

In accordance with APB 14, the Company allocated $4,645,544 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 is 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 for the three months ended March 31, 2006 and is included as a component of interest expense in the accompanying statement 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 would increase to 12% per annum, and the Company would be 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, issuable upon extension of the maturity date of the Junior Convertible Promissory Notes, feature a term of 5 years and an exercise price of $18.00 per share. In addition, if the Bridge III Notes were not paid in full on or before the extended maturity date, each note became convertible into 0.128 shares of the Company's common stock for each $1.00 of principal then outstanding. The intrinsic value of this conversion option measured at the issuance date of the notes amounts to $5,234,000 and would have been recognized as interest expense in accordance with EITF 00-27. The Company agreed to file with the SEC, a registration statement for the resale of the restricted shares of its common stock issuable upon exercise of the conversion option that would be issuable in this transaction, on a best efforts basis.

Beginning on October 29, 2005, the Company elected to extend the contractual maturity date of the various 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. In addition, during the three month ended March 31, 2006, the Company was required to issue 39,917 additional warrants (the "Bridge III Extension Warrants"). The aggregate fair value of the warrants, which amounted to $48,129 was recorded as a deferred financing cost and was being amortized over the 60-day extension period or until March 27, 2006 when the Bridge III Notes were surrendered as payment for the Series A-1 Preferred stock under the creditor and claimant liabilities restructuring. The Bridge III Extension Warrants have a term of 5 years and an exercise price of $18.00 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 Company did not redeem Bridge III Notes on contractual maturity dates that occurred through January 12, 2006 (the date of the Series A-1 creditor and claimant liabilities restructuring). As a result, $3,400,000 of 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. This amounts to a total of 70,400 shares during the three months ended of March 31, 2006. 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. With the surrender of the Bridge III Notes in payment for Series A-1 Preferred stock under the creditor and claimant liabilities restructuring, these conversion options are no longer exercisable and have been cancelled.

As of September 30, 2006, all of the Bridge III Notes were surrendered as payment for Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 17).

Contractual interest expense on the Bridge III Notes amounted to $153,036 and $0 for the nine months ended September 30, 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 (as defined below). 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 an original issuance discount that was fully expensed during the nine months ended September 30, 2006.

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 nine months ended September 30, 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 converts 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 21). 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 21 below.

NOTE 12 - RELATED PARTY TRANSACTIONS

EXPENSE REIMBURSEMENTS DUE TO OFFICERS AND STOCKHOLDERS

Certain stockholders and officers of the Company have paid expenses on the Company's behalf since its inception, of which $4,458 remains outstanding at September 30, 2006. The amounts payable to such officers and stockholders are due on demand.

As of September 30, 2006, $135,535 of expense reimbursements were surrendered as payment for Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 17).

NOTES PAYABLE TO OFFICERS AND STOCKHOLDERS

As of September 30, 2006, $284,212 of notes payable to officers and stockholders were surrendered as payment for Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 17).

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 quarter ended June 30, 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 17.

NOTES PAYABLE (TO CREDITORS OF ACQUIRED BUSINESS)

The notes issued to creditors of Entelagent (in connection with the acquisition described in Note 6) include $554,202 that is payable to related parties for settlements of accrued payroll, notes payable and other payables that remain outstanding at September 30, 2006. The original amount of these notes amounted to $2,602,913. Aggregate interest expense on these notes amounted to $74,184 and $103,901 for the nine months ended September 30, 2006 and 2005, respectively.

During the nine months ended September 30, 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. As of September 30, 2006, $799,982 of the notes payable remain outstanding.

NOTE 13 - OTHER CURRENT LIABILITIES

Other current liabilities principally consist of $439,146 of accrued payroll and sales tax liabilities and estimated penalties that the Company assumed in its acquisition of Entelagent (Note 6). The balance consists of various

miscellaneous other current liabilities.

NOTE 14 - DEFERRED REVENUE

Deferred revenue at September 30, 2006 includes (1) $153,348 for the fair value of remaining service obligations on maintenance and support contracts and (2) $70,532 for contracts on which the revenue recognition is deferred until contract deliverables have been completed. Included in the contracts for which revenue recognition has been deferred are two contracts with a value of $468,947 for which $159,321 of revenue has been recognized and for which the majority of the remaining revenue is expected to be recorded during 2006.

NOTE 15 - 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 receive on or before November 17, 2003 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 also agreed to use "best efforts" to register these shares with the Securities and Exchange Commission 12 months from the date of issue.

In December 2002, the Company received approximately $450,000 of proceeds under the note and provided the Lender the pledged shares. Since that date, no additional proceeds were provided by the Lender and repeated attempts were made by the Company to secure the additional proceeds. The Company has effectively accounted for the Lender's failure to fund the facility and return the pledged shares as a foreclosure on the loan collateral. Accordingly, the Company recorded a $1,047,728 loss during the year ended December 31, 2002.

On March 13, 2003, the Company issued 40,000 replacement shares with an aggregate fair value of $3,708,000 to the stockholders who pledged their shares under the Accommodation Agreements. Accordingly, 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.

In addition, 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 has 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 were $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.

On March 27, 2006, the Company entered into an agreement to release and resolve all outstanding claims between the parties under the creditor and claimant liabilities restructuring (Note 17).

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 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 Shares; (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 $78,247 during the nine months ended September 30, 2006 and 2005, respectively for the fair value of 4,497 and 4,353 shares issuable during the nine months ended September 30, 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 stock based penalties under collateralized financing arrangement in the accompanying statements of operations.

NOTE 16 - COMMITMENTS AND CONTINGENCIES

SEC INVESTIGATION

Pursuant to Section 20(a) of the Securities Act and Section 21(a) of the Securities Exchange Act, the staff of the SEC (the "Staff"), issued an order (In the Matter of Patron Systems, Inc. - Order Directing a Private Investigation and Designating Officers to Take Testimony (C-03739-A, February 12, 2004)) (the "Order") that a private investigation (the "SEC Investigation") be made to determine whether certain actions of, among others, the Company, certain of its former officers and directors and others violated Section 5(a) and 5(c) of the Securities Act and/or Section 10 and Rule 10b-5 promulgated under the Exchange Act. Generally, the Order provides, among other things, that the Staff is investigating (i) the legality of two (2) separate Registration Statements filed by the Company on Form S-8, filed on December 20, 2002 and on April 2, 2003, as amended on April 9, 2003 (collectively, the "Registration Statements"), covering

the resale of, in the aggregate, 145,834 shares of common stock issued to various consultants of the Company, and (ii) whether in connection with the purchase or sale of shares of common stock, certain officers and directors of the Company and others (a) sold common stock in violation of Section 5 of the Securities Act and/or, (b) made misrepresentations and/or omissions of material facts and/or employed fraudulent devices in connection with such purchases and/or sales relating to certain of the Company's press releases regarding, among other items, proposed mergers and acquisitions that were never consummated. If the SEC brings an action against the Company, it could result in, among other items, a civil injunctive order or an administrative cease-and-desist order being entered against the Company, in addition to the imposition of a significant civil penalty. Moreover, the SEC Investigation and/or a subsequent SEC action could affect adversely the Company's ability to have its common stock become listed on a stock exchange and/or quoted on the NASD Bulletin Board or NASDAQ, the Company being able to sell its securities and/or have its securities registered with the SEC and/or in various states and/or the Company's ability to implement its business plan. The Company's legal counsel representing the Company in such matters has indicated that while the SEC Investigation is ongoing and the Company has not received correspondence from the SEC indicating that the matter is officially closed, the Staff has indicated that it does not intend to request additional information from the Company and that, at

this time, it does not intend to recommend that the SEC bring an enforcement action against the Company, its former officers and directors.

LEGAL PROCEEDINGS

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 liability of $320,000 plus accrued interest of $159,432. 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.

NOTE 17 - 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 statue, and (iii) evidence of compliance with the applicable securities laws of other jurisdictions. As described below, the Company completed the sale of $4.8 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:

Settlement Category	Series A-1 Stock Issued	Claim Amount	Fair Value of Stock	Gain/(
General Creditors	22,246,601	$ 18,072,357	$ 13,283,857	$ 4,78
Former Officer/Stockholder	1,549,526	$ 1,180,991	$ 929,716	25
Former Non-Executive Chairman	315,438	$ 254,152	$ 252,350	
Stockholders under Accommodation Agreement	3,000,000	2,400,000	2,400,000	
Mr. Allin and the Allin Dynastic Trust	2,500,000	1,317,089	1,500,000	(18
Other Claimants	7,381,489	1,243,282	4,248,893	(3,00
	36,993,054	$ 24,467,871	$ 22,614,816	$ 1,85

The fair value of the Series A-1 shares issued in settlements reached prior to June 30, 2006 amounted to $0.60 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 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 18) 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 Graul claim to whom the Company issued 1,164,461

shares for a settlement loss of approximately $698,000.

On July 31, 2006, following approval by the Company's stockholders, the Company amended its Second Amended and Restated Certificate of Incorporation, as amended, to affect a 1-for-30 reverse stock split.

OTHER LIABILITIES SETTLEMENTS

The Company also settled $660,494 of other liabilities for $28,140 in cash and a $32,500 note during the nine months ended September 30, 2006 for which it recorded net gains in the amount of $599,854.

LOSS (GAIN) ASSOCIATED WITH SETTLEMENT AGREEMENTS

During the nine months ended September 30, 2006 as part of the creditor and claimant liabilities restructuring, the Company settled a number of disputed and unresolved payables and outstanding claims resulting in a total gain on settlement of $1,853,055. Subsequent to the settlement of the creditor and claimant liabilities restructuring for Series A-1 Preferred Stock, the Company also settled other claims that resulted in a gain of $599,854, resulting in a net gain on settlement of $2,452,909 for the nine months ended September 30, 2006.

During the nine months ended September 30, 2005, the Company entered into a settlement agreement with Cook Associates to settle all claims related to a lawsuit filed by Cook Associates filed against the Company. This settlement resulted in the Company recognizing a gain on settlement of $389,103.

NOTE 18 - SERIES A AND SERIES A-1 PREFERRED STOCK

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.

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 accumulating on a cumulative basis. The dividend is 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 ("Liquidation Preference Amount"). Accrued but unpaid dividends on the Series A Preferred amount to $246,968 at September 30, 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 Company evaluated the conversion option at the commitment date of the financing in accordance with APB 14 and EITF 00-27 and determined that conversion price was not beneficial.

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 potential adjustment to the conversion price that would occur upon the completion of a subsequent financing transaction on terms more favorable than that of the Series A Preferred (if any) is considered to be a contingent conversion price in accordance with EITF 00-27. Accordingly, such adjustments would be measured and accounted for at the effective time of such adjustment, if any.

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 converts 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 an amendment to the Company's certificate of incorporation which provides 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 September 30, 2006, the Company has issued 36,993,054 shares of Series A-1 Preferred Stock which converted upon the effectiveness of an 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.

PRIVATE PLACEMENT OF SERIES A 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 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 $3.00 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 $3.00 per share. Additionally, the Company shall pay 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%.

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 to Laidlaw 198,375 common stock purchase warrants, the "Agent Warrants", as Series A Preferred Placement Agent.

The Investor Warrants have a fair value of $857,908. Assumptions relating to the estimated fair value of these warrants are 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 964 shares of Series A Preferred Stock outstanding as of September 30, 2006 are convertible, as described above, into 2,008,567 shares of the Company's newly split common stock.

In order to affect the availability of these funds to the Company prior to 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 request for a release of any funds. The Company cannot provide assurance that the securing of additional funding, the completion of the creditor and claimant liabilities restructuring program and the acceptance by individual creditors of the claims settlement will actually improve the Company's ability to fund the further development of its business plan or improve its operations.

NOTE 19 - STOCKHOLDERS' EQUITY

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 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 $18.00 per share exercise price to Apex in connection with the Interim Bridge Financing III financing. 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 $18.00 per share exercise price to Apex in connection with the Interim Bridge Financing III financing. 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 $18.00 per share exercise price to Apex in connection with the Interim Bridge Financing III financing. 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 $18.00 per share exercise price to Apex in connection with the Interim Bridge Financing III financing. 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 $18.00 per

share exercise price to Apex in connection with the Interim Bridge Financing III financing. The aggregate fair value of these warrants amounted to $5,861.

On March 22, 2006 the Company issued warrants for 2,500 shares at an $18.00 per share exercise price to Apex in connection with the Interim Bridge Financing III financing. 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 $3.00 per share exercise price to the investors in the Series A Preferred Financing in connection with the Series A Preferred Financing. Additionally, the Company issued 198,375 common stock purchase warrants at a $3.00 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 $3.00 per share exercise price to Apex in connection with Apex's investment in the Series A Preferred Financing.

ISSUANCE OF EMPLOYEE STOCK OPTIONS

During the nine months ended September 30, 2006, the Company issued stock options to employees to purchase 139,914 shares. These options include a grant 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, 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. 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 September 30, 2006 is $567,512 with a weighted-average remaining vesting period of 3.3 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.

As described in Note 5, 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 5.

On February 16, 2006, the Company issued an aggregate of 99,575 stock options to two newly hired executives upon signing their employment agreements. These options are exercisable at $1.65 per share and have a term of ten years. The aggregate fair value of these options amounts to $131,439. 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: risk-free interest rate of 4.45%; expected dividend yield zero percent; expected option life of four years; and current volatility of 125%.

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 94% of outstanding options will vest annually. Deferred compensation relating to options granted through December 31, 2005 has been adjusted to reflect this assumption. No options have been exercised to date. 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 nine months ended September 30, 2006 is as follows:

OPTIONS	SHARES	WEIGHTED-AVERAGE EXERCISE PRICE	WEIGHTED-AVERAGE REMAINING CONTRACTUAL TERM
Outstanding at January 1, 2006	428,022	$ 21.09	7.2 years
Granted	139,914	$ 1.56	--
Exercised	--	--	--
Forfeited or expired	(63,965)	$ 9.88	--
Outstanding at September 30, 2006	503,971	$ 17.09	7.8 years
Exercisable at September 30, 2006	337,853	$ 23.31	5.9 years

At September 30, 2006, the aggregate intrinsic value of options outstanding and options exercisable, based on the September 29, 2006 closing price of the Company common stock ($2.00 per share) amounted to $68,000 and $68,000, 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 September 30, 2006, these options have a weighted average exercise price of $17.39, weighted average remaining contractual term of 6.4 years and an aggregate intrinsic value of $0. The Company did not enter into any stock based compensation arrangements with non-employees during the nine months ended September 30, 2006. Stock based compensation expense to non-employees amounted to $1,239,083 during the nine months ended September 30, 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.

The weighted-average grant-date fair value of the 139,914 stock options granted during the nine months ended September 30, 2006 amounted to $1.25 per share. The Company granted 175,513 stock options with a weighted average grant-date fair value of $8.31 per share or a total fair value of $1,471,656 during the nine months ended September 30, 2005. There have also not been any exercises of stock options to date.

As of September 30, 2006, there was $567,512 of unrecognized compensation cost related to non-vested share-based compensation arrangements including $1,214,907 for the fair value of stock options that the Company accounted for under APB 25 through December 31, 2005 and $175,368 for option granted during the nine months ended September 30, 2006 that that the Company is accounting for in accordance with SFAS 123(R). These costs are expected to be recognized over a weighted-average period of 3.3 years.

The total fair value of options vested during the nine months ended September 30, 2006 amounted to $321,011. The Company did not modify any stock options granted to employees or non employees under share based payment arrangements. In addition, the Company did not capitalize the cost associated with stock based compensation.

2006 PATRON SYSTEMS, INC. STOCK INCENTIVE PLAN

On July 20, 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 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 September 30, 2006, no options have been granted from the 2006 Stock Plan.

NOTE 20 - 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 expertise to establish the homeland security architecture, the risk and vulnerability assessment evaluation services and the development and operation of the homeland security data center solutions necessary to implement our former business plan to offer model homeland security architecture with state-of-the-art prevention,

response and information management capabilities. 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.

During the period from the acquisition of LucidLine on February 25, 2005 through December 31, 2005, LucidLine generated revenue of almost $227,000, incurred a net loss of approximately $1.4 million and used net cash of over

$1.4 million. For the period from January 1, 2006 to March 31, 2006, LucidLine had revenue of nearly $99,000, a net loss of approximately $105,000 and used net cash of approximately $194,000. Additionally, we recognized a loss on disposal of almost $76,000.

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 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. After approaching a number of parties, none of whom were interested in acquiring a money losing and significantly negative cash flow business, Walnut Valley, Inc. agreed to acquire the legal entity and all of its 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.

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. in consideration for a cash payment 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 consummated the sale of LucidLine as a strategic business transaction designed to enhance our long-term profitability and strategic operations, and to further streamline its business focus on electronic message management.

The Company sold LucidLine to Walnut Valley, Inc. for an aggregate consideration

of $50,000. In February 2005, the Company paid to LucidLine's stockholders cash in the aggregate amount of $200,000 and issued an aggregate of 146,667 shares of the Company's common stock valued at $3,740,000.

NOTE 21 - SUBSEQUENT EVENTS

PRIVATE PLACEMENT OF SERIES B 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 ("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 ("Minimum Amount") and the maximum amount is $5,000,000. Apex has agreed to purchase up to $1,000,000 which will all be available to fund the Minimum Amount, provided however, in the event that the Series B Preferred Financing is over-subscribed as to the Minimum Amount, then for each $1.00 of such over subscription up to $2,000,000, the Apex funding commitment will be increased by $0.333 to a maximum amount of $1,666,667.

The Investor Warrants have a term of 5 years and an exercise price of the greater of i) $2.40 per share or ii) that price per share equal to the volume weighted average closing price of the Company's common stock for the 10 trading days prior to the Closing date. Each Investor Warrant entitles the holder thereof to purchase up to 50% of the Conversion Shares in Company's common stock (the "Warrant Shares"), subject to anti-dilution provisions similar

to those of the conversion rights of the Series B Preferred. The Conversion Shares and the Warrant Shares have piggyback registration rights.

In connection with the Series B Preferred Financing, the Company retained Laidlaw & Company (UK) Ltd. as its non-exclusive placement agent ("Series B Preferred Placement Agent"). Laidlaw shall receive, 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 "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 Investor Warrants issued at each closing. The Agent Warrants have a term of 5 years and an exercise price of the greater of i) $2.40 per share or ii) that price per share equal to the volume weighted average closing price of the Company's common stock for the 10 trading days prior to the Closing date. Additionally, the Company shall pay the Series B Preferred Placement Agent legal expenses not to exceed $25,000.

On October 13, 2006, the Company consummated the first closing of the Series B Preferred Financing with the closing of funds totaling $3,120,966. This amount was comprised of $1,040,322 provided by Apex and $2,080,644 from parties made available by the Series B Preferred Placement Agent. As part of this closing cash fees equal to $280,484 were paid to the Series B Preferred Placement Agent.

SERIES B PREFERRED STOCK

The Series B Preferred Stock ("Series B Preferred") 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 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 ("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 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 B Preferred Stock is junior to the Series A Preferred Stock with respect to liquidation and dividend rights.

The Series B 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) which shall be the lesser of i) $2.40 per share or ii) that price per share equal to the volume weighted average closing price of the Company's common stock for the 10 trading days prior to the original issuance date of such shares, based on the stated value of the Series B 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 B Preferred is mandatorily convertible at the then applicable conversion price ("Conversion Price") into shares of the Company's 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 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.

FILING OF FORM 10-KSB FOR THE YEAR ENDED DECEMBER 31, 2006

On April 10, 2007, the Company filed its Form 10-KSB for the year ended December 31, 2006. The Form 10-KSB for the year ended December 31, 2006 should be referred to for additional subsequent events which have occurred between the original filing date (November 14, 2006) of the Form 10-QSB for the three month and nine month periods ended September 30, 2006 and the filing of the Form 10-KSB on April 10, 2007.

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

PATRON SYSTEMS, INC. AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS SEPTEMBER 30, 2006

The following discussion and analysis should be read in conjunction with the Annual Report on Form 10-KSB, including the consolidated financial statements, and the related notes thereto, for the year ended December 31, 2005 of Patron Systems, Inc. and subsidiaries (collectively referred to as "Patron," the "Company," "we," "us," or "our"). Except for historical information contained herein, the matters discussed below are forward-looking statements made pursuant

to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such statements involve risks and uncertainties, including, but not limited to, economic, governmental, political, competitive and technological factors affecting our operations, markets, products, prices and other factors discussed elsewhere in this report and other reports filed by us with the Securities and Exchange Commission ("SEC"). These factors may cause results to differ materially from the statements made in this report or otherwise made by or on our behalf.

OVERVIEW

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. We merged each of CSSI, Entelagent and PILEC Disbursement Company, a wholly-owned non-operating subsidiary into our company on September 19, 2006. From March 31, 2005 to December 31, 2005, we borrowed $3,300,000 from a stockholder, Apex Investment Fund V, LP. During the three months ended September 30, 2005 we raised approximately $3,600,000 in additional gross funds in five capital financing transactions, which includes converting $1,650,000 in advances from stockholders into Bridge Notes. Net proceeds from all of these transaction amounted to $3,594,000, which were used principally to fund operations and repay certain liabilities. We discuss these transactions in further detail in this report. During the nine months ended September 30, 2006, we raised $5,640,501 of gross proceeds ($5,301,450 net proceeds after the payment of certain transaction expenses) in various financing transactions. We used $5,017,206 of these proceeds to fund operations and a net of $607,152 in investing activities.

Our strategic mission is to solve a set of enterprise-level customer problems associated with electronic message management, whether in the form of e-mail, eforms or instant messaging. Our software and services solutions are designed to help our 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 message management. Our suite of products addresses e-mail policy management, e-mail retention policies, archiving and eDiscovery, proactive e-mail supervision, and the protection of messages and their attachments in motion and at rest. Our eforms solution enables customers to quickly and easily create forms, capture, share, and manage data in an industry standard format.

We currently offer software solutions that fit into overall corporate compliance and data protection initiatives by automatically finding, archiving and applying persistent protection to sensitive data - beyond authentication - whenever, wherever and however sensitive data is shared, accessed and stored. Additionally we offer software solutions that support real-time secure collection, delivery and sharing of field-based report information. This software allows law enforcement and public-safety agencies to have real-time access to field reporting data for use inside a department or in a multi-jurisdictional information sharing system.

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 polices 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 polices with respect to our recognition of revenue that we believe are consistent with the guidance provided under 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 polices 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 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.

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, 2005, which resulted in a goodwill impairment charge of $12,929,696 (Note 6). Intangible assets continue to be amortized over their estimated useful lives.

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 proforma 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 finance our business.

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

THREE MONTHS ENDED SEPTEMBER 30, 2006 COMPARED TO THE THREE MONTHS ENDED SEPTEMBER 30, 2005.

For the three months ended September 30, 2006, our consolidated revenues amounted to $276,825 compared to $93,457 for the three months ended September 30, 2005. The increase is principally the result of growth of our business, principally with the FormStream product, since the combinations were consummated with CSSI in February 2005 and Entelagent in March 2005.

Cost of Sales for the three months ended September 30, 2006 amounted to $54,619 compared to $133,124 for the three months ended September 30, 2005. Cost of sales during the three months ended September 30, 2006 and September 30, 2005 includes $44,936 and $133,124, respectively, associated with the amortization of developed technology that we acquired from CSSI and Entelagent.

Operating expenses amounted to $1,315,328 for the three months ended September 30, 2006 as compared to $2,199,920 for the three months ended September 30, 2005, a reduction of $884,592. The reduction in operating expenses includes an increase of approximately $62,000 for employee stock option compensation expense, approximately $300,000 associated with the reduction in value of a put right in 2005 and an increase of approximately $3,000 associated with a stock-based penalty under a collateralized financing arrangement. These increases were offset by approximately $42,000 for reduced salaries associated with an reduction in the number of employees, an approximately $286,000 reduction in stock-based compensation expense, approximately $59,000 reduction in legal and professional fees associated with the work performed in 2005 to bring the Company's SEC filings into compliance, a reduction of approximately $104,000 in general and administrative expense, a $135,000 reduction in expense associated with 2005 penalties under stock-based accommodation agreements and an approximately $625,000 reduction associated with gains related to settlement agreements.

Our consolidated loss from operations for the three months ended September 30, 2006 amounted to $1,156,877 compared to a loss of $12,677,722 for the same period in 2005. Our loss was reduced as a result of the reductions in operating expenses and the increased revenues discussed above.

Interest expense during the three months ended September 30, 2006 amounted to $64,564 as compared to $10,158,714 for the three months ended September 30, 2005. The reduction is principally related to the issuance, in

the three months ended September 30, 2005, of the Bridge III Notes and the associated amortization of deferred financing costs and the accretion of debt discounts incurred with that financing not being incurred in the three months ended September 30, 2006. Additionally, the interest expense associated with the outstanding Acquisition Notes and the Bridge I, Bridge II and Bridge III Notes in the three months ended September 30, 2005 was reduced with the exchange of a substantial portion of these notes for Series A-1 Preferred Stock as of September 30, 2006. Non-cash interest relating to the amortization of deferred financing costs and the accretion of debt discounts during the three months

ended September 30, 2006 amounted to approximately $0 compared to $1,865,355 in the same period in 2005. Amortization of deferred finance charges which have been classified as interest expense was $0 in the three months ended September 30, 2006 compared to $750,334 in the same period in 2005. Accretion of debt discounts during the three months ended September 30, 2006 were approximately $0 compared to $1,115,021 in the same period in 2005. Interest income, was $809 and $0 in the three months ended September 30, 2006 and 2005, respectively. Interest income represents the interest earned on cash balances.

During the three months ended September 30, 2006, the Company presented accumulated dividends on its Series A Preferred of $122,184 as an increase in the net loss available to common stockholders.

For the three months ended September 30, 2006, the net loss available to common stockholders was $1,279,061 or $(0.12) per share on 10,490,543 weighted average common shares outstanding compared to a net loss available to common stockholders of $12,677,722 or $(6.18) per share on 2,049,970 weighted average common shares outstanding for the three months ended September 30, 2005.

NINE MONTHS ENDED SEPTEMBER 30, 2006 COMPARED TO THE NINE MONTHS ENDED SEPTEMBER 30, 2005.

For the nine months ended September 30, 2006, our consolidated revenues amounted to $857,570 compared to $184,300 for the nine months ended September 30, 2005. The increase is principally the result of growth of our business, principally with the FormStream product, since the combinations were consummated with CSSI in February 2005 and Entelagent in March 2005.

Cost of Sales for the nine months ended September 30, 2006 amounted to $139,560 compared to $282,858 for the nine months ended September 30, 2005. Cost of sales during the nine months ended September 30, 2006 and September 30, 2005 includes $99,980 and $280,855, respectively, associated with the amortization of developed technology that we acquired from CSSI and Entelagent.

Operating expenses amounted to $3,465,493 for the nine months ended September 30, 2006 as compared to $6,345,170 for the nine months ended September 30, 2005, a reduction of $2,879,677. The reduction in operating expenses includes an increase of approximately $1,086,000 for salaries associated with an increase in the number of employees from acquired businesses, approximately $308,000 of employee stock option compensation expense, approximately $173,000 for increased legal and professional fees that we incurred principally in connection with the year-end financial audit, the negotiation and settlement of various legal matters under the creditor and claimant liabilities restructuring program and the implementation of the Series A Preferred Stock private placement, approximately $23,000 for amortization of acquired intangible assets, approximately $300,000 associated with the reduction in value of a put right in 2005 and approximately $8,000 associated with a stock-based penalty under a collateralized financing arrangement. These increases were partially offset by an approximately $1,239,000 reduction in non-employee stock-based compensation , approximately $2,452,909 in gain associated with the settlement of outstanding litigation, liabilities and claims under the creditor and claimant liabilities restructuring, a reduction of approximately $240,000 in general and administrative expense, an expense reduction of $366,000 associated with a 2005 loss on a collateralized financing arrangement and approximately $824,000 reduction in expense associated with a penalty provision of an Accommodation Agreement.

Our consolidated loss from operations for the nine months ended September 30, 2006 amounted to $2,747,483 compared to a loss of $6,443,728 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 nine months ended September 30, 2006 amounted to $1,125,449 as compared to $12,355,249 for the nine months ended September 30, 2005. The reduction is due to the accretion of debt discounts and the intrinsic value of the conversion option for bridge note holders being lower in total during the nine months

ended September 30, 2006 as compared to the nine months ended September 30, 2005. Offsetting this reduction was the increase in interest expense due to the increased level of total debt financing during the nine months ended September 30, 2006 than during the same period in 2005. Non-cash interest relating to the amortization of deferred financing costs and the accretion of debt discounts during the nine months ended September 30, 2006 amounted to approximately $303,038 compared to $3,678,606 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 nine months ended September 30, 2006 compared to $8,000,000 in the same period in 2005. Amortization of deferred finance charges which have been classified as interest expense was approximately $282,129 in the nine months ended September 30, 2006 compared to $1,751,232 in the same period in 2005. Accretion of debt discounts during the nine months ended September 30, 2006 were approximately $20,909 compared to $1,927,374 in the same period in 2005. Interest income, was $2,770 and $19,250 in the nine months ended September 30, 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 nine months ended September 30, 2006.

During the nine months ended September 30, 2006, the Company presented accumulated dividends on its Series A Preferred of $246,968 as an increase in the net loss available to common stockholders.

For the nine months ended September 30, 2006, the net loss available to common stockholders was $4,298,137 or $(0.87) per share on 4,945,846 weighted average common shares outstanding compared to a net loss available to common stockholders of $19,910,022 or $(10.43) per share on 1,909,483 weighted average common shares outstanding for the nine months ended September 30, 2005.

LIQUIDITY AND CAPITAL RESOURCES

We incurred a net loss of $4,051,169 for the nine months ended September 30, 2006, which includes $1,172,518 of non-cash charges including non-cash charges associated with the fair value of common stock we issued as penalties under certain registration rights agreements ($8,560), fair value of a conversion option in connection with bridge note holders ($192,000), accretion related to warrants issued in conjunction with notes payable ($20,909), amortization of deferred financing costs ($282,129), loss on disposal of discontinued operation ($75,920), non-cash increase in interest payable to a former stockholder ($48,400), depreciation and amortization ($236,845), and a charge for stock option based compensation ($307,629). We also used $511,691 of our restricted cash escrowed to settle liabilities assumed. Offsetting these non-cash charges was the non-cash gain on settlement of outstanding liabilities, claims and litigation of $2,452,909. Including the amounts above, we used net cash flows in our operating activities of $4,732,156 during the nine months ended September 30, 2006. Our working capital deficiency at September 30, 2006 amounts to $4,968,639 and we are continuing to experience shortages in working capital. We are involved in litigation and are being investigated by the Securities and Exchange Commission with respect to certain of our press releases and our use of form S-8 to register shares of common stock that we issued to certain

consultants in prior periods. Our legal counsel representing us in such matters has indicated that while the SEC Investigation is ongoing and we have not received correspondence from the SEC indicating that the matter is officially closed, the Staff has indicated that it does not intend to request additional information from us and that, at this time, it does not intend to recommend that the SEC bring an enforcement action against us, our officers or directors. 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.

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. Our ability to successfully integrate the acquired businesses described in Note 6 is critical to the realization of its business plan. We raised $5,460,501 of gross proceeds ($5,301,450 net proceeds after the payment of certain transaction expenses) in financing transactions during the nine months ended September 30, 2006. We used $4,732,156 of these proceeds to fund its operations and a net of $607,152 in investing activities, principally for the purchase and development of software technology. Additionally, we made $125,000 in legal payments associated with the settlement of accommodation agreements and incurred $54,000 in deferred financing costs. We received $50,000 in proceeds from the disposition of discontinued operations and received $180,000 in proceeds in connection with a financing settlement.

We are currently in the process of attempting to raise additional capital and have taken certain steps to conserve our liquidity while we continue to integrate the acquired businesses. 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. In an effort to secure additional financing, we completed a program pursuant to which we offered our creditors and claimants an agreement to receive shares of our capital stock for amounts owed to the holders of our indebtedness (including lenders, past-due trade accounts, and employees, consultants and other service providers with claims for fees, wages or expenses).

OFF-BALANCE SHEET ARRANGEMENTS

At September 30, 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.

CAUTIONARY STATEMENTS AND 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. We are also subject to substantial litigation and an investigation by the SEC described elsewhere herein. If we cannot generate additional revenues or raise additional capital in the near future, we may become insolvent. As of September 30, 2006, our cash balance was $60,156 and we had a working capital deficit of $4,968,639. 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 $24.5 million 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 creditors and claimants had with us pursuant to our creditor and claimant liabilities restructuring described in Note 17. We are currently unable to provide assurance that the acceptance of the claims settlement 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 generated no revenue from operations before December 31, 2004 and only limited revenues in the year ended December 31, 2005. We 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 September 30, 2006, we had an accumulated deficit of approximately $88.7 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 85.3% 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.

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 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 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.

WE ARE CURRENTLY SUBJECT TO AN SEC INVESTIGATION WHICH COULD HAVE AN ADVERSE AFFECT ON OUR BUSINESS AND RESULTS OF OPERATIONS.

Pursuant to Section 20(a) of the Securities Act and Section 21(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), the staff of the SEC (the "Staff"), issued an order (In the Matter of Patron Systems, Inc. - Order Directing a Private Investigation and Designating Officers to Take Testimony (C-03739-A, February 12, 2004)) (the "Order") that a private investigation (the "SEC Investigation") be made to determine whether certain of our actions and certain of the actions of our former officers and directors and others (as described below) violated Section 5(a) and 5(c) of the Securities Act and/or Section 10 and Rule 10b-5 promulgated under the Exchange Act. Generally, the Order provides, among other things, that the Staff is investigating (i) the legality of two (2) separate Registration Statements filed by us on Form S-8, filed on December 20, 2002 and on April 2, 2003, as amended on April 9, 2003 (collectively, the "Registration Statements"), covering the resale of, in the aggregate, 4,375,000 shares of common stock issued to various of our consultants, and (ii) whether in connection with the purchase or sale of shares of common stock, certain of our officers, directors and others (a) sold common stock in violation of Section 5 of the Securities Act and/or, (b) made misrepresentations and/or omissions of material facts and/or employed fraudulent devices in connection with such purchases and/or sales relating to certain of our press releases regarding, among other items, proposed mergers and acquisitions that were never consummated. If the SEC brings an action against us, it could result in, among other items, a civil injunctive order or an administrative cease-and-desist order being entered against us, in addition to the imposition of a significant civil penalty. Moreover, the SEC Investigation and/or a subsequent SEC action could affect adversely our ability to have our common stock listed on a stock exchange and/or quoted on the OTC Bulletin Board or NASDAQ, our ability to sell our securities and/or have our securities registered with the SEC and/or in various states and/or our ability to implement our business plan. Our legal counsel representing us in such matters has indicated that while the SEC Investigation is ongoing and we have not received correspondence from the SEC indicating that the matter is officially closed, the Staff has indicated that it does not intend to request additional information from us and that, at this time, it does not intend to recommend that the SEC bring an enforcement action against us or our former officers and directors. There can be no assurance that the SEC will accept the Staff's recommendation not to bring an enforcement action against us or that the Staff will not elect at some future time to seek additional information from us with respect to these matters.

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 October 13, 2006, there were 14,462,260

shares of common stock outstanding, of which 5,527,432 shares were held by directors, executive officers and other affiliates, the sale of which are subject to volume limitations under Rule 144, various vesting agreements and 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 agreements 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:

- the demand for our subsidiaries' current product offerings and our future products;
- the length of sales cycles;
- the timing of recognizing revenues;
- new product introductions by us or our competitors;
- changes in our pricing policies or the pricing policies of our competitors;
- variations in sales channels, product costs or mix of products sold;
- our ability to develop, introduce and ship in a timely manner new products and product enhancements that meet customer requirements;
- our ability to obtain sufficient supplies of sole or limited source components for our products;
- variations in the prices of the components we purchase;
- our ability to attain and maintain production volumes and quality levels for our products at reasonable prices at our third-party manufacturers;
- our ability to manage our customer base and credit risk and to collect our accounts receivable; and
- 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.

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:

- make a special written suitability determination for the purchaser;
- receive the purchaser's written agreement to a transaction prior to sale;
- 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
- 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.

If our common stock becomes 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.

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 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 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, 2005, our Chief Executive Officer and Acting 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 weakness in our internal controls. These material weaknesses affected our ability to timely file our reports with the SEC and communicate critical information to management that was needed to make business decisions. Although we have taken steps to correct these previous deficiencies and are currently in compliance with the SEC's reporting requirements, 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 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.

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 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 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. 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:

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

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.

PART II - OTHER INFORMATION

ITEM 6. EXHIBITS

See attached Exhibit Index.

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: May 21, 2007

PATRON SYSTEMS, INC.
(Registrant)

/s/ Braden Waverley

By: Braden Waverley
Its: Chief Executive Officer

/s/ Martin T. Johnson

By: Martin T. Johnson

Its: Chief Financial Officer

EXHIBIT INDEX

EXHIBIT NUMBER	DESCRIPTION OF EXHIBIT
10.1	Stock Purchase Agreement dated April 18, 2006 between Patron Systems, Inc. and Walnut Valley, Inc. Previously filed with the Form 10-QSB.
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.

52