PATRON SYSTEMS INC
Form 10QSB
May 21, 2007

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

FORM 10-QSB

(Mark One)

|X| QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2007

|_| 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: 14,512,260 shares of common stock outstanding as of May 21, 2007.

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

PATRON SYSTEMS, INC.

FORM 10-QSB QUARTERLY REPORT

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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. 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.
CONDENSED BALANCE SHEET
(unaudited)

	MARCH 31, 2007
ASSETS	
Current Assets	
Cash	$ 120,004
Accounts receivable	690,856
Other current assets	102,803
Total current assets	913,663
Property and equipment, net	223,867
Capitalized software development costs, net	444,071
Intangible assets, net	112,603
Assets held for sale	174,376
Goodwill	9,300,000
Total assets	$ 11,168,580
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current Liabilities	
Accounts payable	$ 502,261
Other current liabilities	1,918,805
Secured demand notes	625,000
Demand notes payable	312,557
Notes payable (to creditors of acquired business, including $554,202 to related parties)	799,982
Deferred revenue	254,564
Bridge notes payable	519,975
Derivative conversion liability	285,874
Liabilities of discontinued operations	81,206
Total current liabilities	5,300,224
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 $6,512,959	
Series A-1 convertible: 50,000,000 authorized; 0 issued and outstanding	--
liquidation preference of $0	
Series B convertible: 2,000 shares authorized; 791 shares issued and outstanding; liquidation preference of $5,159,535	8
Common stock, par value $0.01 per share, 150,000,000 shares authorized, 14,512,260 shares issued and outstanding	145,127

Additional paid-in capital	104,337,679
Accumulated deficit	(98,614,468)
Total stockholders' equity	5,868,356
Total liabilities and stockholders' equity	$ 11,168,580

See notes to unaudited condensed financial statements.

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

	THREE MONTHS ENDED MARCH 31,	
	2007	2006
Revenue	$ 171,218	$ 179,925
Cost of Sales		
Cost of products/services	37,620	29,897
Amortization of technology	27,015	27,522
Total cost of sales	64,635	57,419
Gross profit	106,583	122,506
Operating Expenses		
Salaries and related expenses	1,331,139	679,829
Professional fees	204,958	658,115
General and administrative	237,934	320,576
Stock based penalties under financing arrangements	--	2,852
Gain on settlements	--	(906,987)
Total operating expenses	1,774,031	754,385
Loss from operations	(1,667,448)	(631,879)
Other Income (Expense)		
Interest income	2,120	--
Interest expense	(505,925)	(972,464)
Change in fair value of conversion option	8,712	--
Gain on sale of property and equpment	(42)	62
Total Other Expense	(495,135)	(972,402)
Loss from continuing operations	(2,162,583)	(1,604,281)

Income (loss) from discontinued operations	4,541	(387,543)
Net loss	(2,158,042)	(1,991,824)
Preferred stock contractual dividend	(216,325)	--
Net loss available to common stockholders	$ (2,374,367)	$ (1,991,824)
Net Loss Per Share - Basic and Diluted		
- Continuing operations	$ (0.16)	$ (0.77)
- Discontinued operations	--	(0.19)
- Total net loss per share available to common stockholders	$ (0.16)	$ (0.96)
Weighted Average Number of Common Shares Outstanding - Basic and Diluted	14,512,260	2,083,954

See notes to unaudited condensed financial statements.

PATRON SYSTEMS, INC.
CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY
(UNAUDITED)
FOR THE THREE MONTHS ENDED MARCH 31, 2007

	SHARES OF SERIES A CONVERTIBLE PREFERRED STOCK	PAR VALUE SERIES A CONVERTIBLE PREFERRED STOCK	SHARES OF SERIES A-1 PREFERRED STOCK	PAR VALUE SERIES A-1 PREFERRED STOCK	SHARE SERIE CONVE PREFE STO
Balance - January 1, 2007	964	$ 10	--	$ --	
Stock based compensation - employees	--	--	--	--	
Issuance of warrants to 2007 Bridge Note Investors	--	--	--	--	
Net Loss	--	--	--	--	
BALANCE - MARCH 31, 2007	964	$ 10	--	$ --	

SHARES OF COMMON STOCK	PAR VALUE COMMON STOCK	ADDITIONAL PAID IN CAPITAL	ACCUMULATED DEFICIT	T

Balance - January 1, 2007 ..	14,512,260	$ 145,127	$103,743,111	$(96,456,426)	$ 7,
Stock based compensation - employees	--	--	430,809	--	
Issuance of warrants to 2007 Bridge Note Investors ...	--	--	163,759	--	
Net Loss	--	--	--	(2,158,042)	(2,
BALANCE - MARCH 31, 2007 ...	14,512,260	$ 145,127	$104,337,679	$(98,614,468)	$ 5,

See notes to unaudited condensed financial statements.

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

	THREE MONTHS E MARCH 31,	
	2007	
Cash Flows from Continuing Operating Activities		
Net loss	$ (2,162,583)	$ (
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	51,026	
Stock based compensation	430,809	
Non cash interest expense	458,345	
Gain on derivative conversion valuation	(8,712)	
Stock based penalty under financing arrangements	--	
Loss on issuance of preferred stock in settlement of debt	--	
(Gain)/Loss on sale of fixed assets	42	
Changes in assets and liabilities:		
Restricted cash escrowed to settle liabilities assumed	--	
Accounts receivable	138,019	
Other current assets	31,038	
Accounts payable	(32,866)	
Accrued interest	40,949	
Deferred revenue	90,269	
Expense reimbursements due to officers and shareholders	(1,000)	
Accrued payroll and payroll related expenses	77,573	
Other current liabilities	(57,595)	
Total adjustments	1,217,897	(
NET CASH USED IN CONTINUING OPERATING ACTIVITIES	(944,686)	(
CASH FLOWS USED IN CONTINUING INVESTING ACTIVITIES		
Purchase and development of technology	(41,839)	
Proceeds from sale of fixed assets	--	

Purchase of fixed assets	(73,130)	
NET CASH USED IN CONTINUING INVESTING ACTIVITIES	(114,969)	
CASH FLOWS FROM CONTINUING FINANCING ACTIVITIES		
Payments on settlement of accommodation agreements	--	
Deferred financing costs	--	
Net proceeds from issuance of Preferred Series A convertible stock	--	
Proceeds from issuance of bridge notes	625,000	
NET CASH PROVIDED BY CONTINUING FINANCING ACTIVITIES	625,000	
CASH FLOWS FROM DISCONTINUED OPERATIONS		
Operating cash flows	13,089	
Investing cash flows	--	
NET CASH PROVIDED BY (USED IN) DISCONTINUED OPERATIONS	13,089	
NET (DECREASE) INCREASE IN CASH	$ (421,566)	$
CASH, beginning of period	$ 541,570	$
CASH, end of period	$ 120,004	$
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for:		
Interest	$ 6,631	
Non-cash Investing and Financing Activities		
Liabilities and claims settled in exchange for Series A-1 Preferred Convertible Stock	--	$ 2

See notes to unaudited condensed financial statements.

PATRON SYSTEMS, INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS (UNAUDITED)
MARCH 31, 2007

NOTE 1 - BASIS OF INTERIM FINANCIAL STATEMENT PRESENTATION

The accompanying unaudited Condensed Financial Statements of Patron Systems, Inc. (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 period ended March 31, 2007 is not necessarily indicative of the operating results that

may be expected for the entire year ending December 31, 2007.

Amounts reflected herein for the three months ended March 31, 2006 represent the restated financial information included in the Form 10-QSB/A which was filed with the SEC on May 21, 2007.

This form 10-QSB should be read in conjunction with the Company's 10-KSB for the year ended December 31, 2006.

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. The Company was recapitalized upon its completion of a share exchange transaction with an inactive public company on October 11, 2002.

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

NOTE 3 - RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS

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

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

Specifically, the Company recorded for the three months ended March 31, 2006, (1) a net loss of $858,213 on the settlement of various liabilities under its creditor and claimant liabilities restructuring program when it should have recorded a net gain of approximately $906,987, (2) recorded 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. 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.

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

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

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

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

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

NOTE 4 - GOING CONCERN, 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 from continuing operations of $2,162,583 for the three months ended March 31, 2007, which includes an aggregate of $931,468 of non-cash charges including non-cash interest expense, depreciation and amortization, stock based compensation net of a change in the fair value of a conversion option. The Company's working capital deficiency at March 31, 2007 amounted to $4,386,561 and the Company is continuing to experience shortages in working capital. 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.

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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 is critical to the realization of its business plan. The Company raised $625,000 of bridge financing through the issuance of secured demand notes during the three months ended March 31, 2007 (Note 8). The Company used $510,031 of these proceeds to fund its operations and a net of $114,969 in investing activities. Subsequent to March 31, 2007, the Company has raised an additional $417,000 of bridge financing through the issuance of secured demand notes (Note 20).

The Company is currently in the process of attempting to raise additional capital and has taken certain steps to conserve its liquidity. 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

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 March 31, 2007 the uninsured bank cash balances were approximately $35,000. 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.

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. In accordance with SFAS 142, the Company conducted its annual impairment review of goodwill for the year ended December 31, 2006, which resulted in a goodwill impairment charge of $210,716. This 2006 charge, which principally represents goodwill remaining from the PolicyBridge business the Company acquired from Entelagent is classified in discontinued operations as a result of its decision to exit that business. The remaining amount of goodwill, which amounts to $9,300,000 at March 31, 2007, relates to the Company's

acquisition of CSSI in February 2005 from which the Company acquired the FormStream software technology, its sole line of business. The Company engaged an outside specialist to assist the Company with performing its annual goodwill impairment tests. These tests were made using a discounted cash flow model to value the business. This approach requires the Company to forecast its 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.

USE OF ESTIMATES IN PREPARING FINANCIAL STATEMENTS

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

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.

As described in Note 8, the Company completed a $625,000 interim bridge financing transaction in which convertible notes were deemed to be non-conventional instrument in accordance with SFAS 133 and EITF 05-2.

COMMON STOCK PURCHASE WARRANTS AND OTHER DERIVATIVE FINANCIAL INSTRUMENTS

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

As described in Note 8, the Company has determined that the conversion option embedded in the 2007 Interim Bridge Financing notes is a derivative financial instrument requiring liability classification in accordance with EITF 00-19 since it is exercisable for indeterminate number of shares. The note was amended in May 2007 to establish a minimum conversion price of $.05 per share. Accordingly, the Company intends to reclassify this derivative to stockholders equity in its June 30, 2006 balance sheet assuming all other conditions for equity classification under EITF 00-19 are met at that time.

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 17. Accordingly, the Company recognized in salaries and related expense in the statement of operations, $430,809 and $180,835 for the fair value of stock options expected to vest during the three month periods ended March 31, 2007 and 2006, respectively.

INCOME TAXES

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("SFAS No. 109"). 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.

The Company has not recognized any income tax expense (benefit) in the accompanying financial statements for the three months ended March 31, 2007 and 2006. Deferred tax assets, which principally arise from net operating losses, are fully reserved due to management's assessment that it is more likely than not that the benefit of these assets will not be realized in future periods.

As describe in Note 16, the Company adopted FASB Interpretation No. 48 - "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109" ("FIN 48"), effective January 1, 2007. A discussion of the effect of having adopted FIN 48 is also described in Note 12.

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.

The Company has 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 and 10,306 shares to-be-issued under a stock pledge agreement entered into in 2004.

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

	MARCH 31,	
	2007	2006
Options	5,734,519	438,090
Warrants	5,097,590	1,289,909
Series A Preferred Stock	12,051,254	1,860,650
Series A-1 Preferred Stock	--	11,140,063
Series B Preferred Stock	4,820,417	--
Convertible Notes	1,202,921	--
	28,906,701	14,728,712

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued SFAS 157 - "Fair Value Measurements" ("SFAS 157"), which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The provisions of SFAS 157 are effective for the first fiscal year beginning after November 2007. The Company is currently evaluating the impact of adopting SFAS 157 on its

financial statements.

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

In November 2006, the FASB ratified EITF Issue No. 06-7, Issuer's Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation

Criteria in FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities ("EITF 06-7"). At the time of issuance, an embedded conversion option in a convertible debt instrument may be required to be bifurcated from the debt instrument and accounted for separately by the issuer as a derivative under FAS 133, based on the application of EITF 00-19. Subsequent to the issuance of the convertible debt, facts may change and cause the embedded conversion option to no longer meet the conditions for separate accounting as a derivative instrument, such as when the bifurcated instrument meets the conditions of Issue 00-19 to be classified in stockholders' equity. Under EITF 06-7, when an embedded conversion option previously accounted for as a derivative under FAS 133 no longer meets the bifurcation criteria under that standard, an issuer shall disclose a description of the principal changes causing the embedded conversion option to no longer require bifurcation under FAS 133 and the amount of the liability for the conversion option reclassified to stockholders' equity. EITF 06-7 applies to all previously bifurcated conversion options in convertible debt instruments that no longer meet the bifurcation criteria in FAS 133 in interim or annual periods beginning after December 15, 2006, regardless of whether the debt instrument was entered into prior or subsequent to the effective date of EITF 06-7. The adoption of EITF 06-7 did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

In December 2006, the FASB issued FSP EITF 00-19-2, "Accounting for Registration Payment Arrangements." FSP EITF 00-19-2 addresses an issuer's accounting for registration payment arrangements. This pronouncement specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument, should be separately recognized and accounted for as a contingency in accordance with SFAS 5 "Accounting for Contingencies." FSP EITF 00-19-2 amending previous standards relating to rights agreements became effective on December 21, 2006 with respect to arrangements entered into or modified beginning on such date and for the first fiscal year beginning after December 15, 2006 with respect to those arrangements entered into prior to December 21, 2006. The adoption of FSP EITF 00-19-2 did not have a material effect on the Company's financial statements.

In February 2007, the FASB issued SFAS 159, "The Fair Value Option for Financial

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

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

NOTE 6 - CAPITALIZED SOFTWARE

Capitalized software development costs are as follows:

Beginning of the year	$ 414,560
Capitalized	41,839
Amortization	(12,328)
Balance at March 31, 2007	$ 444,071

The Company classifies amortization of developed technology as a component of cost of sales. Amortization expense amounted to $12,328 and $37,022 for the three months ended March 31, 2007 and 2006, respectively.

AMORTIZATION OF CAPITALIZED SOFTWARE

The amortization of capitalized software for reporting subsequent to the quarter ended March 31, 2007 is as follows:

	SOFTWARE AMORTIZATION
Period of April 2, 2007 through December 31, 2007	$ 65,028
YEARS ENDED DECEMBER 31:	
2008	105,402
2009	105,403
2010	73,733
2011	66,460
2012	28,045
	$ 444,071

NOTE 7 - AMORTIZABLE INTANGIBLE ASSETS

The components of intangible assets as of March 31, 2007 are set forth in the following table:

	MARCH 31, 2007
Customer relationships	$ 180,000
Trademarks and tradenames	55,000
	235,000
less: accumulated amortization	(122,397)
Amortizable intangible assets, net	$ 112,603

Intangible amortization expense amounted to $14,687 and $21,312 for the three months ended March 31, 2007 and 2006, respectively.

AMORTIZATION OF INTANGIBLE ASSETS

The amortization of intangible assets for reporting subsequent to the quarter ended March 31, 2007 is as follows:

	INTANGIBLE AMORTIZATION
Period of April 2, 2007 through December 31, 2007	$ 44,063
YEARS ENDED DECEMBER 31:	
2008	58,750
2009	9,790
	$ 112,603

NOTE 8 - SECURED DEMAND NOTES PAYABLE

On February 20, 2007, the Company signed a secured convertible promissory note ("2007 Interim Bridge Financing") with Apex Investment Fund V, LP in exchange for working capital advances made to the Company. The Company received advances of $200,000 on February 20, 2007; $100,000 on March 2, 2007; $160,000 on March 20, 2007; and $165,000 on March 27, 2007 for a total of $625,000 advanced as of March 31, 2007.

The Company signed a Security Agreement granting Apex a security interest and lien in and upon all of Debtors' assets including, without limitation, all of Debtor's right, title and interest in and to all accounts, chattel paper,

documents, general intangibles, instruments, goods and money, whether now existing or hereafter created and whether now owned or hereafter acquired, and all proceeds of all of the foregoing.

The 2007 Interim Bridge Financing note is due on demand and bears interest at 9% per annum ("2007 Bridge Note"). The 2007 Bridge Note can be converted at the option of the Holder at any time, into that number of shares of the Company's voting common stock (the "Conversion Shares"), either a) equal to the quotient of the principal and accrued interest being converted, divided by the offering

price per share ("Offering Price") associated with any offering of equity securities made by the Company or b) equal to the quotient of the principal and accrued interest being converted, divided by the Fair Market Value of such shares.

In conjunction with the 2007 Interim Bridge Financing, the Company issued common stock purchase warrants to Apex. The Company issued 200,000 common stock purchase warrants with an exercise price of $1.00 per share on February 20, 2007; 100,000 common stock purchase warrants with an exercise price of $1.25 per share on March 2, 2007; 160,000 common stock purchase warrants with an exercise price of $1.14 per share on March 19, 2007; and 168,000 common stock purchase warrants with an exercise price of $0.69 per share on March 27, 2007. The 200,000 warrants issued on February 20, 2007 have a relative fair value of $134,419; the 100,000 warrants issued on March 2, 2007 have a relative fair value of $83,984; the 160,000 warrants issued on March 19, 2007 have a relative fair value of $122,225; and the 165,000 warrants issued on March 27, 2007 have a relative fair value of $76,167. The Company estimated the fair values of these warrants using the Black-Scholes option pricing model with the following assumptions: fair value of common stock from $1.00 to $0.55; risk-free interest rate of 4.92% to 5.05%; expected dividend yield zero percent; expected warrant life of five years; and current volatility of 125%.

In accordance with APB 14, the Company allocated $166,655 of the proceeds to the 2007 Bridge Note and $458,345 of proceeds to the warrants based upon the relative fair values of these instruments. The portion of the proceeds allocated to the warrants was recorded as an increase to additional paid in capital. The difference between the carrying amount of the 2007 Bridge Note and their contractual redemption amount ($458,345) was immediately charged as interest expense in the accompanying statement of operations for the three months ended March 31, 2007 since the notes are payable on demand. Accordingly, the 2007 Bridge Notes are presented in the accompanying balance sheet at their principal amount. Contractual interest expense on the 2007 Bridge Note amounted to $2,903 during the three months ended March 31, 2007.

As described in Note 3, the Company evaluated the conversion options embedded in the 2007 Bridge Notes and determined that since the conversion prices are not fixed, such conversion options should be bifurcated from the notes and accounted for as free standing derivatives in accordance with SFAS 133. The derivatives have been classified as liability instruments in the accompanying balance sheet. Apex has agreed that (i) in the event the holders of other derivative securities elect to convert or exercise, Apex will permit the conversion or exercise of such derivative securities prior to the conversion of the 2007 Bridge Notes and (ii) in the event that the Company does not have a sufficient number of authorized but unissued and unreserved share of common stock to permit the conversion of all of the 2007 Bridge Notes, Apex will convert only such portion of the 2007 Bridge Note that will result in the issuance of the available authorized but unissued and unreserved shares of common stock, provided, however, that the Company will take all reasonable steps to increase the authorized but unissued and unreserved shares of common stock to permit the conversion of the remaining portion of the 2007 Bridge Notes as soon as practicable thereafter. The aggregate fair value of the derivative conversion options, at their respective dates of issuance amounted to $294,586. The Company estimated the fair values of these options using the Black-Scholes option pricing model with the following assumptions: fair value of common stock from $0.55 to $1.00; risk-free interest rate of from 4.90% to 5.04% expected dividend yield zero percent, expected term of 0.9 to 1.0 year.; and current volatility of 125%.

The aggregate fair value of the derivative conversion option at March 31, 2007 amounts to $285,874. The Company recognized a gain of $8,712 at March 31, 2007 on the valuation of this derivative conversion option. The Company estimated the fair values of these warrants using the Black-Scholes option pricing model with

the following assumptions: fair value of common stock from $0.55; risk-free interest rate of 4.90%; expected dividend yield zero percent, expected term of 0.89 years. The change in fair value of the conversion option, which amounts to $8,712, is presented as a change in fair value of conversion option in the accompanying statement of operations for the three months ended March 31, 2007.

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Subsequent to March 31, 2007, Apex agreed to establish a minimum conversion price of $0.05 per share to be utilized in the calculation of the Conversion Shares. This conversion floor explicitly limits the number of shares issuable upon conversion of the notes to a maximum of 12,500,000 shares for which the Company has sufficient authorized but unissued and unreserved capital available to net share settle the derivative.

NOTE 9 -DEMAND NOTES PAYABLE

The demand note at March 31, 2007, which amounts to $312,557, is payable to Lok Technology and is secured by Entelagent's accounts receivable, which approximate $55,000 and $51,000 at March 31, 2007 and 2006, respectively. The note bears interest at 15% per annum. Interest on this demand note amounted to $11,721 and $11,721 for the three months ended March 31, 2007 and 2006, respectively. As described in Note 14, on May 4, 2006, the Company became aware of a complaint that Lok Technologies, Inc. had filed in the Superior Court of California, County of Santa Clara on or about March 30, 2006 against the Company, Entelagent Software Corp. and unnamed defendants.

NOTE 10 - BRIDGE NOTES PAYABLE

The Company completed three bridge note financing transactions in 2005 - the Bridge I Notes were completed for $3,500,000; the Bridge II Notes were completed for $2,543,000; and the Bridge III Notes were completed for $5,234,000.

During 2006, $3,180,025 of the Bridge I Notes were surrendered as payment for 3,975,031 shares of Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 15). As of March 31, 2007, $319,975 of Bridge I Notes remain outstanding. Contractual interest expense on the Bridge I Notes amounted to $9,467 and $103,562 for the three months ended March 31, 2007 and 2006, respectively, and is included as a component of interest expense in the accompanying statement of operations.

During 2006, $2,343,000 of the Bridge II Notes were surrendered as payment for 2,928,750 shares of Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 15). As of March 31, 2007, $200,000 of the Bridge II Notes remain outstanding. Contractual interest expense on the Bridge II Notes amounted to $5,918 and $75,245 for the three months ended March 31, 2007 and 2006, respectively and is included as a component of interest expense in the accompanying statement of operations.

During 2006, all of the Bridge III Notes were surrendered as payment for 6,542,500 shares of Series A-1 Preferred stock as part of the creditor and claimant liabilities restructuring (Note 15). Contractual interest expense on the Bridge III Notes amounted to $0 and $153,036 for the three months ended March 31, 2007 and 2006, respectively, and is included as a component of interest expense in the accompanying statement of operations.

NOTE 11 - RELATED PARTY TRANSACTIONS

NOTES PAYABLE (TO CREDITORS OF ACQUIRED BUSINESS)

The notes issued to creditors of Entelagent (in connection with the acquisition of Entelagent Software Corp.) include $554,202 that is payable to related parties for settlements of accrued payroll, notes payable and other payables that remain outstanding at March 31, 2007. The original amount of these notes amounted to $2,602,913. Aggregate interest expense on these notes amounted to $16,000 and $52,058 for the three months ended March 31, 2007 and 2006, respectively.

During 2006, $1,795,930 of the notes payable to creditors of acquired business were surrendered as payment for Series A-1 Preferred stock under the creditor and claimant liabilities restructuring (Note 15). As of March 31, 2007, $799,982 of the notes payable remain outstanding.

NOTE 12 - ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

Accrued expenses and other current liabilities consist of the following:

	MARCH 31, 2007
Payroll and payroll related expenses	$ 659,797
Accrued interest	670,280
Reserve for preacquisition tax contingencies	336,828
Other current liabilities	242,942
Expense reimbursement payable	8,958
	$ 1,918,805

NOTE 13 - DEFERRED REVENUE

Deferred revenue at March 31, 2007 includes (1) $42,177 for the fair value of remaining service obligations on maintenance and support contracts and (2) $212,387 for contracts on which the revenue recognition is deferred until contract deliverables have been completed.

NOTE 14 - COMMITMENTS AND CONTINGENCIES

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 called 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 15 - 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 following table provides a summary as of March 31, 2006 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/(LOSS
General Creditors	20,358,589	$16,476,818	$12,201,308	$ 4,275,51
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	(182,91
Other Claimants	7,381,489	1,243,282	4,428,894	$(3,185,61
	33,240,078	$21,437,189	$20,530,202	$ 906,98

The fair value of the Series A-1 shares issued in settlements reached prior to March 31, 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 16) 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.

NOTE 16 - INCOME TAXES

As described in Note 5, the Company adopted FIN 48 effective January 1, 2007. FIN 48 requires companies to recognize in the financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. FIN 48 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. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure. The Company's policy is to classify penalties and interest associated with uncertain tax positions, if required as a component of its income tax provision.

The Company has filed federal and various state income tax returns for the period ended December 31, 2002, and for the years ended December 31, 2003, 2004 and 2005 (for which the 2005 return was consolidated with the returns of acquired businesses) during 2006. These income tax returns and returns of acquired businesses filed prior to 2006 have not been examined by the applicable Federal and State tax authorities. The Company's tax returns and certain of the returns of the acquired business were not filed timely. Accordingly, statutes of limitation with respect to certain of these returns commenced during 2006. The Company has not yet filed its income tax returns for the year ended December 31, 2006.

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Management does not believe that the Company has any material uncertain tax position requiring recognition or measurement in accordance with the provision of FIN 48. At December 31, 2006, the Company had approximately $30 million of net deferred tax assets, of which $11.8 million relates to the tax effects of net operating losses.

The Company's net operating losses amounted to approximately $31 million as of

December 31, 2006 and expire at various times through the year ended December 31, 2026. The Company's determination of the amount of its net operating losses includes approximately $11 million associated with business acquired during 2005. In addition, the Company estimated that a substantial majority of the remaining $20 million of NOL's are subject to limitations due to the change in ownership provisions under Section 382 of the Internal Revenue Code. After giving effect to such changes, the Company estimates that its net operating losses available to offset future taxable income, if any, amount to approximately $13 million. Accordingly, the Company reduced the carrying amount of its net deferred tax asset and related reserve by approximately $6.7 million for the tax effects having reduced net operating losses by approximately $18 million.

The utilization of the remaining net operating losses may be subject to substantial limitations in future periods due to the change in ownership provisions under Section 382 of the Internal Revenue Code and separate return loss year limitations under Section 1502 of the Internal Revenue Code and similar state provisions. The Company, as a result of having evaluated all available evidence as required under SFAS 109, fully reserved for its net deferred tax assets since it is more likely than not that the benefits of these deferred tax assets will not be realized in future periods.

NOTE 17 - PREFERRED STOCK

AMENDMENT TO CERTIFICATE OF INCORPORATION AND AUTHORIZED SHARE CAPITAL

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

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

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

SERIES A PREFERRED STOCK

The Series A Preferred Stock has a stated value of $5,000 per share and carries a dividend of 10% per annum with such dividend accruing on a cumulative basis. The dividend is payable only (i) at such time as declared payable by the Board of Directors of the Company or (ii) in the event of liquidation, as part of the liquidation preference amount ("Liquidation Preference Amount"). Accumulated but unpaid dividends on the Series A Preferred, which have not been declared by the board of directors, amount to $487,333 of which $118,962 is presented in the accompanying statement of operations as an increase in the net loss available to common stockholders.

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. As described below, the conversion price was reduced to $0.90 per share on November 16, 2006 when the Company's issued Series B Preferred Stock convertible at $0.90 per share with warrants exercisable at $1.03 per share, and to $0.40 per share on January 24, 2007 when the Company issued employee stock options exercisable at $0.40 per share.

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

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

SERIES B PREFERRED STOCK

We have designated 2,000 shares of preferred stock as Series B Preferred Stock. The Series B Preferred Stock has a stated value of $5,000 per share, has no maturity date, carries a dividend of 10% per annum, with such dividend accruing on a cumulative basis and is payable only (i) at such time as declared payable by the board of directors or (ii) in the event of liquidation, as part of the liquidation preference amount ("Liquidation Preference Amount"). The Liquidation Preference Amount is equal to 125% of the sum of: (i) the stated value of any then unconverted shares of Series B Preferred Stock and (ii) any accrued and unpaid dividends thereon. An event of liquidation means any liquidation, dissolution or winding up of the Company, whether voluntary or involuntary, as well as any change of 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. Accumulated and unpaid dividends on the Series B Preferred, which have not been declared by the board of directors, amount to $174,912 of which $97,363 is presented in the accompanying statement of operations as an increase in the net loss available to common stockholders.

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

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

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

PRIVATE PLACEMENTS OF CONVERTIBLE PREFERRED STOCKS

PRIVATE PLACEMENT OF SERIES A CONVERTIBLE PREFERRED STOCK AND WARRANTS

Beginning on March 27, 2006 and completed on April 2, 2006, the Company consummated the Series A Preferred Financing with the closing of funds totaling $4,820,501, resulting in the issuance of 964 shares of Series A Preferred Stock and 669,539 common stock purchase warrants to the purchasers of the Series A Preferred Stock ("Investor Warrants"). The Company also issued common stock purchase warrants to Laidlaw as placement agent in this financing ("Agent Warrants") exercisable for 198,375 shares of common stock. The Investor Warrants and the Agent Warrants have a term of 5 years and an exercise price of $1.46 per share.

Pursuant to the Certificate of Designation for the Series A Preferred Stock, in the event that additional shares of common stock are issued or deemed to be issued at an effective price that is lower than the conversion price of the Series A Preferred Stock, the conversion price for the Series A Preferred Stock shall be reduced to the effective price of such issuance. On November 16, 2006, the Series B Preferred Financing was completed at a conversion price of $0.82 per share as compared to the $2.40 per share conversion price for the Series A Preferred Stock. Pursuant to the terms of the Certificate of Designation for the Series A Preferred Stock the conversion price of the Series A Preferred Stock was adjusted to $0.90 per share. This change resulted in an additional 3,347,571 shares of Common Stock being reserved for issuance upon the conversion of the Series A Preferred Stock. The Company recorded $3,795,059 of deemed dividends which is equal to the full amount of proceeds allocable to the preferred shares based on computations made to determine the relative fair values of the preferred shares and warrants and the effective conversion price of the shares in accordance with EITF 00-27.

On January 24, 2007, the Company issued 5,270,553 stock options under the Patron Systems Inc. 2006 Stock Incentive Plan. These options have an exercise price of $0.40 per share. This issuance has resulted in the adjustment of the Series A Preferred conversion price to $0.40 per share and has resulted in an additional 6,695,116 shares of Common Stock being reserved for issuance upon the conversion of the Series A Preferred Stock. The Company was not required to record an additional deemed dividend since the deemed dividend recorded in November 2006

was equal to the proceeds allocable to the preferred shares at their original dates of issuance. As of March 31, 2007, the 964 shares of Series A Preferred Stock outstanding are convertible, as described above, into 12,051,254 shares of Common Stock.

PRIVATE PLACEMENT OF SERIES B CONVERTIBLE PREFERRED STOCK AND WARRANTS

On October 13, 2006 and November 16, 2006, the Company consummated two closings of the Series B Preferred Financing through the sale of Units, at a per Unit price of $100,000, consisting of (i) 20 shares of Series B Preferred Stock and (ii) Series B Investor Warrants to purchase shares of Common Stock in an amount equal to 50% of the shares issuable upon conversion of the Series B Preferred Stock, in the aggregate amount of $3,952,716. The closings of the Series B Preferred Financing resulted in the issuance of 790.54 shares of Series B Preferred Stock with a conversion price of $0.82 and Series B Investor Warrants to purchase 2,410,222 shares of Common Stock at an exercise price of $1.03 per share. The Series B Investor Warrants have a term of 5 years.

In connection with the Series B Preferred Financing, the Company retained Laidlaw as its non-exclusive placement agent ("Series B Preferred Placement Agent"). The Company paid Laidlaw a fee of $352,569 and issued to Laidlaw common stock purchase warrants, the Series B Agent Warrants, to purchase 723,065 shares of Common Stock for its services as the Series B Preferred Placement Agent and paid $32,750 of Laidlaw's legal expenses associated with the Series B Preferred Financing. The Series B Agent Warrants have a term of 5 years.

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

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

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NOTE 18 - STOCKHOLDERS' EQUITY

ISSUANCE OF COMMON STOCK PURCHASE WARRANTS

On February 20, 2007, the Company issued common stock purchase warrants for 200,000 shares at an exercise price of $1.00 per share to Apex in connection with the 2007 Interim Bridge Financing. The aggregate fair value of these warrants amounted to $134,419 (Note 8).

On March 2, 2007, the Company issued common stock purchase warrants for 100,000 shares at an exercise price of $1.25 per share to Apex in connection with the 2007 Interim Bridge Financing. The aggregate fair value of these warrants amounted to $83,984 (Note 8).

On March 19, 2007, the Company issued common stock purchase warrants for 160,000 shares at an exercise price of $1.14 per share to Apex in connection with the 2007 Interim Bridge Financing. The aggregate fair value of these warrants amounted to $122,225 (Note 8).

On March 27, 2007, the Company issued common stock purchase warrants for 165,000 shares at an exercise price of $0.69 per share to Apex in connection with the 2007 Interim Bridge Financing. The aggregate fair value of these warrants amounted to $76,167 (Note 8).

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.

On July 21, 2006, the stockholders of the Company approved the 2006 Patron Systems, Inc. Stock Incentive Plan (the "2006 Stock Plan"). The 2006 Stock Plan provides for the granting of incentive stock options to employees and the granting of nonstatutory stock options to employees, non-employee directors, advisors, and consultants. The 2006 Stock Plan also provides for grants of restricted stock, stock appreciation rights and stock unit awards to employees, non-employee directors, advisors and consultants. The 2006 Stock Plan authorizes and reserves 5,600,000 shares for issuance of options that may be granted under plan.

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.

During the three months ended March 31, 2007, the Company issued stock options to employees to purchase 5,270,553 shares. These options include a grant to purchase 2,047,121 shares at an exercise price of $0.40 per share, with a fair value of $663,267, to the Chief Executive Officer of the Company, Mr. Braden Waverley, to conform to his employment agreement requirements. Additionally, the Company granted options to purchase 731,114 shares at an exercise price of $0.40 per share, with a fair value of $236,881, to Mr. Martin T. Johnson, the Company's Chief Financial Officer, to conform with his employment agreement with the Company. The Company granted options to purchase 757,318 shares at an exercise price of $.40 per share, with a fair value of $245,371 to Robert Cross, Chairman of the Board. The Company granted options to purchase 50,000 shares at an exercise price of $.40 per share with a fair value of $16,200 to George Middlemas, a director of the Company. The Company also granted options to 26 employees for a total of 1,685,000 shares at an exercise price of $0.40 per share with a fair value of $545,940. Assumptions relating to the estimated fair value of these warrants are as follows: fair value of common stock $0.40; risk-free interest rate of 5.0%; expected dividend yield zero percent; expected warrant 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.

Accordingly, the Company considers more recent data relating to employee turnover rates to be indicative of future vesting. Based on available data, the Company has assumed that approximately 84% of outstanding options will vest annually. 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 three months ended March 31, 2007 is as follows:

OPTIONS	SHARES	WEIGHTED-AVERAGE EXERCISE PRICE	WEIGHTED-AVERAGE REMAINING CONTRACTUAL TERM
Outstanding at January 1, 2007	532,636	$16.34	6.5 years
Granted	5,270,553	$ 0.40	
Exercised	--	--	
Forfeited or expired	(28,669)	$ 9.48	
Outstanding at March 31, 2007	5,774,520	$ 1.83	9.5 years
Exercisable at March 31, 2007	1,546,692	$ 5.47	8.8 years

At March 31, 2007, the aggregate intrinsic value of options outstanding and options exercisable, based on the March 30, 2007 closing price of the Company common stock ($0.55 per share) amounted to $800,583 and $222,274, respectively. In addition the table includes 206,670 fully vested and non-forfeitable stock options outstanding that it issued to non-employees through March 31, 2007. As of March 31, 2007, these options have a weighted average exercise price of $13.77, weighted average remaining contractual term of 5.1 years and an aggregate intrinsic value of $0. The fair value of the unvested portion of stock options at March 31, 2007 is $1,677,013 with a weighted-average remaining vesting period of 3.6 years.

The weighted-average grant-date fair value of the 5,270,553 stock options granted during the three month period ended March 31, 2007 amounted to $1,707,659 or $0.32 per share. There have also not been any exercises of stock options to date. The total fair value of options vested during the three months ended March 31, 2007 amounted to $430,303. Additionally, the Company did not capitalize the cost associated with stock based compensation.

Aggregate stock based compensation to employees and non employees amounted to $430,809 for the three months ended March 31, 2007.

NOTE 19 - DISCONTINUED OPERATIONS

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 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. The Company decided in the first quarter of 2006 to sell the LucidLine business.

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.

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	JANUARY 1, 2006 THROUGH MARCH 31, 2006
Revenue	$ 99,167
Cost of Sales	91,601
Gross Profit	7,566
Operating expenses	111,992
Loss from operations	(104,426)
Other expense	(538)
Loss before income taxes	(104,964)
Income taxes	--
Net loss	$ (104,964)

During December 2006, the Company made an affirmative decision to exit and actively pursue a plan to sell its PolicyBridge software product business. As a result of this decision, the Company has classified its PolicyBridge software product business as a discontinued operation in its financial statements as of March 31, 2007 and 2006 in accordance with SFAS 144. While management continues to search for a buyer of this business, the Company will continue to provide services under the existing maintenance and support agreements to its PolicyBridge customers.

	THREE MONTHS ENDED	
	MARCH 31, 2007	MARCH 31, 2006
Revenue	$ 61,751	$ 81,860
Cost of Sales	--	34,147
Gross Profit	61,751	47,713
Operating expenses	57,210	330,292
Gain (loss) from operations	4,541	(282,579)
Other income/(expense)		
Income (loss) before income taxes	4,541	(282,579)
Income taxes	--	--
Net income (loss)	$ 4,541	$ (282,579)

NOTE 20 - SUBSEQUENT EVENTS

ENGAGEMENT OF FIRST ANALYSIS SECURITIES CORPORATION

On April 18, 2007, the Company announced that it has entered into an agreement with First Analysis Securities Corporation ("FASC"), a research-driven investment bank, to provide strategic counsel on identifying acquisition targets and support for future capital raising activities. FASC shall be paid a $20,000 per month fee. In the event that FASC facilitates i) an equity, debt or other capital investment in the Company by a third party; facilitates an alliance, partnership, joint venture or other related event with a third party; or ii) a merger, combination, reorganization, recapitalization, business combination, or the purchase of all or substantially all of the assets of the Company by a third party, then a cash transaction fee shall be paid equal to 6% of the transaction value as defined in the agreement or $300,000 whichever is greater upon the closing of a transaction. FASC shall be paid an Alliance Fee if FASC facilitates an alliance, partnership, joint venture or other related event which generates at least $2 million in additional revenues for the Company, warrants with a value of $300,000 shall be issued to FASC.

MODIFICATION OF THE CERTIFICATE OF DESIGNATION OF THE SERIES A PREFERRED STOCK AND THE SERIES B PREFERRED STOCK

On April 12, 2007, the Board of Directors approved the amendment of each of the Certificate of Designation of Preferences, Rights and Limitations of Series A Convertible Preferred Stock and Series A-1 Convertible Preferred Stock of Patron Systems, Inc. (the "Series A Certificate of Designation"), and the Certificate of Designation of Preferences, Rights and Limitations of Series B Convertible Preferred Stock of Patron Systems, Inc. (the "Series B Certificate of Designation" and together with the Series A Certificate of Designation, the "Certificates of Designation"), to remove the limitation on the Company's ability to issue funded debt over $1,000,000. On May 1,

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2007, the Board of Directors approved the amendment of the Series A Certificate of Designation to increase the limitation on the Company's ability to issue funded debt to a limit of $3,000,000 from the current limit of $1,000,000.

MODIFICATION OF THE CERTIFICATE OF DESIGNATION OF THE SERIES B PREFERRED STOCK

On May 2, 2007, the Company filed with the Secretary of State of Delaware a Certificate of Amendment of the Series B Certificate of Designation. On May 8, 2007 the Company filed a Certificate of Correction with the Secretary of State of Delaware to correct an error in the previously filed Certificate of Amendment of the Series B Certificate of Designation. The Amended Series B Certificate of Designation removes the limitation on the Company's ability to issue funded debt over $1,000,000.

ADDITIONAL ADVANCES UNDER THE 2007 INTERIM BRIDGE FINANCING

On April 4, 2007, April 19, 2007 and May 7, 2007 the Company was advanced $168,000, $99,000, and $150,000 respectively, from Apex under the 2007 Interim Bridge Financing (Note 8). In conjunction with the April 4, 2007 advance, the Company issued to Apex 168,000 common stock purchase warrants at an exercise price of $0.69 per share. In conjunction with the April 19, 2007 advance, the Company issued to Apex 99,000 common stock purchase warrants at an exercise price of $0.94 per share. In conjunction with the May 7, 2007 advance, the Company issued to Apex 150,000 common stock purchase warrants at an exercise

price of $1.25 per share. These warrants have a term of 5 years.

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

PATRON SYSTEMS, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS
MARCH 31, 2007

The following discussion and analysis should be read in conjunction with the Annual Report on Form 10-KSB, including the financial statements, and the related notes thereto, for the year ended December 31, 2006 of Patron Systems, Inc. (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

From our inception through December 31, 2004, we were principally engaged in developing our business plan, raising capital, identifying merger and acquisition candidates and negotiating merger and acquisition transactions that we closed during the first quarter of 2005.In 2005, we consummated the acquisitions of Complete Security Solutions, Inc. ("CSSI") and LucidLine, Inc. ("LucidLine") and Entelagent Software Corp. ("Entelagent"). In April 2006, LucidLine was sold and is classified as a discontinued operation for 2006. In December 2006, management decided to exit the PolicyBridge business which was acquired in the Entelagent acquisition and these assets and liabilities are held for sale at March 31, 2007.

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

and other information to the state and federal governments in standard formats for information sharing purposes. FormStream addresses mobile e-form creation, capture and sharing over wireless networks and manages data in industry standard formats (forms: .pdf, XDP and XML; law enforcement: Global Justice XML data model (GJXDM) and National Information Exchange Model (NIEM)).

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

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. In accordance with SFAS 142, we conducted our annual impairment review of goodwill for the year ended December 31, 2006, which resulted in a goodwill impairment charge of $210,716. This 2006 charge, which principally represents goodwill remaining from the PolicyBridge business we acquired from Entelagent is classified in discontinued operations as a result of our decision to exit that business. The remaining amount of goodwill, which amounts to $9,300,000 at March 31, 2007, relates to our acquisition of CSSI in February 2005 from which we acquired the FormStream software technology, our sole line of business. We engaged an outside specialist to assist us with performing our annual goodwill impairment tests. These tests were made using a discounted cash flow model to value the business. This approach requires us to forecast our expectation of revenues and cash flows in future periods and to work with an independent specialist on developing assumptions relating to the risk that such cash flows may or may not materialize in future periods.

SHARE BASED PAYMENTS AND OTHER EQUITY TRANSACTIONS

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 MARCH 31, 2007 COMPARED TO THE THREE MONTHS ENDED MARCH 31, 2006.

For the three months ended March 31, 2007, our revenues amounted to $171,218 compared to $179,925 for the three months ended March 31, 2006.

Cost of Sales for the three months ended March 31, 2007 amounted to $64,635 compared to $57,419 for the three months ended March 31, 2006. Cost of sales during the three months ended March 31, 2007 and March 31, 2006 includes $27,015 and $27,522, respectively, associated with the amortization of developed technology.

Operating expenses amounted to $1,774,031 for the three months ended March 31, 2007 as compared to $754,385 for the three months ended March 31, 2006, an increase of $1,019,646. The increase in operating expenses includes an increase of approximately $250,000 for employee stock option compensation expense, an increase of approximately $401,000 associated with increased staffing in the Company's engineering, support and professional services functions and a increase of approximately $907,000 associated with the 2006 gain associated with the settlements under the creditor and claimant liabilities restructuring program. These increases were offset by approximately $83,000 for reduced salaries associated with a reduction in the number of employees, primarily in general and administrative functions, an approximately $3,000 reduction in expense associated with stock based penalties under financing arrangements and an approximately $453,000 reduction in legal and professional fees.

Our loss from continuing operations for the three months ended March 31, 2007 amounted to $2,162,583 compared to a loss of $1,604,281 for the same period in 2006. Our loss increased as a result of the increased operating expenses and the non-recurrence of settlement gains.

Interest expense during the three months ended March 31, 2007 amounted to $505,925 as compared to $972,464 for the three months ended March 31, 2006. The reduction is principally related to the issuance, in the three months ended March 31, 2006, of the Bridge III Notes and the associated amortization of deferred financing costs and the accretion of debt discounts incurred with that financing being incurred in the three months ended March 31, 2007 at a reduced total expense associated with the 2007 Interim Bridge Financing. 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 March 31, 2006 was reduced with the exchange of a substantial portion of these notes for Series A-1 Preferred Stock. Non-cash interest relating to the amortization of deferred financing costs, valuation of a derivative conversion option and the accretion of debt discounts during the three months ended March 31, 2007 amounted to $458,345 compared to $303,038 in the same period in 2006. Amortization of deferred finance charges which have been classified as interest expense was $0 in the three months ended March 31, 2007 compared to $282,129 in

the same period in 2006. Accretion of debt discounts during the three months ended March 31, 2007 were $163,759 compared to $20,909 in the same period in 2006. The change in the fair value of the derivative conversion option, presented in the statement of operations for the three months ended March 31, 2007 amounted to $8,712. The Company did not have any free standing derivatives requiring liability classification and periodic adjustment to market value outstanding during the three months ended March 31, 2006. Interest income, was $2,120 and $0 in the three months ended March 31, 2007 and 2006, respectively.

During the three months ended March 31, 2007, the Company's contractual dividends on its Series A Preferred and Series B Preferred was $216,325.

For the three months ended March 31, 2007, the net loss available to common stockholders was $2,374,367 or $(0.16) per share on 14,512,260 weighted average common shares outstanding compared to a net loss available to common stockholders of $1,991,824 or $(0.96) per share on 2,083,954 weighted average common shares outstanding for the three months ended March 31, 2006.

LIQUIDITY AND CAPITAL RESOURCES

We incurred a net loss from continuing operations of $2,162,583 for the three months ended March 31, 2007, which includes $931,510 of non-cash charges including non-cash charges associated with the accretion related to warrants issued in conjunction with notes payable ($458,345), depreciation and amortization ($51,026), a charge for stock option based compensation ($430,809) and a gain on the derivative conversion liability valuation of $8,712. Including the amounts above, we used net cash in our operating activities of $944,686 during the three months ended March 31, 2007. Our working capital deficiency at March 31, 2007 amounts to $4,386,561and we are continuing to experience shortages in working capital. We cannot provide any assurance that the outcome of these matters will not have a material adverse affect on our ability to sustain the business. These matters raise substantial doubt about our ability to continue as a going concern.

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. The Company raised $625,000 of bridge financing through issuance of secured demand notes during the three months ended March 31, 2007 The Company used $510,031 of these proceeds to fund its operations and a net of $114,969 in investing activities.

We are currently in the process of attempting to raise additional capital and have taken certain steps to conserve our liquidity. Subsequent to March 31, 2007, the Company has been advanced an additional $417,000 under the 2007 Interim Bridge Financing. Although we believe that we have access to capital resources, we have not secured any commitments for additional financing at this time nor can we provide any assurance that we will be successful in our efforts

to raise additional capital and/or successfully execute our business plan.

OFF-BALANCE SHEET ARRANGEMENTS

At March 31, 2007, 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. If we cannot generate additional revenues or raise additional capital in the near future, we may become insolvent. As of March 31, 2007, our cash balance was $120,004 and we had a working capital deficit of $4,386,561. 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 elsewhere in this annual report. We are currently unable to provide assurance that the acceptance of the creditor and claimant liabilities restructuring will actually improve our ability to fund the further development of our business plan or improve our operations. Our failure to fund the further development of our business plan and operations would materially adversely affect our ability to continue as a going concern.

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

We are at an early stage of executing our business plan and have no history of offering information security capabilities. We were incorporated in Delaware in

2002. Significant business operations only began with the acquisitions completed in February and March 2005. As a result of our limited history, it may be difficult to plan operating expenses or forecast our revenues accurately. Our assumptions about customer or network requirements may be wrong. The revenue and income potential of these products is unproven, and the markets addressed by these products are volatile. If such products are not successful, our actual operating results could be below our expectations and the expectations of investors and market analysts, which would likely cause the price of our common stock to decline.

We have generated limited revenues and have relied on financing generated from our capital raising activities to fund the implementation of our business plan. We have incurred operating and net losses and negative cash flows from operations since our inception. As of March 31, 2007, we had an accumulated deficit of approximately $98.6 million. We may continue to incur operating and net losses, due in part to implementing our acquisitions strategy, engaging in financing activities and expansion of our personnel and our business development capabilities. We will continue to seek financing for the acquisition of other acquisition targets that we may identify in the future. We continue to believe that we will secure financing in the near future, but there can be no assurance of our success. If we are unable to obtain the necessary funding, it will materially adversely affect our ability to execute our business plan and to continue our operations.

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

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

The automatic conversion of our Series A-1 Preferred Stock on July 31, 2006 resulted in significant dilution to our existing stockholders and resulted in our former creditors and claimants owning approximately 85.0% of our outstanding shares of common stock. These creditors and claimants, to the extent they act in concert, would be able to determine all actions brought before our stockholders. As a result of the automatic conversion of our Series A-1 Preferred Stock, each

of Per Gustafsson, Arco van Nieuwland and Sherleigh Associates, Inc. Profit Sharing Plan became greater than five percent beneficial owners of our common stock.

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

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 May 4, 2007, there were 14,512,260 shares of common stock outstanding, of which 1,365,601 shares were beneficially held by directors, executive officers and other affiliates, the sale of which are subject to volume limitations under Rule 144, various vesting agreements and our quarterly and other "blackout" periods. Furthermore, shares subject to outstanding options and warrants and shares reserved for future issuance under our stock option plan will become eligible for sale in the public market to the extent permitted by the provisions of various vesting agreements, the lock-up arrangements and Rule 144 under the Securities Act.

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

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

- 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

o obtain a signed and dated acknowledgment from the purchaser demonstrating that the purchaser has actually received the required risk disclosure document before a transaction in a "penny stock" can be completed.

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

RISKS RELATED TO OUR BUSINESS

WE MAY BE UNABLE TO SUCCESSFULLY INTEGRATE ACQUIRED BUSINESSES.

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

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

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

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.

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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 March 31, 2007, our Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of our disclosure controls and procedures in accordance with Exchange Act Rules 13a-15 or 15d-15 and identified material weaknesses in our internal controls. These material weaknesses related to the fact that that our overall financial reporting structure and current staffing levels were not sufficient to support the complexity of our financial reporting requirements. We currently lack the expertise we need to apply complex accounting principles relating to our business combinations and equity transactions and have experienced difficulty in applying income tax accounting principles. Although we have taken steps to correct these previous deficiencies, including the hiring of a Chief Financial Officer, and are currently in compliance with the SEC's reporting requirements, additional time is still required to test and document our internal and disclosure control processes to ensure their operating effectiveness. In addition, we have limited capital resources and are still at risk for the loss of key personnel in our finance department. The loss of key personnel in our finance department, or any other conditions that could disrupt our operations in this area, could have a material adverse affect on our ability to communicate critical information to management and our investors, raise capital and/or maintain compliance with our SEC reporting obligations. These circumstances, if they arise, could have a material adverse affect on our business.

We have limited management resources to date and are still establishing our management and financial systems. Growth, to the extent it occurs, is likely to place a considerable strain on our management resources, systems, processes and controls. To address these issues, we will need to continue to improve our financial and managerial controls, reporting systems and procedures, and will need to continue to expand, train and manage our work force worldwide. If we are unable to maintain an adequate level of financial processes and controls, we may not be able to accurately report our financial performance on a timely basis and our business and stock price would be harmed.

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

The SEC, as directed by Section 404 of the Sarbanes-Oxley Act of 2002, adopted

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

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

Future products will be designed to interface with our end customers' existing networks, each of which have different specifications and utilize multiple protocol standards. Many end customers' networks contain multiple generations of products that have been added over time as these networks have grown and evolved. Our future products must interoperate with all of the products within these networks as well as with future products that might 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. In addition, we will become subject to the internal control reporting requirement specified in Section 404 of the Sarbanes-Oxley Act of 2002 beginning in the year ended December 31, 2007, which will require us to expend substantial financial resources in order to become compliant with these requirements. These laws and regulations could make it more difficult or more costly for us to obtain certain types of insurance, including director and officer liability insurance, and we may be forced to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. The impact of these events could also make it more difficult for us to attract and retain qualified persons to serve on our board of

directors, board committees or as executive officers. We cannot estimate the amount or timing of additional costs we may incur as a result of these laws and regulations.

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

Our future success depends upon the continued services of our executive officers. The loss of the services of any of our key employees, the inability to attract or retain qualified personnel in the future, or delays in hiring

required personnel, could delay the development and introduction of, and negatively impact our ability to sell, our intended product offerings.

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

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

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

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

- 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.

ITEM 3. CONTROLS AND PROCEDURES

Members of Company management, including the Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures, as defined by paragraph (e) of Exchange Act Rules 13(a)-15 or 15(d)-15 for the three months ended March 31, 2007, the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of March 31, 2007 the Company's disclosure controls and procedures were not effective.

DISCLOSURE CONTROLS AND INTERNAL CONTROLS

Disclosure controls are procedures that are designed with the objective of ensuring that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, as amended, such as this Report, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls are also designed with the objective of ensuring that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Internal controls are procedures which are designed with the objective of providing reasonable assurance that our transactions are properly authorized, recorded and reported and our assets are safeguarded against unauthorized or improper use, to permit the preparation of our financial statements in conformity with generally accepted accounting principles.

Our company is not an "accelerated filer" (as defined in the Securities Exchange Act) and is not required to deliver management's report on control over our financial reporting until our year ended December 31, 2007. Nevertheless, we identified certain matters that constitute material weakness (as defined under the Public Company Accounting Oversight Board Auditing Standard No. 2) in our internal controls over financial reporting.

In previous periods, we reported that we had identified certain matters that constituted material weakness (as defined under the Public Company Accounting Oversight Board Auditing Standard No. 2) in our internal controls over financial reporting. The material weaknesses that we identified related to the fact that that our overall financial reporting structure and current staffing levels were not sufficient to support the complexity of our financial reporting requirements. We currently lack the expertise we need to apply complex accounting principles relating to our business combinations and equity transactions and have experienced difficulty in applying income tax accounting principles. As a result, our internal controls have not reduced to a reasonably low level, the risk of material misstatement to our financial statements. We also, until recently, lacked the structure we needed to ensure the timely filing of our tax returns.

Although we believe that we have made various improvements in our financial reporting processes additional time is still required to test and document our internal and disclosure control processes to ensure their operating effectiveness. As a result, our internal controls have not reduced to a reasonably low level, the risk of material misstatement to our financial statements.

On March 6, 2007, our board of directors determined that certain amounts reported in its unaudited condensed 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.

While performing their audit of our financial statements for the year ended December 31, 2006, Marcum & Kliegman LLP ("M&K"), our independent registered public accounting firm, discovered that the accounting for certain transactions occurring during the quarter ended March 31, 2006 and the quarter ended June 30, 2006, may have been in error. M&K informed our management of the possible misstatements. Upon review of these transactions our management discovered that the accounting for these transactions resulted in a $2,408,250 overstatement of its loss for the quarterly period ended March 31, 2006 and a $593,765

overstatement of its loss for the quarterly period ended June 30, 2006, which also resulted in an overstatement of the year to date losses in the six and nine month periods ended June 30, 2006 and September 30, 2006, respectively. Specifically, we recorded for the three months ended March 31, 2006, (1) a net loss of $858,213 on the settlement of various liabilities under our creditor and claimant liabilities restructuring program when we 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 our Interim Bridge Financing III notes and (3) charged, as interest expense, a $285,050 fee paid to the placement agent in our 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, we recorded a net gain of $371,616 on the settlement of various liabilities under our creditor and claimant liabilities restructuring program when we 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 20, 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.

On May 18, 2007, our board of directors determined that certain amounts reported in our December 31, 2006 financial statements included in form 10KSB needed to be restated as described below.

The specific error that came to management's attention relates to our accounting for a deemed dividend that was recognized upon a reduction in the conversion price of our Series A Preferred Stock that occurred on November 16, 2006. The reduction in the conversion price occurred upon our issuance of additional convertible securities featuring a conversion price lower than the conversion price embedded in the Series A Preferred. In calculating the deemed dividend, we originally determined that the net loss available to our common stockholders should be increased by $589,175, We reevaluated this computation during the quarter ended March 31, 2007 and determined that the net loss available to our common stockholders should have be increased by $3,759,059. The nature of the adjustment relates to our having used an incorrect price for the value of our common stock when we computed the intrinsic value of the conversion feature embedded in our Series A Preferred stock at the time of the reduction in the conversion price.

We are continuing to evaluate potential changes to make in our financial reporting procedures to enable us to reduce financial reporting risks that exist as a result of our limited resources. We are continuing to evaluate our risks and resources. We will seek to make additional changes in our financial reporting systems and procedures wherever necessary and appropriate to ensure their effectiveness in future periods.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

not have a material adverse affect on our financial condition.

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

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following unregistered securities have been sold by us during the period from January 1, 2007 to March 31, 2007:

DATE OF GRANT	TITLE AND AMOUNT OF SECURITIES GRANTED/EXERCISE PRICE IF APPLICABLE	NAME OF PRINCIPAL UNDERWRITER	NAME OR CLASS OF PERSONS WHO RECEIVED SECURITIES	CON R
February 2007	200,000/Common Stock Purchase Warrants	None	Apex Investment Fund V, L.P.	$
March 2007	100,000/Common Stock Purchase Warrants	None	Apex Investment Fund V, L.P.	$
March 2007	160,000/Common Stock Purchase Warrants	None	Apex Investment Fund V, L.P.	$
March 2007	165,000/Common Stock Purchase Warrants	None	Apex Investment Fund V, L.P.	$

The above unregistered securities were issued pursuant to an exemption from the registration requirements of the Securities Act under Section 4(2) of the Securities Act as such securities were issued to accredited investors and were not issued pursuant to any general solicitation or advertisement.

ITEM 6. EXHIBITS

See attached Exhibit Index.

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(1) On February 20, 2007, we issued warrants to purchase up to 200,000 shares of our common stock to Apex Investment Fund V, L.P. in conjunction with the 2007 Interim Bridge Financing transaction. The warrants have a term of 5 years and an exercise price of $1.00 per share. The aggregate fair value of these warrants amounted to $134,419.

(2) On March 2, 2007, we issued warrants to purchase up to 100,000 shares of our common stock to Apex Investment Fund V, L.P. in conjunction with the 2007 Interim Bridge Financing transaction. The warrants have a term of 5 years and an exercise price of $1.25 per share. The aggregate fair value of these warrants amounted to $83,984.

(3) On March 19, 2007, we issued warrants to purchase up to 160,000 shares of our common stock to Apex Investment Fund V, L.P. in conjunction with the 2007 Interim Bridge Financing transaction. The warrants have a term

of 5 years and an exercise price of $1.14 per share. The aggregate fair value of these warrants amounted to $122,225.

(4) On March 27, 2007, we issued warrants to purchase up to 165,000 shares of our common stock to Apex Investment Fund V, L.P. in conjunction with the 2007 Interim Bridge Financing transaction. The warrants have a term of 5 years and an exercise price of $0.69 per share. The aggregate fair value of these warrants amounted to $76,167.

EXHIBIT INDEX

EXHIBIT NUMBER	DESCRIPTION OF EXHIBIT
10.1	First Amendment to Executive Employment Agreement dated Februaryf17,12006, entered into on January 24, 2007, between Patron Systems, Inc. and Braden Waverley. Incorporated by reference to Exhibit 10.40 to the Annual Report on Form 10-KSB filed on April 10, 2007.*
10.2	First Amendment to Executive Employment Agreement dated February 17, 2006, entered into on January 24, 2007, between Patron Systems, Inc. and Martin T. Johnson. Incorporated by reference to Exhibit 10.41 to the Annual Report on Form 10-KSB filed on April 10, 2007.*
10.3	Secured Convertible Promissory note dated February 20, 2007, issued by Patron Systems, Inc. in favor of Apex Investment Fund V, L.P. Incorporated by reference to Exhibit 10.42 to the Annual Report on Form 10-KSB filed on April 10, 2007.
10.4	Security Agreement dated February 20, 2007, between Patron Systems, Inc. and Apex Investment Fund V, L.P. Incorporated by reference to Exhibit 10.43 to the Annual Report on Form 10-KSB filed on April 10, 2007.
10.5	Form of Warrant issued by Patron Systems, Inc. in favor of Apex Investment Fund V, L.P. Incorporated by reference to Exhibit 10.44 to the Annual Report on Form 10-KSB filed on April 10, 2007.
31.1	Certification of Principal Executive Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Indicates a management contract or compensatory plan.

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