

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

PATRON SYSTEMS INC
Form 10QSB
November 21, 2005

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

FORM 10-QSB

(Mark One)

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

For the quarterly period ended September 30, 2005

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
(STATE OR OTHER JURISDICTION OF
INCORPORATION OR ORGANIZATION)

74-3055158
(IRS EMPLOYER IDENTIFICATION NO.)

500 N. MICHIGAN AVE, SUITE 300
CHICAGO, IL
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

60611
(ZIP CODE)

(312) 396-4031
(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 No

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 60,427,299 shares of common stock outstanding as of November 11, 2005.

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

PATRON SYSTEMS, INC.

FORM 10-QSB QUARTERLY REPORT

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

TABLE OF CONTENTS

PART I - FINANCIAL INFORMATION	PAGE
-----	----
ITEM 1. FINANCIAL STATEMENTS.....	3
Condensed Consolidated Balance Sheet at September 30, 2005 (unaudited).....	3
Condensed Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2005 and 2004 (unaudited).....	4
Condensed Consolidated Statement of Stockholders' (Deficiency) Equity for the Nine Months Ended September 30, 2005 (unaudited).....	5
Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2005 and 2004 (unaudited).....	6
Notes to Condensed Consolidated Financial Statements (unaudited).....	7
ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.....	32
ITEM 3. CONTROLS AND PROCEDURES.....	44
PART II - OTHER INFORMATION	

ITEM 1. LEGAL PROCEEDINGS.....	47
ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.....	47
ITEM 6. EXHIBITS.....	48
SIGNATURES.....	49

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.

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

ITEM 1. FINANCIAL STATEMENTS

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

	SEPTEMBER 30, 2005 -----
ASSETS	
Current Assets:	
Cash	\$ 80,233
Restricted cash	517,003
Accounts receivable, net	174,110
Other current assets	186,447

Total current assets	957,793
Property and equipment, net	160,012
Deferred financing costs	3,000
Intangible assets, net	2,851,064
Goodwill	22,413,300

Total assets	\$ 26,385,169 =====
 LIABILITIES AND STOCKHOLDERS' DEFICIENCY	
Current Liabilities	
Accounts payable	\$ 1,505,808
Accrued payroll and related expenses	1,095,191
Accrued interest	999,880
Consulting agreement payable	100,000
Demand notes payable	1,007,556
Bridge notes payable	9,443,013
Acquisition notes payable	4,500,000
Notes payable (to creditors of acquired business, including \$1,655,548 to related parties)	2,588,000
Expense reimbursements due to officers and stockholders	243,340
Notes payable to officers and stockholders	284,212
Other current liabilities	977,555
Amounts due under settlement with former officer	982,123
Deferred revenue	265,018

Total current liabilities	23,991,696
Note payable - stock repurchase obligation due to former officer	1,738,667

Total liabilities	25,730,363 -----
Common stock subject to put right (2,000,000 shares)	1,000,000 -----
 Stockholders' Deficiency	
Preferred stock, par value \$0.01 per share, 75,000,000 shares authorized, none issued and outstanding	--
Common stock, par value \$0.01 per share, 150,000,000 shares authorized, 50,219,867	

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

shares issued and outstanding as of September 30, 2005 (net of 2,000,000 shares subject to put right)	502,199
Additional paid-in capital	56,996,739
Common stock to be issued (8,409,080 shares)	3,558,016
Common stock repurchase obligation	(1,300,000)
Deferred compensation	(250,250)
Accumulated deficit	(59,851,898)

Total stockholders' deficiency	(345,194)

Total liabilities and stockholders' deficiency	\$ 26,385,169
	=====

See notes to condensed consolidated financial statements.

3

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

	NINE MONTHS ENDED SEPTEMBER 30,		THREE MONTHS ENDED SEPTEMBER 30,	
	2005	2004	2005	2004
		(Development Stage)		(Development Stage)
Revenue	\$ 339,212	\$ --	\$ 152,941	\$ --
Cost of Sales				
Cost of products/services	203,934	--	116,757	--
Amortization of technology	272,792	--	133,124	--
Total cost of sales	476,726	--	249,881	--
Gross loss	(137,514)	--	(96,940)	--
Operating Expenses				
Salaries and related expenses	3,314,154	620,233	1,399,189	400,000
Consulting expense	1,239,083	477,817	286,208	300,000
Professional fees	986,405	283,489	279,272	100,000
General and administrative	888,608	414,192	545,540	100,000
Amortization of intangibles	69,691	--	30,814	--
Stock based penalties under accomodation agreements	823,747	1,040,400	134,645	400,000
Assessment fee	370,000	--	--	--
Loss on collateralized financing arrangement	366,193	--	--	--
Change in intrinsic value of common stock put right	(300,000)	--	(300,000)	--
Loss/(gain) associated with settlement agreements	(343,571)	438,667	45,532	--

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

Total operating expenses	7,414,310	3,274,798	2,421,200	1,4
Loss from operations	(7,551,824)	(3,274,798)	(2,518,140)	(1,4
Other Income (Expense)				
Interest income	19,250	57,750	--	
Loss on sale of property and equipment	(544)	--	(544)	
Interest expense	(12,376,904)	(99,263)	(10,159,038)	(
Total Other Expense	(12,358,198)	(41,513)	(10,159,582)	(
Loss before income taxes	(19,910,022)	(3,316,311)	(12,677,722)	(1,4
Income taxes	--	--	--	
Net loss	\$ (19,910,022)	(3,316,311)	\$ (12,677,722)	(1,4
Net Loss Per Share - Basic and Diluted .	\$ (0.35)	\$ (0.09)	\$ (0.21)	\$
Weighted Average Number of Shares				
Outstanding				
- Basic and diluted	57,284,490	38,610,646	61,499,103	39,0

See notes to condensed consolidated financial statements.

4

PATRON SYSTEMS, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' DEFICIENCY (UNAUDITED)
 FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2005

	SHARES OF COMMON STOCK	PAR VALUE COMMON STOCK	ADDITIONAL PAID IN CAPITAL	SHARES OF COMMON STOCK TO BE ISSUED
Balance, January 1, 2005 (development stage)	37,006,212	\$ 370,062	\$ 28,973,711	5,951,6
Common stock issued in purchase business combinations				
Complete Security Solutions, Inc. ..	--	--	6,300,000	7,500,0
LucidLine, Inc.	--	--	3,696,000	4,400,0
Entelagent Software Corporation	--	--	2,520,000	3,000,0
Amortization of deferred stock-based compensation	--	--	--	--
Issuance of warrants and bridge notes to investors 1/1/05 through 3/31/05	--	--	1,043,860	--
Issuance of warrants issued as purchase consideration	--	--	1,912,500	--

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

Issuance of warrants to transaction advisors	--	--	255,000	--
Issuance of warrants to placement agent - Interim Bridge Financing I .	--	--	297,500	--
Common stock to be issued under accommodation agreement as a penalty	--	--	--	1,350,000
Common stock issued under collateralized financing arrangement	890,500	8,905	397,300	--
Common stock to be issued under collateralized financing arrangement as a penalty	--	--	--	130,500
Common stock issued in lieu of cash ..	1,000,000	10,000	939,000	(1,000,000)
Common stock issued in purchase business combinations	11,323,155	113,232	--	(11,323,155)
Rescission of common stock to be issued under consulting agreement payable	--	--	--	(100,000)
Issuance of warrants to Bridge Note II investors	--	--	532,723	--
Issuance of warrants to placement agent - Interim Bridge Financing II	--	--	80,867	--
Issuance of warrants in connection with bridge loan extension - extension warrants	--	--	822,500	--
Issuance of stock options to Chief Executive Officer	--	--	30,000	--
Issuance of warrants to Bridge Note III investors	--	--	550,778	--
Adjustment to shares issuable under compensation arrangement	--	--	945,000	(1,500,000)
Reduction of intrinsic value of put right	--	--	(300,000)	--
Conversion option in connection with Interim Bridge Financing I	--	--	3,500,000	--
Conversion option in connection with Subordinated Notes	--	--	4,500,000	--
Net Loss	--	--	--	--
BALANCE, SEPTEMBER 30, 2005	50,219,867	\$ 502,199	\$ 56,996,739	8,409,000

	DEFERRED COMPENSATION	ACCUMULATED DEFICIT	TOTAL
	-----	-----	-----
Balance, January 1, 2005 (development stage)	\$ (1,475,333)	\$ (39,941,876)	\$ (8,702,036)
Common stock issued in purchase business combinations			
Complete Security Solutions, Inc. ..	--	--	6,375,000
LucidLine, Inc.	--	--	3,740,000
Entelagent Software Corporation	--	--	2,550,000
Amortization of deferred stock-based compensation	1,239,083	--	1,239,083
Issuance of warrants and bridge notes to investors 1/1/05 through 3/31/05	--	--	1,043,860
Issuance of warrants issued as purchase consideration	--	--	1,912,500

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

Issuance of warrants to transaction advisors	--	--	255,000
Issuance of warrants to placement agent - Interim Bridge Financing I .	--	--	297,500
Common stock to be issued under accommodation agreement as a penalty	--	--	745,501
Common stock issued under collateralized financing arrangement	--	--	406,205
Common stock to be issued under collateralized financing arrangement as a penalty	--	--	78,247
Common stock issued in lieu of cash ..	--	--	--
Common stock issued in purchase business combinations	--	--	--
Rescission of common stock to be issued under consulting agreement payable	--	--	(78,900)
Issuance of warrants to Bridge Note II investors	--	--	532,723
Issuance of warrants to placement agent - Interim Bridge Financing II	--	--	80,867
Issuance of warrants in connection with bridge loan extension - extension warrants	--	--	822,500
Issuance of stock options to Chief Executive Officer	(14,000)	--	16,000
Issuance of warrants to Bridge Note III investors	--	--	550,778
Adjustment to shares issuable under compensation arrangement	--	--	--
Reduction of intrinsic value of put right	--	--	(300,000)
Conversion option in connection with Interim Bridge Financing I	--	--	3,500,000
Conversion option in connection with Subordinated Notes	--	--	4,500,000
Net Loss	--	(19,910,022)	(19,910,022)
	-----	-----	-----
BALANCE, SEPTEMBER 30, 2005	\$ (250,250)	\$ (59,851,898)	\$ (345,194)
	=====	=====	=====

See notes to condensed consolidated financial statements.

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

	SEPTEMBER 30,	
	----- 2005	----- 2004
	-----	-----
Cash Flows from Operating Activities		
Net loss	\$ (19,910,022)	\$ (3,316,311)

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	382,872	--
Amortization of deferred compensation	1,239,083	--
Accretion related to warrants issued for notes payable	1,927,374	--
Amortization of deferred financing costs	1,825,606	--
Common stock issued in lieu of cash for services	--	477,81
Stock based penalty on accomodation agreement	823,747	1,040,40
Stock options issued to chief executive officer	16,000	--
Penalty warrants issued to bridge note holders	8,000,000	--
Reduction in intrinsic value of put right	(300,000)	--
Gain on settlement of consulting agreement payable	(228,900)	--
Loss on collateralized financing arrangement	366,194	--
Gain on legal settlement	(389,103)	--
Loss associated with settlement agreement	--	438,66
Non-cash increase in notes payable to former officer	17,399	--
Non-cash interest income	(19,250)	(57,75)
Changes in assets and liabilities:		
Restricted cash escrowed to settle liabilities assumed	(517,003)	--
Prepaid expenses	51,487	(27,35)
Accounts receivable	(38,465)	--
Other current assets	(93,858)	--
Accounts payable	(284,594)	(6,31)
Accrued interest	12,202	99,26
Deferred revenue	65,267	--
Expense reimbursements due to officers and shareholders ..	(30,521)	--
Accrued payroll and payroll related expenses	(1,043,209)	179,65
Other current liabilities	399,155	--
Consulting agreements payable	(50,000)	300,00
Loss on sale of property and equipment	544	--
Other accrued expenses	(3,413)	--
	-----	-----
Total adjustments	12,128,614	2,444,38
	-----	-----
NET CASH USED IN OPERATING ACTIVITIES	(7,781,408)	(871,93)
	=====	=====
CASH FLOWS USED IN INVESTING ACTIVITIES		
Advances to prospective acquiree businesses	--	(20,00)
Cash payments in purchase business combinations	(857,633)	--
Cash acquired in purchase business combinations	416,397	--
Acquisition of intellectual property	(92,547)	--
Proceeds from sale of property and equipment	1,500	--
Purchase of fixed assets	(67,445)	--
	-----	-----
NET CASH USED IN INVESTING ACTIVITIES	(599,728)	(20,00)
	=====	=====
CASH FLOWS FROM FINANCING ACTIVITIES		
Expenses financed by (repaid to) officers and stockholders	(273,223)	151,84
Advances from stockholders	--	(8,16)
Advances from prospective acquiree business	--	135,50
Deferred financing costs	(621,739)	--
Repayments of amounts due under settlement with former officer ..	(200,000)	--
Proceeds from issuance of bridge notes	7,100,000	--
Proceeds from issuance of common stock	--	700,00
Proceeds from issuance of notes	2,543,000	41,13
Deferred financing charges	(6,000)	--
Repayments of advances from shareholders	(126,570)	--
	-----	-----
NET CASH PROVIDED BY FINANCING ACTIVITIES	8,415,468	1,020,30

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

	=====	=====
NET INCREASE IN CASH	34,332	128,37
CASH, beginning of period	45,901	22,95
	=====	=====
CASH, end of period	\$ 80,233	\$ 151,33
	=====	=====
Supplemental Disclosures of Cash Flow Information:		
Issuance of note under stock repurchase obligation	\$ 1,300,000	\$ --
Obligation to repurchase 2,000,000 shares of common stock subject to put right	1,000,000	--
Cash paid during the period for:		
Interest	527,231	301,37
Supplemental non-cash investing and financial activity:		
Acquisition of businesses:		
Current tangible assets acquired	300,911	--
Non-current tangible assets acquired	2,809,689	--
Current liabilities assumed with acquisitions	(8,403,374)	--
Non-current liabilities assumed with acquisitions	(447,790)	--
Intangible assets acquired	3,101,000	--
Goodwill recognized on purchase business combinations	22,413,300	--
Non-cash consideration	(19,332,500)	--
Cash acquired in purchase business combinations	416,397	--
	-----	-----
Cash paid to acquire businesses	857,633	--
	=====	=====

See notes to condensed consolidated financial statements.

6

PATRON SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
SEPTEMBER 30, 2005

NOTE A - BASIS OF INTERIM FINANCIAL STATEMENT PRESENTATION

The accompanying unaudited Condensed Consolidated Financial Statements of Patron Systems, Inc. (the "Company," "Patron," "us," or "we") 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 nine-month period ended September 30, 2005 are not necessarily indicative of the operating results that may be expected for the entire year ending December 31, 2005.

This form 10QSB should be read in conjunction with the Company's 10KSB for the year ended December 31, 2004.

NOTE B - THE COMPANY

ORGANIZATION AND DESCRIPTION OF BUSINESS

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

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

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

DEVELOPMENT STAGE OPERATIONS

In accordance with Statement of Financial Accounting Standard ("SFAS") No.7, the Company was considered to be a development stage enterprise through December 31, 2004, as its activities principally consisted of raising capital and screening potential acquisition candidates in the information and homeland security segments. As described in Note E, the Company consummated acquisitions of three businesses that have developed technologies, customer bases and are generating revenue. Accordingly, the Company is no longer considered to be a development stage enterprise effective for the nine months ended September 30, 2005.

NOTE C - LIQUIDITY AND FINANCIAL CONDITION

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. The Company incurred a net loss of \$19,910,022 for the nine months ended September 30, 2005, which includes an aggregate of \$13,661,022 net of non-cash charges including the fair value of common stock of the Company issued as penalties under certain registration rights agreements, the fair value of common stock warrants issued as penalties to bridge note and subordinated note holders, the conversion option cost for bridge note and subordinated note holders, non-cash interest expense and the amortization of deferred compensation under a stock based compensation arrangement. The Company used net cash flows in its operating activities of \$7,781,408 during the nine months ended September 30, 2005. The Company's working capital deficiency at September 30, 2005 amounted to \$23,033,903 and the Company is continuing to experience shortages in working capital. The Company is also involved in substantial litigation and is being investigated by the Securities and Exchange Commission with respect to certain of its press releases and its use of form S-8 to register shares of common stock issued to certain

7

consultants (Note Q). The Company cannot provide any assurance that the outcome of these matters will not have a material adverse affect on its ability to sustain the business. These matters raise substantial doubt about the Company's ability to continue as a going concern. The accompanying financial statements do not include any adjustments that may result from the outcome of this uncertainty.

The Company expects to continue incurring losses for the foreseeable future due to the inherent uncertainty that is related to establishing the commercial feasibility of technological products and developing a presence in new markets. The Company's ability to successfully integrate the acquired businesses described in Note E is critical to the realization of its business plan. The

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

Company raised \$9,643,000 of gross proceeds (\$9,015,261 net proceeds after the payment of certain transaction expenses) in financing transactions during the nine months ended September 30, 2005. The Company used \$7,781,408 of these proceeds to fund its operations (which includes a \$1,388,000 escrow deposit for the payment of liabilities assumed in business combinations), and a net of \$599,728 in investing activities, which principally includes the cash component of purchase business combinations that the Company consummated during February and March of 2005, (net of cash acquired) and the purchase of property and equipment. In addition, the Company repaid an aggregate of \$668,093 of certain obligations due to certain officers/stockholders, \$339,256 of which was a reduction of the funds held in the restricted cash escrow account established in connection with the Entelagent Merger (Note E).

On September 23, 2005, the Company offered its creditors and claimants a proposed agreement to issue common stock for amounts owed to the holders of the Company's indebtedness (including lenders, past-due trade accounts, and employees, consultants and other service providers with claims for fees, wages or expenses) (Note S). The Company is currently unable to determine whether any of its creditors will accept the Company's proposal. The Company is currently unable to provide assurance that any of its creditors will accept this proposal or that the acceptance of such proposal will actually improve the Company's ability to fund the further development of its business plan or improve its operations.

Subsequent to September 30, 2005 the Company raised approximately \$820,000 in additional gross funds in three capital financing transactions consummated with a related party that were used principally to fund operations (Note T).

The Company is currently in the process of attempting to raise additional capital and has taken certain steps to conserve its liquidity while it continues to integrate the acquired businesses. 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 D - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Entelagent Software Corporation, IDK Enterprises, Inc. and LucidLine, Inc. All significant inter-company transactions have been eliminated.

CASH

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

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.

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

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 all of 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 probable.

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 to allocate revenues to delivered elements once it has established vendor-specific evidence for such undelivered elements.

The Company provides its internet access and back-up, retrieval and restoration services under contractual arrangements with terms ranging from 1 year to 5 years. These contracts are billed monthly, in advance, based on the contractually stated rates. At the inception of a contract, the Company may activate the customer's account for a contractual fee that it amortizes over the term of the contract in accordance with Emerging Issues Task Force Issue ("EITF") 00-21 "Revenue Arrangements with Multiple Deliverables." The Company's standard contracts are automatically renewable by the customer unless terminated on 30 days written notice. Early termination of the contract generally results in an early termination fee equal to the lesser of six months of service or the remaining term of the contract.

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.

Revenue from the resale of third-party hardware and software is recognized upon delivery provided there are no further obligations to install or modify the hardware or software. Revenue from the sales of hardware/software is recorded at the gross amount of the sale when the contract satisfies the requirements of EITF 99-19.

ACCOUNTS RECEIVABLE

The Company adjusts its accounts receivable balances that it deems to be uncollectible. The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company reviews its allowance for doubtful accounts on

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

a monthly basis and determines the allowance based on an analysis of its past due accounts. All past due balances that are over 90 days are reviewed individually for collectability. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote.

PROPERTY AND EQUIPMENT

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

9

GOODWILL

Statement of Financial Accounting Standard ("SFAS") No. 142, "Goodwill and Other Intangible Assets", requires that goodwill be tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis (September 30th for the Company) and between annual tests in certain circumstances. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value. Significant judgments required to estimate the fair value of reporting units include estimating future cash flows, determining appropriate discount rates and other assumptions. Changes in these estimates and assumptions could materially affect the determination of fair value and/or goodwill impairment for each reporting unit. We have recorded goodwill in connection with the Company's acquisitions described in Note E amounting to \$22,413,300. The Company has determined that no impairment charges are necessary during the nine months ended September 30, 2005.

LONG LIVED ASSETS

The Company periodically reviews the carrying values of its long lived assets in accordance with SFAS 144 "Long Lived Assets" when events or changes in circumstances would indicate that it is more likely than not that their carrying values may exceed their realizable value and records impairment charges when necessary. The Company has determined that no impairment charges are necessary during the nine months ended September 30, 2005.

STOCK OPTION PLANS

As permitted under SFAS No. 148 "Accounting for Stock-Based Compensation - Transition and Disclosure," which amended SFAS No. 123 "Accounting for Stock-Based Compensation," the Company has elected to continue to follow the intrinsic value method in accounting for its stock-based compensation arrangements as defined by Accounting Principles Board ("APB") Opinion No. 25 "Accounting for Stock Issued to Employees," and related interpretations including Financial Accounting Standards Board ("FASB") Interpretation No. 44 "Accounting for Certain Transactions Involving Stock Compensation," an interpretation of APB No. 25.

The following table summarizes the proforma operating results of the Company, had compensation expense for stock options granted to employees been determined

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

in accordance with the fair market value based method prescribed by SFAS No. 123. The Company has presented the following disclosures in accordance with SFAS No. 148.

	NINE MONTHS ENDED SEPTEMBER 30,		THREE MONTHS ENDED SEPTEMBER 30,	
	2005	2004	2005	2004
Net Loss, as reported	\$(19,910,022)	\$ (3,316,311)	\$(12,677,722)	\$ (1,49
(+) Stock-based compensation cost reflected in the financial statements	--	--	--	
(-) Stock-based employee compensation expense under the fair value method.	375,000	613,333	225,000	20
Proforma Net Loss	\$(20,285,022)	\$ (3,929,644)	\$(12,902,722)	\$ (1,69
Net Loss per Share-				
Basic and Diluted, as reported	\$ (0.35)	\$ (0.09)	\$ (0.21)	\$
Basic and Diluted, proforma	\$ (0.35)	\$ (0.10)	\$ (0.21)	\$
Weighted Average Number of Shares Outstanding:				
Basic and Diluted	57,284,490	38,610,646	61,499,103	39,01

10

NON-EMPLOYEE STOCK BASED COMPENSATION

The cost of stock based compensation awards issued to non-employees for services are recorded at either the fair value of the services rendered or the instruments issued in exchange for such services, whichever is more readily determinable, using the measurement date guidelines enumerated in EITF 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services."

COMMON STOCK PURCHASE WARRANTS

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

Based on the provisions of EITF 00-19, the Company classifies as equity any contracts that (i) require physical settlement or net-share settlement or (ii) gives the company a choice of net-cash settlement or settlement in its own shares (physical settlement or net-share settlement). The Company classifies as assets or liabilities any contracts that (i) require net-cash settlement (including a requirement to net cash settle the contract if an event occurs and if that event is outside the control of the company) (ii) give the counterparty a choice of net-cash settlement or settlement in shares (physical settlement or net-share settlement).

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

INCOME TAXES

The Company accounts for income taxes pursuant to SFAS No. 109, "Accounting for Income Taxes". Deferred taxes arise from temporary differences, primarily attributable to the use of the cash method for tax purposes and accrual method for book purposes and net operating loss carry-forwards. The Company records valuation allowances for deferred tax assets when circumstances indicate it is more likely than not that the Company will not realize the benefit of its deferred tax assets.

NET LOSS PER SHARE

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

As a result of the consummation of the Share Exchange described in Note B, the Company included 1,200,000 stock options with an exercise price of \$.01 per share that it issued to certain employees during 2002 in its calculation of weighted-average number of common shares outstanding for all periods presented.

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

	SEPTEMBER 30,	
	2005	2004
Options	11,190,000	3,925,000
Warrants	9,639,080	15,000
Convertible Notes	30,720,000	120,462
	51,549,080	4,060,462
	=====	=====

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. Actual results could differ from those estimates.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts reported in the balance sheet for cash, accounts receivable, accounts payable accrued expenses, advances from stockholders and all note obligations classified as current liabilities approximate their fair values based on the short-term maturity of these instruments. The carrying amounts of the Company's convertible and subordinated note obligations, stock repurchase obligation and common stock subject to put right approximate fair

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

value as such instruments feature contractual interest rates that are consistent with current market rates of interest or have effective yields that are consistent with instruments of similar risk, when taken together with any equity instruments concurrently issued to holders.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In January 2003, the Financial Accounting Standards Board issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"). This interpretation of Accounting Research Bulletin No. 51, "Consolidated Financial Statements," provides guidance for identifying a controlling interest in a variable interest entity ("VIE") established by means other than voting interest. FIN 46 also requires consolidation of a VIE by an enterprise that holds such controlling interest. In December 2003, the FASB completed its deliberations regarding the proposed modifications to FIN No., 46 and issued Interpretation Number 46R, "Consolidation of Variable Interest Entities - an Interpretation of ARB 51" ("FIN No. 46 R"). The decisions reached included a deferral of the effective date and provisions for additional scope exceptions for certain types of variable interests. Application of FIN No. 46R is required in financial statements of public entities that have interests in VIE's or potential VIE's commonly referred to as special-purpose entities for periods ending after December 15, 2003. Application by public issuers' entities is required in all interim and annual financial statements for periods ending after December 15, 2004. The adoption of this pronouncement did not have material effect on the Company's financial statements.

In December 2004, the FASB issued SFAS No. 123R "Share Based Payment". This statement is a revision of SFAS Statement No. 123, "Accounting for Stock-Based Compensation" and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees", 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 will be measured at fair value on the awards' grant date, based on the estimated number of awards that are expected to vest and will result in a charge to operations for stock-based compensation expense. The charge will be reflected in the Company's Statements of Operations during periods in which such charges are recorded, but will not affect its Balance Sheets or Statements or Cash Flows. SFAS 123R is effective for public entities that file as small business issuers--as of the beginning of the first reporting period of the fiscal year that begins after December 15, 2005. The Company is currently in the process of evaluating the effect that the adoption of this pronouncement will have on its financial statements.

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

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

EITF Issue No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share." The EITF reached a consensus that contingently convertible instruments, such as contingently convertible debt, contingently convertible preferred stock, and other such securities should be included in diluted earnings per share (if dilutive) regardless of whether the market price trigger has been met. The consensus became effective for reporting periods ending after December 15, 2004. The adoption of this pronouncement did not have a material effect on the Company's financial statements.

NOTE E - BUSINESS COMBINATIONS

MERGER WITH COMPLETE SECURITY SOLUTIONS, INC.

On February 25, 2005, pursuant to the filing of an Agreement and Plan of Merger, the Company's merger with Complete Security Solutions, Inc. ("CSSI") became effective. The merger was consummated pursuant to a definitive Supplemental Agreement and the Agreement and Plan of Merger, entered into as of February 24, 2005, each among the Company, CSSI Acquisition Co. I, Inc., a wholly-owned subsidiary of the Company and CSSI. Pursuant to the terms of the Supplemental Agreement and Agreement and Plan of Merger with CSSI, CSSI Acquisition Co. I, Inc. merged with and into CSSI, with CSSI surviving the merger as a wholly-owned subsidiary of the Company.

CSSI sells computer software that supports real-time secure collection, delivery and sharing of field-based report information for public safety agencies. The Company believes that CSSI's electronic forms technology provides law enforcement and other justice agencies with secure, real-time access to field reporting data for use inside a department or in a multi-jurisdictional information sharing system. The Company acquired CSSI because it believes that such technologies fit within its strategic plan of building a business that addresses the urgency of homeland and information security initiatives.

In connection with the CSSI merger, the Company issued 7,500,000 shares of common stock in exchange for the outstanding shares of the common stock of CSSI, and subordinated promissory notes in the aggregate principal amount of \$4,500,000 (the "Subordinated Notes") and warrants to purchase 2,250,000 shares of common stock ("Purchase Warrants") in exchange for the outstanding shares of the preferred stock of CSSI. The Purchase Warrants have a term of 5 years and an exercise price of \$0.70 per share. The Subordinated Notes and Purchase Warrants were issued to Apex Investment Fund V, L.P. ("Apex"), The Northwestern Mutual Life Insurance Company ("Northwestern"), and Advanced Equities Venture Partners I, L.P. ("Advanced Equities").

The Subordinated Notes issued to the holders of the outstanding preferred stock of CSSI have an initial term of 120 days (due on June 25, 2005), with the Company's option to extend the term for an additional 60 days to August 24, 2005. The Subordinated Notes are interest free and automatically convert into the securities offered by the Company at the first closing of a subsequent financing for the Company, for such number of offered securities as could be purchased for the principal amount being converted.

The Company did not redeem the Subordinated Notes on August 24, 2005 and, as a result, the notes became automatically convertible into 3.84 shares of common stock for each \$1 of principal then outstanding in accordance with the original note agreement. Accordingly, the Company recorded a charge of \$4,500,000 based upon the intrinsic value of this conversion option measured at the original issuance date of the note in accordance with EITF 00-27 "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios" ("EITF 00-27"). The Company has agreed to file with the SEC, a registration statement for the resale of the restricted shares of the Company's common stock issuable upon exercise of the conversion option

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

that would be issued in this transaction, on a best efforts basis.

The Company has agreed to register the resale of the 7,500,000 shares of common stock issued to the holders of the outstanding common stock of CSSI and the 2,250,000 shares of common stock issuable upon the exercise of the warrants issued to the holders of the outstanding preferred stock of CSSI at such time as the Company next files a registration statement with the Securities and Exchange Commission ("SEC") on a best efforts basis.

13

MERGER WITH LUCIDLINE, INC.

On February 25, 2005, pursuant to the filing of an Agreement and Plan of Merger, the Company's merger with LucidLine, Inc. ("LucidLine") became effective. The merger was consummated pursuant to a definitive Supplemental Agreement and the Agreement and Plan of Merger entered into as of February 24, 2005, each among the Company, LL Acquisition I Corp., a wholly-owned subsidiary of the Company and LucidLine. Pursuant to the terms of the Supplemental Agreement and Agreement and Plan of Merger with LucidLine, LL Acquisition I Corp. merged with and into LucidLine, with LucidLine surviving the merger as a wholly-owned subsidiary of the Company.

LucidLine provides high-speed Internet access, synchronized remote back-up, retrieval, and restoration services to small and mid-size businesses. The Company acquired LucidLine because it believes that LucidLine's information protection technologies fit within its strategic plan of building a business that addresses the urgency of homeland and information security initiatives.

In connection with the LucidLine merger, the Company issued 4,400,000 shares of common stock and \$200,000 of cash, in exchange for all of the outstanding shares of LucidLine's common stock. The Company has agreed to register the resale of the shares of common stock issued to the holders of the outstanding common stock of LucidLine at such time as the Company next files a registration statement with the SEC on a best efforts basis.

MERGER WITH ENTELAGENT SOFTWARE CORP.

On November 24, 2002, the Company, ESC Acquisition, Inc., a California corporation and wholly-owned subsidiary of Patron ("Entelagent Mergerco"), and Entelagent Software Corp., a California corporation ("Entelagent"), entered into an Agreement and Plan of Merger, (the "Entelagent Merger Agreement") whereby Entelagent Mergerco would be merged with and into Entelagent with Entelagent surviving as a wholly-owned subsidiary of the Company (the "Entelagent Merger"). The Company, Entelagent Mergerco and Entelagent also concurrently entered into a Supplemental Agreement (the "Entelagent Supplemental Agreement").

On February 24, 2005, the Company entered into a definitive Amended and Restated Supplemental Agreement pursuant to which Entelagent Mergerco would merge with and into Entelagent, with Entelagent surviving the merger as a wholly-owned subsidiary of the Company. On March 30, 2005, pursuant to the filing of an Amended and Restated Agreement and Plan of Merger, Patron's merger with Entelagent became effective. The Amended and Restated Agreement and Plan of Merger amended and restated the Entelagent Merger Agreement.

Entelagent provides flexible and scalable real-time content-aware email monitoring and post-event review of e-mail messages and their attachments as well as infrastructure for knowledge management of archived e-mail messages and attachments in all media. Entelagent's e-mail content monitoring technology

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

addresses the need for comprehensive internal security measures to safeguard company intellectual capital. The Company acquired Entelagent because it believes that Entelagent's information surveillance and protection technologies fit within its strategic plan of building a business that addresses the urgency of homeland and information security initiatives.

In connection with the Entelagent Merger, the Company issued 3,000,000 shares of the Company's common stock in exchange for all of the outstanding shares of the capital stock of Entelagent. The Company has agreed to register the resale of the 3,000,000 shares of common stock issued to the holders of the outstanding capital stock of Entelagent at such time as the Company next files a registration statement with the SEC on a best efforts basis. In addition, pursuant to the terms of the Amended and Restated Supplemental Agreement, the Company also agreed to (i) issue to certain officers, directors, stockholders and creditors of Entelagent, in consideration of amounts owed by Entelagent to such parties, promissory notes in the aggregate principal amount of \$2,640,000, with interest payable thereon at a rate of 8% per annum and maturing one year after the completion of the merger and (ii) pay \$1,388,000 in outstanding liabilities of Entelagent from the net proceeds of the Interim Bridge Financing I completed on February 28, 2005. Accordingly, the Company placed \$1,388,000 of the proceeds it received from the Interim Bridge Financing I financing transaction in an escrow account to be specifically used for the payment of such liabilities. The non-disbursed funds as of September 30, 2005 are presented as restricted cash in the accompanying balance sheet.

14

Subsequent to the date of the acquisition, the Company modified its purchase price allocation to offset approximately \$52,000 of previously existing advances against the note, which reduced the aggregate balance of the note to \$2,588,000.

BUSINESS COMBINATION ACCOUNTING

The Company accounted for its acquisitions of CSSI, LucidLine and Entelagent using the purchase method of accounting prescribed under SFAS 141 "Business Combinations." Under the purchase method, the acquiring enterprise records any purchase consideration issued to the sellers of the acquired business at their fair values. The aggregate of the fair value of the purchase consideration plus any direct transaction expenses incurred by the acquiring enterprise is allocated to the assets acquired (including any separately identifiable intangibles) and liabilities assumed based on their fair values at the date of acquisition. The excess of cost of the acquired entities over the fair values of identifiable assets acquired and liabilities assumed was recorded as goodwill. The results of operations for each of the acquired companies following the dates of each business combination is included in the Company consolidated results of operations for the quarter ended September 30, 2005.

The Company evaluated each of the aforementioned transactions to identify the acquiring entity as required under SFAS 141 for business combinations effected through an exchange of equity interests. Based on such evaluation the Company determined that it was the acquiring entity in each transaction (and cumulatively for all transactions) as (1) the larger portion of the relative voting rights in the Company after each combination was retained by its previously existing stockholders, (2) the previously existing stockholders, through their retention of a majority of voting rights, retained the ability to elect or appoint a voting majority of the governing body of the combined entity, and (3) under the terms of the exchange of equity securities, the Company paid a premium over the market value of the equity securities of the other combining entities.

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

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

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

The fair value of common stock issued to the sellers as purchase consideration was determined in accordance with the provisions of EITF 99-12 "Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination." The fair value of subordinated notes issued to the sellers as purchase consideration is considered to be equal to their principal amounts due to the short-term maturity of those instruments. The Company calculated the fair value of common stock purchase warrants issued to the sellers as purchase consideration using the Black-Scholes option-pricing model.

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

PRELIMINARY PURCHASE PRICE ALLOCATION

Under business combination accounting, the total preliminary purchase price was allocated to CSSI's and LucidLine's net tangible and identifiable intangible assets based on their estimated fair values as of February 25,

2005. The total preliminary purchase price allocation for Entelagent's net tangible and identifiable intangible assets was based on their estimated fair values as of March 30, 2005. The preliminary allocation of the purchase price for these three acquisitions is set forth below. The excess of the purchase price over the net tangible and identifiable intangible assets was recorded as goodwill.

The Company assumed \$476,594 of payroll and sales tax liabilities in its acquisition of Entelagent that were in arrears at the date the transaction was consummated (Note M). These liabilities have been estimated at their fair value in the preliminary purchase price allocation. The settlement of these amounts is in negotiation and could change, as the outcome of any proposed settlement is unknown at the date of acquisition.

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

	CSSI	LUCIDLINE	ENTELAGENT	TOTAL
	-----	-----	-----	-----
Fair value of tangible assets:				
Cash	\$ 399,636	\$ 9,563	\$ 7,198	\$ 416,397
Accounts receivable	27,791	22,936	84,918	135,645
Employee receivables	111,773	2,000	27,500	141,273
Other current assets	45,177	326	5,990	51,493
	-----	-----	-----	-----
Total current assets	584,377	34,825	125,606	744,808
Property and Equipment	62,000	61,000	12,000	135,000
Other assets	--	--	--	--
Advances to prospective affiliates	2,674,689	--	--	2,674,689
	-----	-----	-----	-----
Total tangible assets	3,321,066	95,825	137,606	3,554,497
Liabilities assumed:				
Accounts payable	(128,854)	(32,473)	(345,769)	(507,096)
Advances from prospective affiliate	--	(829,032)	(2,363,359)	(3,192,391)
Accrued expenses and other current liabilities	(391,141)	--	(4,340,246)	(4,731,387)
	-----	-----	-----	-----
Total current liabilities .	(519,995)	(861,505)	(7,049,374)	(8,430,874)
Long term liabilities	--	(102,460)	(345,330)	(447,790)
	-----	-----	-----	-----
Total liabilities assumed .	(519,995)	(963,965)	(7,394,704)	(8,878,664)
	-----	-----	-----	-----
Net tangible assets acquired .	2,801,071	(868,140)	(7,257,098)	(5,324,167)
Value of excess allocated to:				
Developed technology	670,000	--	1,900,000	2,570,000
Customer relationships	180,000	--	--	180,000
Trademarks and tradenames ...	55,000	--	106,000	161,000
In-process research and development	190,000	--	--	190,000
Goodwill	9,289,557	4,962,751	8,160,992	22,413,300
	-----	-----	-----	-----
Purchase Price	\$ 13,185,628	\$ 4,094,611	\$ 2,909,894	\$ 20,190,133
	=====	=====	=====	=====

The purchase price allocation is preliminary, based on management's estimates and a valuation study performed by an independent outside appraisal firm that has not yet been finalized. The Company considered its intention for future use of the acquired assets, analyses of the historical financial performance of each of the acquired businesses and estimates of future performance of each acquired businesses' products and services. The Company made certain adjustments during the nine months ended September 30, 2005 to its original purchase price allocation as a result of having negotiated settlements of certain liabilities that it assumed in its business combination with Entelagent and reevaluating the carrying amounts of certain accounts receivable balances recorded in purchase accounting. These changes resulted in a net decrease of \$110,663 to the Company's previous determination of goodwill. In addition, the Company reduced both other current assets and current liabilities by \$27,500 to offset a prepayment of a liability that occurred prior to the acquisition. The Company's final determination of the purchase price allocation could

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

result in additional changes to the amounts reflected in its preliminary estimate. The Company is in the process of finalizing the information required to file its Form 8-K with the SEC and will do so as soon as practicable.

The Company, as of September 30, 2005, evaluated the carrying amounts of its goodwill and other intangible assets it recorded in its business combinations with Entelagent, LucidLine and CSSI. The Company made its evaluation to determine whether conditions exist that would indicate that reductions in the carrying amounts of these assets would be required. The Company concluded, based upon (a) its hiring of a full-time sales staff and (b) recent marketing initiatives it has undertaken as part of its plan to integrate the acquired business, that demand for its products is significant. Accordingly, the Company believes there are currently no conditions that would indicate that carrying amounts of its goodwill and amortizable intangible assets is impaired.

The Company has established December 31, as the date to perform its annual evaluation of goodwill and intangible assets in accordance with SFAS 142 and SFAS 144, which valuation will be formally conducted by an outside specialist. The Company intends to continue monitoring the carrying amounts of these assets to determine whether circumstances change and, if necessary, record impairment charges if required.

PROFORMA FINANCIAL INFORMATION

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

The unaudited proforma financial information for the nine months ended September 30, 2005 combines the historical results for Patron for the nine months ended September 30, 2005 and the historical results for CSSI and LucidLine for the period from January 1, 2005 to February 24, 2005 and the historical results for Entelagent for the period from January 1, 2005 to March 30, 2005. The unaudited proforma financial results for the nine months ended September 30, 2004 combines the historical results for Patron for this period with the historical results for CSSI, Entelagent and LucidLine for the nine months ended September 30, 2004.

	2005	2004
	-----	-----
Total revenues	\$ 498,172	\$ 940,208
Net loss	(21,276,483)	(6,244,863)
Weighted average shares outstanding		
on a proforma basis	60,703,538	55,610,931
Proforma net loss per share, basic		
and diluted	\$ (0.35)	\$ (0.11)

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

NOTE F - OTHER CURRENT ASSETS

Other current assets consist of the following:

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

	SEPTEMBER 30, 2005
Employee receivables	\$ 18,371
Prepaid expenses	140,055
Deposits	28,021
Other current assets	\$ 186,447

NOTE G - PROPERTY AND EQUIPMENT

	SEPTEMBER 30, 2005
Computers	\$ 160,197
Furniture and Fixtures	39,949
sub-total	200,146
less: accumulated depreciation	(40,134)
Property and equipment, net	\$ 160,012

Depreciation expense for the nine months ended September 30, 2005 was \$40,389.

17

NOTE H - DEFERRED FINANCING COSTS

Deferred financing costs, which amount to \$3,000 are presented net of amortization and include the following:

	Interim Bridge Financing			
	Bridge I	Bridge II	Bridge III	Total
Cash fees paid to agent and investor to originate loans ...	\$ 316,579	\$ 305,160	\$ 6,000	\$ 627,739
Fair value of warrants issued to:				
Placement agent	297,500	80,867	--	378,367
Investors upon the extension of due dates	822,500	--	--	822,500
Accumulated amortization	1,436,579 (1,436,579)	386,027 (386,027)	6,000 (3,000)	1,828,606 (1,825,606)
Deferred financing costs, net ...	\$ --	\$ --	\$ 3,000	\$ 3,000

The Company incurred \$316,579 of cash fees and \$297,500 of non-cash fees representing the fair value of 350,000 common stock purchase warrants issued to Laidlaw in its capacity as the placement agent in the \$3,500,000 Interim Bridge

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

Financing I completed in February 2005. Fees incurred in connection with the Interim Bridge 1 financing were fully amortized during the nine months ended September 30, 2005.

On June 28, 2005, the Company elected to extend the due date of the Interim Bridge Financing I notes in exchange for 1,750,000 additional common stock purchase warrants (the "Bridge I Extension Warrants") that were issued to the investors in this transaction. The aggregate fair value of the warrants, which amounted to \$822,500 was recorded as a deferred financing cost and was fully amortized over the 60-day extension period, which ended on August 27, 2005.

The Company incurred cash fees of \$305,160 and non-cash fees of \$80,867 representing the fair value of 152,580 common stock purchase warrants issued to Laidlaw & Company (UK) Ltd. in its capacity as the placement agent in the \$2,543,000 Interim Bridge Financing II (Note K). These deferred financing costs were fully amortized during the nine months ended September 30, 2005.

The Company paid \$6,000 to Advanced Equities on July 29, 2005 with respect to transaction services performed in connection with the Interim Bridge Financing III completed in September 2005. The fees are being amortized over the term of the note to November 25, 2005.

The fair value of all of the aforementioned warrants was determined using the Black-Scholes option-pricing model. Aggregate amortization expense with respect to deferred financing costs amounted to \$1,825,606 for the nine months ended September 30, 2005 and is included as a component of interest expense in the accompanying statement of operations.

NOTE I - INTANGIBLE ASSETS

The components of intangible assets as of September 30, 2005 are set forth in the following table:

18

	FAIR VALUE AND ADDITIONS	ACCUMULATED AMORTIZATION	NET BOOK VALUE AT 9/30/2005	ESTIMATED USEFUL LIFE
	-----	-----	-----	-----
Developed technology	\$2,662,547	\$ 272,792	\$2,389,755	5 years
Customer relationships ...	180,000	26,250	153,750	4 years
Trademarks and tradenames	161,000	21,272	139,728	4 years
In-process research and development	190,000	22,169	167,831	5 years
	-----	-----	-----	
	\$3,193,547	\$ 342,483	\$2,851,064	
	=====	=====	=====	

The Company classifies amortization of developed technology as a component of cost of sales.

AMORTIZATION OF INTANGIBLE ASSETS

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

INTANGIBLE
AMORTIZATION

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

October 1, 2005 to	
December 31, 2005	\$ 193,186
YEARS ENDED DECEMBER 31:	

2006	655,759
2007	655,759
2008	655,759
2009	584,718
2010	105,883

	\$2,851,064

NOTE J - DEMAND NOTES PAYABLE

Through December 31, 2004, the Company borrowed an aggregate amount of \$695,000 from four unrelated parties. These notes are payable on demand and bear interest at the rate of 10% per annum. Interest expense on these notes amounted to \$53,625 for each of the nine months ended September 30, 2005 and 2004, respectively.

Demand notes also include a note payable to Lok Technology secured by Entelagent's accounts receivable. At September 30, 2005, the balance outstanding on this note is \$312,556. The note bears interest at 15% per annum. Interest on this note amounted to \$25,163 for the nine months ended September 30, 2005.

NOTE K - BRIDGE NOTES PAYABLE

INTERIM BRIDGE FINANCING I

On February 28, 2005, the Company completed a \$3,500,000 financing (the "Interim Bridge Financing I") through the issuance of 10% Senior Convertible Promissory Notes (the "Bridge I Notes") and warrants to purchase up to 1,750,000 shares of the Company's common stock ("Bridge I Warrants"). The warrants have a term of 5 years and an exercise price of \$0.70 per share. The aggregate fair value of the Bridge I Warrants amounts to \$1,487,500. Prior to final maturity, the Bridge I Notes may be converted into securities that would be issuable at the first closing of a subsequent financing by the Company, for such number of offered securities that could be purchased for the principal amount being converted. The Bridge I Notes had an initial term of 120 days (due on June 28, 2005) with

19

interest at a contractual rate of 10% per annum and featured an option for the Company to extend the term for an additional 60 days to August 27, 2005.

In accordance with APB 14, the Company allocated \$2,456,140 of the proceeds to the Bridge I Notes and \$1,043,860 of proceeds to the Bridge I Warrants. The difference between the carrying amount of the Bridge I Notes and their contractual redemption amount was accreted as interest expense to June 28, 2005, their earliest date of redemption. Accretion of the aforementioned discount amounted to \$1,043,860 for the nine months ended September 30, 2005 and is included as a component of interest expense in the accompanying statement of operations.

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

On June 28, 2005, the Company elected to extend the contractual maturity date of the Bridge I Notes for an additional 60 days to August 27, 2005, which caused the contractual interest rate to increase to 12% per annum. In addition, the Company was required to issue the 1,750,000 additional warrants (the "Bridge I Extension Warrants") to purchase such number of shares of common stock equal to 1/2 of a share for each \$1.00 of principal amount outstanding. The Bridge I Extension Warrants have a term of 5 years and an exercise price of \$0.70 per share. The Bridge I Warrants are included in Deferred Financing Costs at their fair value, which amounts to \$822,500.

The Company did not redeem the Bridge I Notes on August 27, 2005 and, as a result, the notes became automatically convertible into 3.84 shares of common stock for each \$1 of principal then outstanding in accordance with the original note agreement. Accordingly, the Company recorded a charge of \$3,500,000 based upon the intrinsic value of this conversion option measured at the original issuance date of the note in accordance with EITF 00-27. The Company has agreed to file with the SEC, a registration statement for the resale of the restricted shares of the Company's common stock issuable upon exercise of the conversion option that would be issued in this transaction, on a best efforts basis.

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

The Company sold these securities to thirty-three accredited investors introduced by Laidlaw, the placement agent in the Interim Bridge Financing I. As described in Note H, the Company incurred \$614,079 of fees in connection with this transaction including \$297,500 for the fair value of warrants to purchase up to 350,000 shares of the Company's common stock (the "Placement Agent Warrants") at an exercise price of \$0.70 per share.

INTERIM BRIDGE FINANCING II

On June 6, 2005, the Company completed a \$2,543,000 financing (the "Interim Bridge Financing II") through the issuance of (i) 10% Junior Convertible Promissory Notes (the "Bridge II Notes") and (ii) warrants to purchase up to 1,271,500 shares of common stock (the "Bridge II Warrants"). The warrants have a term of 5 years and an exercise price of \$0.60 per share. The aggregate fair value of the Bridge II Warrants amounts to \$673,895. Prior to maturity, the Junior Convertible Promissory Notes may be converted into the securities offered by the Company at the first closing of a subsequent financing for the Company, for such number of offered securities as could be purchased for the principal amount being converted.

In accordance with APB 14, the Company allocated \$2,010,277 of the proceeds to the Bridge II Notes and \$532,723 of proceeds to the Bridge II Warrants. The difference between the carrying amount of the Bridge II Notes and their contractual redemption amount is being accreted as interest expense to October 3, 2005, their earliest date of redemption. Accretion of the aforementioned discount amounted to \$532,723 for the nine months ended September 30, 2005 and is included as a component of interest expense in the accompanying statement of operations.

The Bridge II Notes have an initial term of 120 days (due on various dates beginning October 3, 2005) with interest at 10% per annum and feature an option for the Company to extend the term for an additional 60 days to various dates beginning December 2, 2005. Upon the extension of the maturity date of the Bridge II Notes, the contractual interest rate would increase to 12% per annum, and the Company would be required to issue warrants (the "Bridge II Extension Warrants") to purchase such number of shares of the Company's common stock equal to one-half of a share for each \$1.00 of principal then outstanding. The Bridge II Extension Warrants issuable upon extension of the maturity date of the Junior

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

Convertible Promissory notes feature a term of 5 years and an exercise price of \$0.60 per

20

share. In addition, if the Bridge II Notes are not paid in full on or before the extended maturity date, each note becomes convertible into 3.84 shares of the Company's common stock for each \$1.00 of principal then outstanding. The intrinsic value of this conversion option measured at the issuance date of the notes amounts to \$2,543,000 and would be recognized as interest expense in accordance with EITF 00-27. The Company has agreed to file with the SEC, a registration statement for the resale of the restricted shares of its common stock issuable upon exercise of the conversion option that would be issuable in this transaction, on a best efforts basis.

The Company sold these securities to seven accredited investors introduced by Laidlaw, placement agent in the Interim Bridge Financing II. As described in Note H, the Company incurred \$386,027 of fees in connection with this transaction including a cash fee of \$305,160 and \$80,867 for the fair value of warrants to purchase 152,580 shares of the Company's common stock at an exercise price of \$0.60 per share.

As described in Note T, the Company elected to extend the due dates of these notes by an additional 60 days to various dates beginning December 2, 2005.

INTERIM BRIDGE FINANCING III

Beginning on July 1, 2005, and continuing through September 30, 2005, the Company completed a \$3,600,000 financing (the "Interim Bridge Financing III") through the issuance of (i) 10% Junior Convertible Promissory Notes (the "Bridge III Notes") and (ii) warrants to purchase up to 1,800,000 shares of common stock (the "Bridge III Warrants"). The warrants have a term of 5 years and an exercise price of \$0.60 per share. The aggregate fair value of the Bridge III Warrants amounts to \$550,778. Prior to maturity, the Junior Convertible Promissory Notes may be converted into the securities offered by the Company at the first closing of a subsequent financing for the Company, for such number of offered securities as could be purchased for the principal amount being converted.

In accordance with APB 14, the Company allocated \$3,049,222 of the proceeds to the Bridge III Notes and \$550,778 of proceeds to the Bridge III Warrants. The difference between the carrying amount of the Bridge III Notes and their contractual redemption amount is being accreted as interest expense to various dates from November 1, 2005, their earliest date of redemption. Accretion of the aforementioned discount amounted to \$350,791 for the nine months ended September 30, 2005 and is included as a component of interest expense in the accompanying statement of operations.

The Bridge III Notes have an initial term of 120 days (due on various dates beginning October 28, 2005) with interest at 10% per annum and feature an option for the Company to extend the term for an additional 60 days to various dates beginning December 28, 2005. Upon the extension of the maturity date of the Bridge III Notes, the contractual interest rate would increase to 12% per annum, and the Company would be required to issue warrants (the "Bridge III Extension Warrants") to purchase such number of shares of the Company's common stock equal to one-half of a share for each \$1.00 of principal then outstanding. The Bridge III Extension Warrants issuable upon extension of the maturity date of the Junior Convertible Promissory Notes feature a term of 5 years and an exercise price of \$0.60 per share. In addition, if the Bridge III Notes are not paid in full on or before the extended maturity date, each note becomes convertible into

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

3.84 shares of the Company's common stock for each \$1.00 of principal then outstanding. The intrinsic value of this conversion option measured at the issuance date of the notes amounts to \$3,600,000 and would be recognized as interest expense in accordance with EITF 00-27. The Company has agreed to file with the SEC, a registration statement for the resale of the restricted shares of its common stock issuable upon exercise of the conversion option that would be issuable in this transaction, on a best efforts basis.

The Company sold these securities to Apex, Northwestern, and Advanced Equities. Funding for the Bridge III Notes included the conversion of \$1,650,000 of stockholder advances made during the period March 30, 2005 to June 30, 2005 into Bridge III Notes. In conjunction with Bridge III Notes, Advanced Equities was paid a fee of \$6,000 as described in Note H.

21

NOTE L - RELATED PARTY TRANSACTIONS

EXPENSE REIMBURSEMENTS DUE TO OFFICERS AND STOCKHOLDERS

Certain stockholders and officers of the Company have paid expenses on the Company's behalf since its inception, of which \$243,340 remains outstanding at September 30, 2005. The amounts payable to such officers and stockholders are due on demand.

NOTES PAYABLE TO OFFICERS AND STOCKHOLDERS

Notes payable to officers and stockholders, which amount to \$284,212, bear interest at 10% per annum and are due on demand. Interest expense on these notes amounted to \$19,314 for the nine months ended September 30, 2005.

CONSULTING AGREEMENT PAYABLE

On June 8, 2005, the Company negotiated a settlement regarding the consulting agreement payable with a related party. The terms of the settlement agreement terminates the prior agreement and reduces the remaining payments due under the contract to \$150,000 including a \$50,000 payment that was made upon the execution of the agreement and two additional \$50,000 payments including one to be made upon the completion of a follow-on-financing by the Company and one not later than September 30, 2005. The \$150,000 reduction in payments was recorded as a reduction of general and administrative expense during the quarter ended June 30, 2005. Additionally, the settlement agreement terminates an obligation for the Company to issue 100,000 shares of unrestricted stock. This stock issuable under this commitment was recorded in 2004 as "Stock to be issued in lieu of cash for services" in the amount of \$78,900 and the 100,000 shares was classified as shares to be issued. The termination of the stock issuance obligation resulted in an additional reduction of \$78,900 in general and administrative expenses during the quarter ended June 30, 2005.

The payment due on September 30, 2005 was not made by the Company. The balance due under this arrangement is included in the liabilities that the Company has offered to settle under the proposed creditor and claimant liabilities restructuring described in Note S.

NOTES PAYABLE (TO CREDITORS OF ACQUIRED BUSINESS)

The notes issued to creditors of Entelagent described in Note E, include \$1,655,548 payable to related parties for settlement of accrued payroll, notes payable and expense reimbursements. In addition, the Company offset \$52,000 of

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

previously existing advances made to certain of the parties to reduce the note to an aggregate carrying amount of \$2,588,000. Aggregate interest expense on this note amounts to \$98,962 for the nine months ended September 30, 2005.

RELATED PARTY PAYMENTS

During the nine months ended September 30, 2005, the Company made payments of \$514,867 to related parties from the \$1,388,000 restricted cash escrow account established in connection with the Entelagent Merger (Note E). Such payments reduced certain outstanding liabilities of Entelagent including advances from shareholders, accounts payable and payroll liabilities.

During the nine months ended September 30, 2005, the Company made a \$200,000 payment to Patrick J. Allin and the Allin Dynastic Trust under the terms of the settlement agreement reached on June 6, 2005 (Note O).

NOTE M - OTHER CURRENT LIABILITIES

Other current liabilities principally consists of \$476,594 of accrued payroll and sales tax liabilities, the settlement of which is being negotiated, and estimated penalties that the Company assumed in its acquisition of Entelagent (Note E). These liabilities are intended to be paid from restricted cash. Also included in this balance is \$469,622 related to two judgments against the Company (Note Q).

22

NOTE N - DEFERRED REVENUE

Deferred revenue includes (1) \$123,287 for the fair value of remaining service obligations on maintenance and support contracts and (2) \$141,730 for contracts on which the revenue recognition is deferred until contract deliverables have been completed.

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

On June 6, 2005, the Company entered into a settlement of certain employment and indemnification related claims brought by Patrick J. Allin, the Company's former Chief Executive Officer and a former member of the Company's Board of Directors, against the Company during the year ended December 31, 2004. Pursuant to the Settlement Agreement and Mutual Release dated June 2, 2005, among the Company, Mr. Allin and The Allin Dynastic Trust, the Company agreed to pay to Mr. Allin, in settlement of Mr. Allin's claims, an aggregate payment of One Million One Hundred Fifty Thousand Dollars (\$1,150,000) payable as follows: (i) \$200,000 that was paid upon execution of the Settlement Agreement and Mutual Release and (ii) Nine Hundred Fifty Thousand Dollars (\$950,000) payable in cash and/or a promissory note upon the consummation of a follow-on-financing by the Company. The parties also agreed to release all claims existing as of the date of the Settlement Agreement and Mutual Release. The Settlement Agreement and Mutual Release featured a provision to terminate on August 15, 2005 if the Company did not consummate a follow-on-financing by such date. As described herein, the Company and Mr. Allin agreed to extend the termination date for an additional 120 days to December 13, 2005. The Company accrued an aggregate of \$927,167 in amounts repayable to Mr. Allin up through the date of his termination in February 2004. The difference between the amounts accrued and the cash settlement, which difference amounts to \$216,507, was recorded in general and administrative expense in the quarter ended March 31, 2004. The remaining

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

amounts payable to Mr. Allin under this provision of the settlement are presented net of the \$200,000 payment made to him upon the execution of the agreement and includes \$46,845 of interest accrued during the nine months ended September 30, 2005.

Pursuant to the Settlement Agreement and Mutual Release, the Company also agreed to purchase from Mr. Allin and The Allin Dynastic Trust an aggregate of four million (4,000,000) shares of the Company's common stock as follows: (i) two million (2,000,000) shares (the "Initial Shares") through the issuance of promissory notes in the aggregate principal amount of One Million Six Hundred Thousand Dollars (\$1,600,000) and (ii) two million (2,000,000) shares (the "Remainder Shares") through a cash payment from the proceeds of a follow-on-financing by the Company, at a price per share equal to the lesser of (a) \$.50 per share or (b) 90% of the issue price or conversion price, as the case may be, of the security issued in a follow-on-financing, provided however that in the event that 90% of the issue price or conversion price, as the case may be, of the security issued in the follow-on-financing is less than \$.50 per share, Mr. Allin and/or The Allin Dynastic Trust may, at their option, refuse to sell any or all of the Remainder Shares to the Company. The Initial Shares are to be held in escrow pursuant to a mutually agreed upon Escrow Agreement to be subsequently entered into between the parties. Each of Mr. Allin and The Allin Dynastic Trust have agreed to lock-up their shares until the shorter of (y) the six month period subsequent to the consummation of a follow-on-financing and (z) the date on which the next registration statement filed by the Company becomes effective.

The promissory notes issued to purchase the Initial Shares bear interest at an annual rate of 8%, with interest payments due and payable on the last day of August, November, February and May during the term of the promissory notes, with a maturity date of June 30, 2006. In addition, if the Company defaults on certain terms under the promissory notes, and such default remains uncured for five days, all payments under the promissory notes accelerate and the Company agrees to confess to a judgment against the Company in a court of the promissory note holder's choosing in Cook County, Illinois. In the alternative, the holders of the promissory notes may demand that the shares purchased by the promissory notes be returned in fulfillment of all obligations remaining under such promissory notes.

As a result of this agreement to repurchase shares of common stock from Mr. Allin and The Allin Dynastic Trust, the Company has recorded certain liabilities and adjustments to stockholders' deficiency retroactively to the quarter ended March 31, 2004.

For the Initial Shares the Company recorded a \$1,738,667 note payable to Mr. Allin with a corresponding increase of \$1,600,000 in stockholders' deficiency and a \$138,667 charge to operations for interest payable through June 6, 2006. For the Remainder Shares, the Company recorded a \$1,000,000 put right as temporary equity with a corresponding \$300,000 charge to operations for the intrinsic value of the put right on June 6, 2005 (fair value of common stock of \$.65 per share less the minimum conversion price of \$50. per share) and a \$700,000 net increase in stockholders' deficiency. The aggregate charge of \$438,667 for the interest and the intrinsic value of the conversion option embedded in the remainder shares is presented as a litigation loss in the statement of operations for the six months ended June 30, 2004. Common stock outstanding in the accompanying balance sheet is presented net of the 2 million Initial Shares that are subject to the repurchase obligation.

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

As of September 30, 2005, the Company's fair value of its common stock was \$0.14 per share, which resulted in a reduction of the charge for the intrinsic value of the put right granted on June 6, 2005 to \$0. Such reduction is presented as a change in the intrinsic value of put right in the accompanying statement of operations for the nine months ended September 30, 2005.

On August 15, 2005, the Company and Patrick J. Allin ("Allin") and the Allin Dynastic Trust ("Allin Trust") entered into an agreement to provide the Company with up to an additional 120 days to arrange the follow-on-financing described under the terms of the original settlement. Under the terms of the time extension, 1) the Company agrees that the 6 month lockup period for the Allin and Allin Trust shares shall begin August 15, 2005; 2) the Company will pay Allin a penalty of \$500 per day for each day after August 15 that the \$950,000 remains unpaid; 3) the Company will also pay the Allin Trust a \$100 per day penalty for each day after August 31 that the interest on the promissory note to purchase the Allin Trust shares remains unpaid provided that \$8,000 of this interest is paid by September 15, 2005. If the September 15th amount is not paid, the Company will pay a \$250 per day penalty commencing August 31, 2005 with all overdue interest and penalties to be paid out of the follow-on-financing. If the promissory note interest of \$16,000 due on November 30, 2005 is not paid by that date, an additional \$250 per day penalty will be paid; 4) the Company shall pay Allin a \$100 per day penalty for each day after August 31 that the interest on the promissory note to purchase the Allin shares remains unpaid provided that \$8,000 of this interest is paid by September 15, 2005. If the September 15th amount is not paid, the Company will pay a \$250 per day penalty commencing August 31, 2005 with all overdue interest and penalties to be paid out of the follow-on-financing. If the promissory note interest of \$16,000 due on November 30, 2005 is not paid by that date, an additional \$250 per day penalty will be paid; and 5) At the end of the 120 day extension period, if the Company has not completed its follow-on-financing and made all payments to Allin and the Allin Trust due and owing under the amended agreement, all payments under the amended agreement will become immediately due and owing. Allin and the Allin Trust will have the option of keeping the Initial and Remainder Shares or demanding payment of the associated notes. The Company will confess to a judgment in a court of Allin's choosing for the \$950,000 and the promissory notes for purchase of the Allin Trust shares (if payment is demanded for the notes to purchase shares). Any actions that would preclude the Company making the payments under this agreement will accelerate all payments due and the Company will confess to judgment. As of September 30, 2005, the \$950,000 promissory note has not been repaid, interest on the promissory note to purchase the Allin Trust shares has not been paid, nor has the September 15th amount totaling \$8,000 been paid.

Additional interest and penalties under this arrangement amounted to \$55,900 during the nine months ended September 30, 2005.

NOTE P - ACCOMMODATION AGREEMENT

In November 2002, the Company entered into a financing arrangement with a third party financial institution (the "Lender"), pursuant to which the Company would borrow \$950,000 under a note to be collateralized by the pledge of 950,000 shares of registered stock from five different stockholders. In connection with this arrangement, the Company executed a series of Accommodation Agreements with these stockholders wherein each stockholder pledged their shares in return for the right to receive on or before November 17, 2003 the return of the pledged shares, or replacement shares in the event of foreclosure, and one additional share of common stock for every four shares pledged as compensation. The Company also agreed to use "best efforts" to register these shares with the US Securities and Exchange Commission 12 months from the date of issue.

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

On March 13, 2003, the Company issued 1,200,000 replacement shares with an aggregate fair value of \$3,708,000 to the stockholders who pledged their shares under the Accommodation Agreements. Accordingly, the Company recorded an additional loss of \$2,210,272 during the year ended December 31, 2003 for the difference between the loss the Company recorded upon the Lender's foreclosure of the collateral and the aggregate fair value of the replacement shares.

In addition, the Accommodation Agreements provided for the Company to pay a penalty in the event of its failure to cause the replacement shares to be registered on or before March 31, 2003. As a result, the Company has accrued a penalty of 450,000 shares per quarter, which penalty amounted to \$118,500 in the three months ended September 30, 2005 and \$745,501 in the nine months ended September 30, 2005.

STOCK PLEDGE ARRANGEMENT

In April 2004, a stockholder of the Company entered into a one-year stock loan financing arrangement ("Stock Financing Facility") with a third party financial institution, pursuant to which such stockholder committed to obtain financing for the Company under a credit facility collateralized by the pledge of 685,000 shares of registered stock (the "Pledged Stock") that was pledged by a second stockholder (the "Pledging Stockholder"). In connection with this arrangement, the Company executed an accommodation agreement with the Pledging Stockholder committing to issue 685,000 shares of restricted stock (the "Replacement Stock") on April 2, 2005 (the "Termination Date") in the event of a loss of the Pledged Stock, plus a premium of 205,500 shares (the "Premium Shares") for entering into the agreement. The Company also agreed to register 300,000 shares of restricted stock held by the Pledging Stockholder (the "Held Stock") within thirty days of the agreement and to use its best efforts register with the SEC, both the Replacement Stock and Premium Stock within 12 months from their date of issue.

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

The Company recorded a charge of \$406,205 for the fair value of the Replacement Stock and Premium Stock (890,500 shares) issued to the Pledging Stockholder under this arrangement. Such charge, net of \$40,012 of advances received, is presented as a loss on collateralized financing arrangement in the accompanying statement of operations. The Company also recorded a \$78,247 charge during the nine months ended September 30, 2005 and \$17,145 during the three months ended

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

September 30, 2005 for the fair value of 130,587 shares issuable to the Pledging Stockholder as penalties for the delays in registering the stock. The charges associated with the penalties are included in stock based penalties under accommodation agreements in the accompanying statements of operations.

25

NOTE Q - COMMITMENTS AND CONTINGENCIES

LEGAL PROCEEDINGS

Sherleigh Associates Inc. Profit Sharing Plan ("Sherleigh") filed a complaint against the Company, Patrick Allin, former Chief Executive Officer of the Company, and Robert E. Yaw, the Company's non-executive Chairman, on February 3, 2004, in the United States District Court for the Southern District of New York (the "Court") alleging common law fraud. The complaint alleged that Sherleigh was fraudulently induced into purchasing 1,000,000 shares of Company common stock in reliance upon certain of the Company's press releases and allegedly false statements by Mr. Allin and Mr. Yaw, concerning the Company's plans to acquire two target companies, TrustWave Corporation (currently a strategic partner of the Company) and Entelagent (a current subsidiary of the Company), and its financing arrangements regarding those acquisitions. Sherleigh seeks rescission of its purchase agreement and return of its \$2,000,000 purchase price or compensatory damages to be proven at trial. Mr. Allin recently entered into a settlement agreement with Sherleigh and is requesting that the Court include in its dismissal order a finding that the settlement is reasonable and a prohibition against any claims by the Company or Mr. Yaw against Mr. Allin for contribution or indemnification with respect to Sherleigh's claims. The Company has opposed Mr. Allin's request. The Court has not yet issued any ruling on Mr. Allin's request. Discovery has been completed, but no trial date has been set by the Court. The Company believes the Plaintiff's claims are without merit and intends to continue to defend against them through trial, if necessary. The amount of loss, if any, with respect to the claim cannot be predicted or quantified at this time and, therefore, no amounts have been recorded on the books of the Company.

In April of 2005, Richard L. Linting, a former President of the Company's Professional Services Group, filed a complaint against the Company and Robert E. Yaw, II, the Company's non-executive Chairman, in the Circuit Court of Cook County, Illinois alleging breach of his purported employment contract and seeking sums allegedly owed under the employment contract in the amount of \$1,321,809, plus court costs and fees. On August 22, 2005, the Company, Mr. Linting and Mr. Yaw entered into a Settlement Agreement and Release whereby Mr. Linting agreed to release all claims against the Company and Mr. Yaw existing as of that date in consideration for (i) the payment by the Company to Mr. Linting of \$100,000 in cash, (ii) the issuance by the Company of an aggregate of 422,827 shares ("Linting Shares") of the Company's common stock (equivalent to \$192,809 divided by \$0.456) to be transferred to Mr. Linting in such numbers and at such times as directed by Mr. Linting subsequent to the registration of the Linting Shares, (iii) the Company's agreement to register the Linting Shares through the filing of a registration statement on or before September 30, 2005, and (iv) the Company's affirmation of the validity of options previously issued to Mr. Linting and agreement to permit exercises of those options for 100,000 shares in each calendar month over a period of 3 years. The Company and Mr. Linting also agreed to the filing of a stipulation to dismiss Mr. Linting's suit with prejudice and without costs with the court retaining jurisdiction to reinstate the case and enforce the terms of the Settlement Agreement and Release in the event the Company defaulted on its obligations under the Settlement Agreement and Release, and to enter judgment, by motion, against the Company for the

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

balance due or appropriate relief. The Company did not make the \$100,000 payment required under the Settlement Agreement and Release, erroneously issued the Linting Shares to Mr. Linting, and did not file a registration statement to register the Linting Shares on or before September 30, 2005. Subsequent to September 30, 2005, Mr. Linting obtained a judgment against the Company for \$100,452 in cash and 422,827 shares of the Company's common stock to be issued to Mr. Linting at his determination upon registration thereof. The Company continues to negotiate with Mr. Linting regarding the amounts owed to him.

In December of 2004, Marie Graul, the Company's former Chief Financial Officer, informed the Company of her intention to assert a claim against the Company for sums allegedly owed under her employment agreement with the Company. On August 31, 2005, the Company and Ms. Graul entered into a Settlement Agreement and Mutual Release whereby Ms. Graul agreed to release all claims against the Company arising from any act or omission occurring on or prior to that date in consideration of (i) the payment by the Company to Ms. Graul of an aggregate of \$176,458 no later than September 30, 2005, \$1,458 of which was payable on execution of the Settlement Agreement and Mutual Release, and (ii) the Company's affirmation of the validity of options previously issued to Ms. Graul. The Company also agreed to confess to a judgment against the Company in a court of Ms. Graul's choosing in the event of the Company's breach of the Settlement Agreement and Mutual Release. The Company did not make the payments required by the Settlement Agreement and Mutual Release. Subsequent to September 30, 2005, Ms. Graul

26

obtained a judgment against the Company for \$176,853 in cash. The Company continues to negotiate with Ms. Graul regarding the amounts owed to her.

In the event the Company is required to pay damages in connection with any one or more of the claims asserted in these actions, such payment could have a material adverse effect on the Company's business and operations.

SETTLEMENT WITH COOK ASSOCIATES, INC.

On June 29, 2005, the Company entered into a settlement with Cook Associates, Inc. ("Cook Associates") to settle all claims and potential claims related to the lawsuit that had been filed by Cook Associates against the Company in October 2004. Under the terms of the settlement, Cook Associates agreed to dismiss its lawsuit and associated claim for \$528,081 in damages and the Company agreed to remove any and all conditions/restrictions that would prevent the 600,000 shares of Company common stock owned by Cook Associates from being freely traded. The Company had previously recorded \$389,103 of payables to Cook Associates that it reversed following its execution of the settlement. The reversal was recorded as a gain and is included in loss/(gain) on settlement agreements in the accompanying statements of operations for the nine months ended September 30, 2005.

SEC INVESTIGATION

Pursuant to Section 20(a) of the Securities Act and Section 21(a) of the Securities Exchange Act, the staff of the SEC (the "Staff"), issued an order (In the Matter of Patron Systems, Inc. - Order Directing a Private Investigation and Designating Officers to Take Testimony (C-03739-A, February 12, 2004)) (the "Order") that a private investigation (the "SEC Investigation") be made to determine whether certain actions of, among others, the Company, certain of its officers and directors and others violated Section 5(a) and 5(c) of the Securities Act and/or Section 10 and Rule 10b-5 promulgated under the Exchange

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

Act. Generally, the Order provides, among other things, that the Staff is investigating (i) the legality of two (2) separate Registration Statements filed by the Company on Form S-8, filed on December 20, 2002 and on April 2, 2003, as amended on April 9, 2003 (collectively, the "Registration Statements"), covering the resale of, in the aggregate, 4,375,000 shares of common stock issued to various consultants of the Company, and (ii) whether in connection with the purchase or sale of shares of common stock, certain officers and directors of the Company and others (a) sold common stock in violation of Section 5 of the Securities Act and/or, (b) made misrepresentations and/or omissions of material facts and/or employed fraudulent devices in connection with such purchases and/or sales relating to certain of the Company's press releases regarding, among other items, proposed mergers and acquisitions that were never consummated. If the SEC brings an action against the Company, it could result in, among other items, a civil injunctive order or an administrative cease-and-desist order being entered against the Company, in addition to the imposition of a significant civil penalty. Moreover, the SEC Investigation and/or a subsequent SEC action could affect adversely the Company's ability to have its common stock become listed on a stock exchange and/or quoted on the NASD Bulletin Board or NASDAQ, the Company being able to sell its securities and/or have its securities registered with the SEC and/or in various states and/or the Company's ability to implement its business plan. To date, the Company's legal counsel representing the Company in such matters has indicated that the SEC Investigation is ongoing and the Staff has not indicated whether it will or will not recommend that the SEC bring an enforcement action against the Company, its officers, directors and/or others.

ROBERT CROSS, CHIEF EXECUTIVE OFFICER - EMPLOYMENT AGREEMENT

On July 1, 2005, the Company entered into an employment agreement (the "Employment Agreement") with Robert W. Cross ("Mr. Cross"), the Company's Chief Executive Officer. The term of the Employment Agreement is one year with automatic one-year renewal unless Mr. Cross is provided with written notice of non-renewal 90 days prior to expiration of the current term of the Employment Agreement. The Employment Agreement provides for a base salary of \$200,000 per year with a non-recoverable draw of \$100,000 (grossed up for taxes) during the first six months of the Agreement. The Employment Agreement also provides for a performance bonus determined in accordance with quarterly revenue milestones that are yet to be established by the Board of Directors. Mr. Cross is eligible to receive a bonus of up to 100% of base salary for each quarter that the Company achieves the agreed upon revenue milestones. Additionally, the Employment Agreement provides for the grant of 1,000,000 stock options at an exercise price of \$0.65 per share with the options vesting 25% on July 1, 2005, 25% on September 30, 2005, 25% on December 31, 2005 and 25% on March 31, 2006. The options expire on June 30, 2012.

27

LEASE AGREEMENT

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

The future minimum rental commitments under the terms are as follows:

For the period of October 1, 2005 through

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

December 31, 2005	\$	-
For the year ended December 31,		
2006		36,567
2007		48,756
2008		48,756
2009		48,756
2010		12,189

Total		\$195,024

NOTE R - STOCKHOLDERS' DEFICIENCY

ISSUANCE OF COMMON STOCK AS PURCHASE CONSIDERATION

On February 25, 2005 the Company committed to issue an aggregate of 11,900,000 shares of its common stock with an aggregate fair value of \$10,115,000 as purchase consideration to the sellers of CSSI and LucidLine (Note E). On February 28, 2005, the Company committed to issue an additional 3,000,000 shares of its common stock with an aggregate fair value of \$2,550,000 as purchase consideration to the sellers of Entelagent (Note E). The aforementioned transactions were recorded as common stock to be issued in the statement of stockholder's (deficiency). The Company issued 11,323,155 of these shares to certain of the selling stockholders during the nine months ended September 30, 2005 and the remaining shares are presented as common stock to be issued in the accompanying balance sheet at September 30, 2005.

ISSUANCE OF COMMON STOCK PURCHASE WARRANTS

On February 25, 2005, the Company issued 2,250,000 common stock purchase warrants with a term of 5 years and an exercise price of \$0.70 per share as a portion of purchase consideration associated with the acquisition of the preferred stock of CSSI (Note E). The aggregate fair value of these warrants amounted to \$1,912,500.

On February 28, the Company issued warrants to purchase up to 1,750,000 shares of its common stock to the Bridge Notes investors described in Note K. The fair value of the warrants amounted to \$1,054,860. Additionally, the Company issued 350,000 common stock purchase warrants with an aggregate fair value of \$297,500 to the Placement Agent in the Interim Bridge Financing I transaction.

On February 28, the Company also issued warrants for 300,000 shares at a \$0.70 per share exercise price to Laidlaw & Company and/or its designees in connection with the receipt of acquisition related services for the Entelagent, LucidLine and CSSI mergers (Note E). The aggregate fair value of these warrants amounted to \$255,000.

On June 6, 2005, the Company issued warrants to purchase up to 1,271,500 shares of its common stock at \$0.60 per share exercise price to the Interim Bridge Financing II investors described in Note K. The fair value of the warrants amounted to \$532,732.

On June 30, 2005 the Company issued warrants for 152,580 shares at a \$0.60 per share exercise price to Laidlaw in connection with the Interim Bridge Financing II financing. The aggregate fair value of these warrants amounted to \$80,867 and was accounted for as deferred financing costs.

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

On June 29, 2005, the Company issued warrants to purchase up to 1,750,000 shares of its common stock at \$0.70 per share exercise price, as Bridge Extension Warrants, to the investors in Interim Bridge Financing I as described in Note K. The fair value of the warrants, which amounted to \$822,500, was accounted for as a deferred financing cost.

On July 1, 2005, the Company issued warrants for 925,000 shares at a \$0.60 per share exercise price to Apex and Northwestern in connection with the Interim Bridge Financing III financing. The aggregate fair value of these warrants amounted to \$415,891.

On July 29, 2005, the Company issued warrants for 50,000 shares at a \$0.60 per share exercise price to Advanced Equities in connection with the Interim Bridge Financing III financing. The fair value of these warrants amounted to \$22,481.

On August 19, 2005, the Company issued warrants for 225,000 shares at a \$0.60 per share exercise price to Apex in connection with the Interim Bridge Financing III financing. The fair value of these warrants amounted to \$55,263.

On September 30, 2005 the Company issued warrants for 600,000 shares at a \$0.60 per share exercise price to Apex in connection with the Interim Bridge Financing III financing. The fair value of these warrants amounted to \$57,143.

All of the aforementioned warrants, unless otherwise noted, are reflected as an increase to additional paid-in capital in the accompanying balance sheet and statement of stockholders' deficiency at September 30, 2005.

ISSUANCE OF COMMON STOCK AS PENALTY UNDER AN ACCOMMODATION AGREEMENT

The Accommodation Agreements (Note P) provided for a penalty in the event the Company failed to register the replacement shares on or before March 31, 2003. The replacement shares were not registered on or before March 31, 2003. As a result, the Company has accrued a penalty of 450,000 shares per quarter for the five stockholders, in the aggregate. The Company recorded charges of \$745,501 for the nine months ended September 30, 2005. The Company intends to include the replacement and penalty shares in a registration statement to be filed in 2005, at which time the penalty will cease to accrue. The penalty shares are presented as common stock to be issued in the accompanying balance sheet and statements of stockholders' deficiency at September 30, 2005.

STOCK ISSUED UNDER STOCK PLEDGE ARRANGEMENT

The Company issued an aggregate of 890,500 shares of common stock (Replacement Shares and Premium Shares) with an aggregate fair value of \$406,205 and recorded a commitment to issue an additional 130,587 shares of stock with a fair value of \$78,247 as penalties for the delays in registering the stock under the original agreement (Note P).

STOCK ISSUED IN LIEU OF CASH FOR SERVICES

On June 8, 2005, the Company negotiated a settlement regarding the Consulting Agreement Payable with a related party. As part of this agreement, an obligation to issue 100,000 shares of unrestricted common stock previously recorded in the quarter ended September 30, 2004 was terminated. This termination resulted in a reduction in general and administrative expenses of \$78,900 and the reduction of 100,000 shares from the Shares to be Issued classification.

ISSUANCE OF EMPLOYEE STOCK OPTIONS

During the three months ended September 30, 2005, the Company issued stock options to employees to purchase 5,265,000 shares. These options include a grant

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

to purchase 1,000,000 shares at \$0.65 per share to the Chief Executive Officer of the Company, Mr. Robert Cross. Mr. Cross' option grant resulted in a \$30,000 expense related to the intrinsic value of the options versus the market price on the date of grant. This amount is being amortized over the vesting period. For the nine months ended September 30, 2005, the Company recorded \$16,000 of compensation expense related to Mr. Cross' options and recorded \$14,000 of deferred compensation at September

29

30, 2005. The remaining options were granted at the closing sale price on the date immediately prior to the date of grant, \$0.35 per share.

NOTE S - PROPOSED CREDITOR AND CLAIMANT LIABILITIES RESTRUCTURING

On September 23, 2005, the Company mailed a package containing a proposed arrangement to (a) restructure approximately \$26,000,000 of obligations that the Company owes to a majority of its creditors, and (b) settle \$2,000,000 of contingent liabilities under the legal proceedings with Sherleigh as described in Note O. The proposal was delivered to the holders of the Company's indebtedness (including certain lenders, all past-due trade creditors, and employees, consultants and other service providers with claims for fees, wages or expenses). Under the proposed arrangement, all creditors with acknowledged balances and all claimants with agreed claims would promptly be issued one share of Patron common stock for each \$0.18 of such balances or claims. The Company would endeavor to register such shares under applicable securities laws promptly following the conclusion of this settlement program. There would be no cash available to pay any of the indebtedness, and there would be no preferential payments. All creditors and claimants would be treated the same on a pro rata basis.

The Company is presently in the process of contacting such creditors and claimants to explain the proposal and to solicit responses. Certain of the creditors and claimants responded subsequent to September 30, 2005 (Note T). If the requisite agreements and approvals are obtained, the Company anticipates issuing the shares following the final determination of the claims and subsequently filing a registration statement to register such shares under applicable securities laws.

The Company is currently unable to determine whether any of its creditors will accept the Company's proposal. The Company is currently unable to provide assurance that any of its creditors will accept this proposal or that the acceptance of such proposal will actually improve the Company's ability to fund the further development of its business plan or improve its operations.

NOTE T - SUBSEQUENT EVENTS

ADVANCES FROM STOCKHOLDERS

On October 17, 2005, the Company received a \$360,000 advance from Apex, on October 25, 2005, the Company received an additional \$75,000 advance from Apex and on October 31, 2005, the Company received an additional \$385,000 advance from Apex. Apex is a current stock and warrant holder of the Company. No expenses were incurred in connection with these transactions.

These funds will be included in the Interim Bridge III Financing and will receive identical terms as described in Note K above. Under terms of the Interim

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

Bridge III Financing, Apex will be issued a total of 217,500 common stock purchase warrants. These warrants will have a term of 5 years and an exercise price of \$0.60 per share.

EXTENSION OF THE INTERIM BRIDGE II FINANCING

On October 4, 2005, the Company elected to extend the contractual maturity date of the Interim Bridge II Financing for an additional 60 days to various dates beginning December 2, 2005. Exercise of the extension provision of the Interim Bridge II Financing caused the contractual interest rate to increase to 12% per annum. In addition, the Company was required to issue to the holders of the notes issued in the Bridge II Financing, the 1,271,500 additional warrants (the "Bridge II Extension Warrants") to purchase 1,271,500 shares of common stock. The Bridge II Extension Warrants were equivalent to 1/2 of a share for each \$1.00 of principal amount outstanding. The Bridge II Extension Warrants have a term of 5 years and an exercise price of \$0.60 per share.

EXTENSION OF THE INTERIM BRIDGE III FINANCING - FIRST TWO FUNDINGS

On October 4, 2005, the Company elected to extend the contractual maturity date of the first two fundings of the Interim Bridge III Financing for an additional 60 days to December 28, 2005. Exercise of the extension provision of

30

the Interim Bridge III Financing causes the contractual interest rate to increase to 12% per annum. In addition, the Company was required to issue to the holders of the notes issued in the Bridge III Financing, the 925,000 additional warrants (the "Bridge III Extension Warrants") to purchase 925,000 shares of common stock. The Bridge III Extension Warrants were equivalent to 1/2 of a share for each \$1.00 of principal amount outstanding. The Bridge III Extension Warrants have a term of 5 years and an exercise price of \$0.60 per share.

OFFICE LEASE AGREEMENT

On October 5, 2005, the Company entered into an office lease agreement providing the Company with 1,269 square feet of space for a sales office in Dallas, Texas. The lease commences on October 24, 2005 and has a term of 12 months. The minimum rental payments, beginning October 2005, amount to \$1,851 per month. In addition, the Company was required to make a \$2,035 security deposit at the inception of the lease.

STATUS OF PROPOSED CREDITOR AND CLAIMANT LIABILITIES RESTRUCTURING

During November 2005, the Company reevaluated its proposal regarding the restructuring of creditor and claimant liabilities. Due to a reduction in the price per share of the Company's common stock since the original proposal was issued to creditors and claimants, the Company repriced the proposal to \$0.10 per share and will be issuing new documents to all creditors that have not already accepted the offer. All claimants that have already accepted the offer will automatically receive the revised proposal pricing. Of the approximately \$26,000,000 of claims, approximately \$15,000,000 is represented by current Company shareholders.

CONSULTING AGREEMENT

On October 28, 2005, the Board of Directors authorized the establishment of a consulting agreement with an investor relations consultant. Under terms of the agreement, the Company will issue, as payment for the consultant's services,

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

200,000 shares of the common stock of the Company and the Company will grant the consultant a three-year stock option to purchase up to 200,000 shares of the common stock of the Company at an exercise price of \$0.25 per share.

ISSUANCE OF EMPLOYEE STOCK OPTIONS

On October 28, the Company issued stock options to an employee to purchase 50,000 shares. The options were granted at market price on the date of grant, \$0.09 per share.

STATUS OF LEGAL PROCEEDINGS

On November 2, 2005, Mr. Linting obtained a judgment against the Company for \$100,452 in cash and 422,827 shares of the Company's common stock to be issued to Mr. Linting at his determination upon registration thereof. The Company continues to negotiate with Mr. Linting regarding the amounts owed to him.

On October 27, 2005, Ms. Graul obtained a judgment against the Company for \$176,853 in cash. The Company continues to negotiate with Ms. Graul regarding the amounts owed to her.

31

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

PATRON SYSTEMS, INC. AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS SEPTEMBER 30, 2005

The following discussion and analysis should be read in conjunction with the Annual Report on Form 10-KSB, including the consolidated financial statements, and the related notes thereto, for the years ended December 31, 2004, 2003 and 2002 of Patron Systems, Inc. and subsidiaries (collectively referred to as "Patron," the "Company," "we," "us," or "our"). Except for historical information contained herein, the matters discussed below are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such statements involve risks and uncertainties, including, but not limited to, economic, governmental, political, competitive and technological factors affecting our operations, markets, products, prices and other factors discussed elsewhere in this report and other reports filed by us with the Securities and Exchange Commission ("SEC"). These factors may cause results to differ materially from the statements made in this report or otherwise made by or on our behalf.

OVERVIEW

On February 25, 2005, we consummated the acquisitions of Complete Security Solutions, Inc. ("CSSI") and LucidLine, Inc. ("LucidLine") pursuant to the filings of Agreements and Plans of Merger with the Secretaries of State of the States of Delaware and Illinois, respectively. On February 28, 2005, Patron Systems, Inc. consummated a private placement with accredited investors in the amount of \$3.5 million. On March 30, 2005, we consummated the acquisition of Entelagent Software Corp. ("Entelagent") pursuant to the filing of an Agreement and Plan of Merger with the Secretary of State of the State of California. From March 31, 2005 to September 30, 2005, we borrowed \$3,300,000 from a shareholder,

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

Apex Investment Fund V, LP. During the three months ended September 30, 2005 we raised approximately \$3,600,000 in additional gross funds in five capital financing transactions, which includes converting \$1,650,000 in advances from stockholders into Bridge Notes. Net proceeds from all of these transaction amounted to \$3,594,000, which were used principally to fund operations and repay certain liabilities. We discuss these transactions in further detail in this report.

Our acquisitions have allowed us to develop a platform for trusted security services and next generation integrated security products, which we intend to deliver to global corporations and government institutions. We intend to work with organizations to ensure that global enterprises implement information security policies, procedures and products that result in "trusted" information environments.

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

We also offer a range of services to corporate and government entities utilizing fiber optics and data replication technologies to provide secure robust off-site data backup, recovery, restoration, and retrieval services coupled with high-speed data communication turnkey solutions. Our secure and scalable high-speed data communication solutions facilitate seamless instantaneous backup of mission critical business data and enable immediate access to data and real-time restoration of critical business functionality in the event of a crisis or disaster. Additionally, we offer our clients a comprehensive Risk and Vulnerability Assessment (RAVA) evaluation service. This service provides security and business impact assessments, which evaluate an organization's compliance with both Homeland Security and NTSA standards.

32

Furthermore, we intend to address the homeland security requirements that are being imposed on state, county and municipal governments. The Company believes that we offer state, county and municipal governments a unique group of product and service offerings focused on their specific homeland security information infrastructure issues. This is accomplished by utilizing the full range of our capabilities for evaluating and assessing information infrastructure risks and vulnerabilities, combined with our experience in designing, implementing and managing large, secure information infrastructure systems. Also contributing is our extensive experience in implementing real-time, secure data collection and the multi-jurisdictional sharing of law enforcement and public-safety information combined with our experience in developing and deploying software solutions which provide secure data and content delivery and management.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the Condensed Consolidated Financial Statements and Notes thereto. Our application of accounting policies affects these estimates and assumptions.

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

Actual results could differ from these estimates under different assumptions or conditions.

REVENUE RECOGNITION

We derive 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.

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 all of our 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 probable.

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 our 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 to allocate revenues to delivered elements once it has established vendor-specific evidence for such undelivered elements.

We provide internet access and back-up, retrieval and restoration services under contractual arrangements with terms ranging from 1 year to 5 years. These contracts are billed monthly, in advance, based on the contractually stated rates. At the inception of a contract, we may activate the customer's account for a contractual fee that it amortizes over the term of the contract in accordance with Emerging Issues Task Force Issue ("EITF") 00-21 "Revenue Arrangements with Multiple Deliverables." Our standard contracts are automatically renewable by the customer unless terminated on 30 days written notice. Early termination of the contract generally results in an early termination fee equal to the lesser of six months of service or the remaining term of the contract.

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.

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

Revenue from the resale of third-party hardware and software is recognized upon delivery provided there are no further obligations to install or modify the hardware or software. Revenue from the sales of hardware/software is recorded at the gross amount of the sale when the contract satisfies the requirements of EITF 99-19.

BUSINESS COMBINATIONS

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

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

GOODWILL AND INTANGIBLE ASSETS

We account for Goodwill and Intangible Assets in accordance with 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. Intangible assets continue to be amortized over their estimated useful lives.

INCOME TAXES

We account for income taxes pursuant to SFAS No. 109, "Accounting for Income Taxes". Deferred taxes arise from temporary differences, primarily attributable to the use of the cash method for tax purposes and accrual method for book purposes and net operating loss carry-forwards. The Company reserves for deferred tax assets when more likely than not, the benefit of the asset will not be realized in the future.

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 has been 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.

STOCK OPTION PLANS

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

As permitted under SFAS No. 148 "Accounting for Stock-Based Compensation - Transition and Disclosure," which amended SFAS No. 123 "Accounting for Stock-Based Compensation," we have elected to continue to follow the intrinsic value method in accounting for our stock-based compensation arrangements as defined by Accounting Principles Board ("APB") Opinion No. 25 "Accounting for Stock Issued to Employees," and related interpretations including Financial Accounting Standards Board ("FASB") Interpretation No. 44 "Accounting for Certain Transactions Involving Stock Compensation," an interpretation of APB No. 25.

34

NON-EMPLOYEE STOCK BASED COMPENSATION

We record the cost of stock based compensation awards that we have issued to non-employees for services at either the fair value of the services rendered or the instruments issued in exchange for such services, whichever is more readily determinable, using the measurement date guidelines enumerated in EITF 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services."

RESULTS OF OPERATIONS

THREE MONTHS ENDED SEPTEMBER 30, 2005 COMPARED TO THE THREE MONTHS ENDED SEPTEMBER 30, 2004.

For the three months ended September 30, 2005, our consolidated revenues amounted to \$152,941 compared to \$0 for the three months ended September 30, 2004. The increase is the result of business combinations that we consummated with CSSI and LucidLine in February 2005 and Entelagent in March 2005.

Cost of Sales for the three months ended September 30, 2005 amounted to \$249,881 compared to \$0 for the three months ended September 30, 2004. Cost of sales during the three months ended September 30, 2005 includes \$133,124 associated with the amortization of developed technology that we acquired from CSSI and Entelagent.

Operating expenses amounted to \$2,421,200 for the three months ended September 30, 2005 as compared to \$1,479,351 for the three months ended September 30, 2004, an increase of \$941,849. The increase in operating expenses includes approximately \$919,000 for salaries associated with an increase in the number of employees from acquired businesses, approximately \$133,000 for legal and professional fees that we incurred principally in connection with bringing the Company into compliance with its Securities and Exchange Commission reporting obligations, approximately \$31,000 for amortization of acquired intangible assets, and approximately \$456,000 for increased general and administrative expenses associated with the acquired businesses. These increases were partially offset by an approximately \$32,000 reduction in expense associated with the amortization of stock-based compensation arrangements, a \$300,000 gain on the reduction in intrinsic value of a stock put right and approximately \$311,000 reduction in expense associated with a penalty provision of an Accommodation Agreement.

Our consolidated loss from operations for the three months ended September 30, 2005 amounted to \$2,518,140 compared to a loss of \$1,479,351 for the same period in 2004. Our loss increased as a result of the increases in operating expenses discussed above.

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

Interest expense during the three months ended September 30, 2005 amounted to \$10,159,038 as compared to \$33,087 for the three months ended September 30, 2004. The increase is directly related to our issuances of notes and the increased borrowings that we made to finance our acquisitions of CSSI, LucidLine and Entelagent and fund our working capital needs. Non cash interest relating to the amortization of deferred financing costs, penalty warrants issued to bridge note holders and the accretion of debt discounts during the three months ended September 30, 2005 amounted to approximately \$9,853,000 compared to \$0 in same period in 2004. The intrinsic value of the conversion option for bridge note holders and subordinated note holders, which has been classified as interest expense amounted to \$8,000,000 for the three months ended September 30, 2005 compared to \$0 in the same period in 2004. Amortization of deferred finance charges which have been classified as interest expense was approximately \$1,115,000 in the three months ended September 30, 2005 compared to \$0 in the same period in 2004. Accretion of debt discounts during the three months ended September 20, 2005 were approximately \$750,000 compared to \$0 in the same period in 2004. Interest income, was \$0 and \$19,250 in the three months ended September 30, 2005 and 2004, respectively. Interest income represents the interest earned from loans that we made to Entelagent prior to our acquisition of that business on March 30, 2005.

For the three months ended September 30, 2005, the net loss was \$12,677,722 or \$(0.21) per share on 61,499,103 weighted average shares outstanding compared to a net loss of \$1,493,188 or \$(0.04) per share on 39,010,560 weighted average shares outstanding for the three months ended September 30, 2004.

35

NINE MONTHS ENDED SEPTEMBER 30, 2005 COMPARED TO THE NINE MONTHS ENDED SEPTEMBER 30, 2004.

For the nine months ended September 30, 2005, our consolidated revenues amounted to \$339,212 compared to \$0 for the nine months ended September 30, 2004. The increase is the result of business combinations that we consummated with CSSI and LucidLine in February 2005 and Entelagent in March 2005.

Cost of Sales for the nine months ended September 30, 2005 amounted to \$476,726 compared to \$0 for the nine months ended September 30, 2004. Cost of sales during the nine months ended September 30, 2005 includes \$272,792 associated with the amortization of developed technology that we acquired from CSSI and Entelagent.

Operating expenses amounted to \$7,414,310 for the nine months ended September 30, 2005 as compared to \$3,274,798 for the nine months ended September 30, 2004, an increase in operating expenses of \$4,139,512. The increase in operating expenses includes approximately \$2,694,000 for salaries associated with an increase in the number of employees from acquired businesses, approximately \$761,000 for the amortization of a stock based compensation arrangements, approximately \$703,000 for legal and professional fees that we incurred principally in connection with bringing the Company into compliance with its Securities and Exchange Commission reporting obligations, approximately \$70,000 for amortization of acquired intangible assets, approximately \$474,000 for increased general and administrative expenses associated with the acquired businesses, \$366,193 loss on collateralized financing arrangement and a \$370,000 expense associated with the preparation of a homeland security operational requirements assessment related to Will County, Illinois. These increases were partially offset by an approximate \$217,000 reduction in expense associated with the stock based penalties under an accommodation agreement, an approximate \$439,000 reduction in expense associated with losses taken on settlement

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

agreements, and a gain of approximately \$344,000 on settlement of legal claims.

Our consolidated loss from operations for the nine months ended September 30, 2005 amounted to \$7,551,824 compared to a loss of \$3,274,798 for the same period in 2004. Our loss increased as a result of the increases in our operating expenses discussed above.

Interest expense during the nine months ended September 30, 2005 amounted to \$12,376,904 as compared to \$99,263 for the nine months ended September 30, 2004. The increase is directly related to our issuances of notes and the increased borrowings that we made to finance our acquisitions of CSSI, LucidLine and Entelagent and to fund our working capital needs. Non-cash interest relating to the amortization of deferred financing costs, penalty warrants issued to bridge note and subordinated note holders and the accretion of debt discounts during the nine months ended September 30, 2005 amounted to approximately \$11,740,000 compared to \$0 in same period in 2004. Amortization of deferred finance charges which have been classified as interest expense was approximately \$1,826,000 in the nine months ended September 30, 2005 compared to \$0 in the same period in 2004. The intrinsic value of the conversion feature on bridge notes and subordinated notes, which has been classified as interest expense amounted to \$8,000,000 for the nine months ended September 30, 2005 compared to \$0 in the same period in 2004. Accretion of debt discounts during the nine months ended September 30, 2005 were approximately \$1,927,000 compared to \$0 in the same period in 2004. Interest income, was \$19,250 and \$57,750 in the nine months ended September 30, 2005 and 2004, respectively. Interest income represents the interest earned from loans that we made to Entelagent prior to our acquisition of that business on March 30, 2005.

For the nine months ended September 30, 2005, the net loss was \$19,910,022 or \$(0.35) per share on 57,284,490 weighted average shares outstanding compared to a net loss of \$3,316,311 or \$(0.09) per share on 38,610,646 weighted average shares outstanding for the nine months ended September 30, 2004.

LIQUIDITY AND CAPITAL RESOURCES

We incurred a net loss of \$19,910,022 for the nine months ended September 30, 2005, which includes \$14,598,275 of non-cash charges associated with the fair value of common stock we issued as penalties under certain registration rights agreements (\$823,747), fair value of common stock warrants issued as a penalty to bridge note and subordinated note holders (\$8,000,000), amortization of deferred compensation under a stock based compensation arrangement (\$1,239,083), accretion related to warrants issued in conjunction with notes payable (\$1,927,374), amortization of deferred financing costs (\$1,825,606), loss on a collateralized financing arrangement (\$366,194),

36

non-cash increase in notes payable to a former officer (\$17,399), depreciation and amortization (\$382,872) and a charge for the intrinsic value of stock options (\$16,000). The non-cash charges were offset by non-cash gains of \$228,900 associated with the settlement of a related party consulting agreement, a gain on reduction in intrinsic value of a put right of \$300,000, a gain on legal settlement of \$389,103 and \$19,250 non-cash interest income. Including the amounts above, we used net cash flows in our operating activities of \$7,781,408 during the nine months ended September 30, 2005. Our working capital deficiency at September 30, 2005 amounts to \$23,033,903 and we are continuing to experience shortages in working capital. We are also involved in substantial litigation and are being investigated by the Securities and Exchange Commission with respect to certain of our press releases and our use of form S-8 to register shares of

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

common stock that we issued to certain consultants in prior periods. 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's ability to successfully integrate the acquired businesses described in Note E is critical to the realization of its business plan. The Company raised \$9,643,000 of gross proceeds (\$9,015,261 net proceeds after the payment of certain transaction expenses) in financing transactions during the nine months ended September 30, 2005. The Company used \$7,781,408 of these proceeds to fund its operations (which includes a \$1,388,000 escrow deposit for the payment of liabilities assumed in business combinations), and a net of \$599,728 in investing activities, which principally includes the cash component of purchase business combinations that the Company consummated (during February and March of 2005), net of cash acquired in the business combinations and the purchase of property and equipment. In addition, the Company repaid an aggregate of \$668,093 of certain obligations due to certain officer/stockholders, \$339,256 of which was a reduction of the funds held in the restricted cash escrow account established in connection with the Entelagent Merger (Note E). Subsequent to September 30, 2005 the Company raised approximately \$820,000 in additional gross funds in three capital financing transactions consummated with a related party that were used principally to fund operations (Note T).

We are currently in the process of attempting to raise additional capital and have taken certain steps to conserve our liquidity while we continue to integrate the acquired businesses. Although we believe that we have access to capital resources, we have not secured any commitments for additional financing at this time nor can we provide any assurance that we will be successful in our efforts to raise additional capital and/or successfully execute our business plan. In an effort to secure additional financing, the Company has, subsequent to September 30, 2005, offered its creditors and claimants a proposed agreement to issue common stock for amounts owed to the holders of the Company's indebtedness (including lenders, past-due trade accounts, and employees, consultants and other service providers with claims for fees, wages or expenses) (see Note S).

OFF-BALANCE SHEET ARRANGEMENTS

At September 30, 2005, 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 DOUBT ABOUT OUR ABILITY TO CONTINUE AS A GOING CONCERN.

We currently have a number of obligations that we are unable to meet without

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

generating additional revenues or raising additional capital. If we cannot generate additional revenues or raise additional capital in the near future, we

37

may become insolvent. As of September 30, 2005, our cash balance was \$80,233 and we had a working capital deficit of \$23,033,903. 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.

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. Combined Professional Services was incorporated in Nevada in 1995 and Patron was incorporated in Delaware in 2002. We have not had significant business operations since inception. As a result of our limited history, it may be difficult to plan operating expenses or forecast our revenues accurately. Our assumptions about customer or network requirements may be wrong. The revenue and income potential of these products is unproven, and the markets addressed by these products are volatile. If such products are not successful, our actual operating results could be below our expectations and the expectations of investors and market analysts, which would likely cause the price of our common stock to decline.

We generated no revenue from operations through December 31, 2004 and relied on financing generated from our capital raising activities to fund the implementation of our business plan. We have incurred operating and net losses and negative cash flows from operations since our inception. As of September 30, 2005, we had an accumulated deficit of approximately \$60 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.

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

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

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.

38

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

WE ARE CURRENTLY SUBJECT TO AN SEC INVESTIGATION.

Pursuant to Section 20(a) of the Securities Act and Section 21(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), the staff of the SEC (the "Staff"), issued an order (In the Matter of Patron Systems, Inc. - Order Directing a Private Investigation and Designating Officers to Take Testimony (C-03739-A, February 12, 2004)) (the "Order") that a private investigation (the "SEC Investigation") be made to determine whether certain of our actions, among others, certain of its officers and directors and others (as described below) violated Section 5(a) and 5(c) of the Securities Act and/or Section 10 and Rule 10b-5 promulgated under the Exchange Act. Generally, the Order provides, among other things, that the Staff is investigating (i) the legality of two (2) separate Registration Statements filed by us on Form S-8, filed on December 20, 2002 and on April 2, 2003, as amended on April 9, 2003 (collectively, the "Registration Statements"), covering the resale of, in the aggregate, 4,375,000 shares of common stock issued to various of our consultants, and (ii) whether in connection with the purchase or sale of shares of common stock, certain of our officers, directors and others (a) sold common stock in violation of Section 5 of the Securities Act and/or, (b) made misrepresentations and/or omissions of material facts and/or employed fraudulent

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

devices in connection with such purchases and/or sales relating to certain of our press releases regarding, among other items, proposed mergers and acquisitions that were never consummated. If the SEC brings an action against us, it could result in, among other items, a civil injunctive order or an administrative cease-and-desist order being entered against us, in addition to the imposition of a significant civil penalty. Moreover, the SEC Investigation and/or a subsequent SEC action could affect adversely our ability to have our common stock listed on a stock exchange and/or quoted on the NASD Bulletin Board or NASDAQ, our ability to sell our securities and/or have our securities registered with the SEC and/or in various states and/or our ability to implement its business plan. To date, our legal counsel representing us in such matters has indicated that the SEC Investigation is ongoing and the Staff has not indicated whether it will or will not recommend that the SEC bring an enforcement action against us, our officers, directors and/or others.

THE CONCENTRATION OF OUR CAPITAL STOCK OWNERSHIP WITH INSIDERS IS LIKELY TO LIMIT THE ABILITY OF OTHER STOCKHOLDERS TO INFLUENCE CORPORATE MATTERS.

As of September 30, 2005, the executive officers, directors and entities affiliated with any of them together beneficially own approximately 17% of our outstanding common stock. As a result, these stockholders may be able to exercise control over matters requiring approval by our stockholders, including the election of directors and approval of significant corporate transactions. This concentration of ownership might also have the effect of delaying or preventing a change in our control that might be viewed as beneficial by other stockholders.

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 September 30, 2005, there are 60,427,299 shares of common stock outstanding and shares to be issued, of which all but 49,998,049 shares are held by directors, executive officers and other affiliates, the sale of which are subject to volume limitations under Rule 144, various vesting agreements and our quarterly and other "blackout" periods. Furthermore, shares subject to outstanding options and warrants and shares reserved for future issuance under our stock option plan will become eligible for sale in the public market to the extent permitted by the provisions of various vesting agreements, the lock-up agreements and Rule 144 under the Securities Act.

39

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

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

- o the demand for our subsidiaries' current product offerings and our future products;
- o the length of sales cycles;
- o the timing of recognizing revenues;
- o new product introductions by us or our competitors;

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

- o changes in our pricing policies or the pricing policies of our competitors;
- o variations in sales channels, product costs or mix of products sold;
- o our ability to develop, introduce and ship in a timely manner new products and product enhancements that meet customer requirements;
- o our ability to obtain sufficient supplies of sole or limited source components for our products;
- o variations in the prices of the components we purchase;
- o our ability to attain and maintain production volumes and quality levels for our products at reasonable prices at our third-party manufacturers;
- o our ability to manage our customer base and credit risk and to collect our accounts receivable; and
- o the financial strength of our value-added resellers and distributors.

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

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

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

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

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

RISKS RELATED TO OUR BUSINESS

WE MAY BE UNABLE TO SUCCESSFULLY INTEGRATE ACQUIRED BUSINESSES.

Our business plan is dependent upon the acquisition and integration of companies that have previously operated independently. The process of integrating could cause an interruption of, or loss of momentum in, the activities of our business

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

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. 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 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

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

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.

41

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 MATERIAL WEAKNESSES IN OUR FINANCIAL SYSTEMS, INTERNAL CONTROLS AND OPERATIONS THAT COULD HAVE A MATERIAL ADVERSE EFFECT ON OUR OPERATIONS, 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. Our Chief Executive Officer and Acting Chief Financial Officer evaluated the effectiveness of our disclosure controls and procedures in accordance with Exchange Act Rules 13a-15 or 15d-15 and identified material weaknesses in our internal control relating to, among other things, our limited segregation of duties, ability to identify and record complex transactions including capital

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

financing transactions and business combinations and timely file our tax returns. The identification of these material weaknesses has led our Chief Executive Officer and Acting Chief Financial Officer to conclude that our disclosure controls and procedures are currently not adequate to enable us to record, process, summarize and report information required to be included in our periodic SEC filings within the required time period.

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

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

Future products will be designed to interface with our end customers' existing networks, each of which have different specifications and utilize multiple protocol standards. Many end customers' networks contain multiple generations of products that have been added over time as these networks have grown and evolved. Our future products must interoperate with all of the products within these networks as well as with future products that might be added to these networks in order to meet end customers' requirements. If we find errors in the existing software used in our end customers' networks, we may elect to modify our software to fix or overcome these errors so that our products will interoperate and scale with their existing software and hardware. If our future products do not

42

interoperate with those within our end customers' networks, installations could be delayed or orders for our products could be cancelled, which could significantly reduce our anticipated revenues.

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

Recently enacted and proposed changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and rules adopted or proposed by the SEC will result in increased costs for us as we evaluate the implications of these laws, regulations and standards and respond to their requirements. These laws and regulations could make it more difficult or more costly for us to obtain certain types of insurance, including director and officer liability insurance, and we may be forced to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. The impact of these events could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors, board committees or as executive officers. We cannot estimate the amount or timing of additional costs we may incur as a result of these laws and regulations.

WE WILL 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

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

RETAIN EXISTING PERSONNEL, OUR ABILITY TO EXECUTE OUR BUSINESS STRATEGY WOULD BE IMPAIRED.

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

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

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

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

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

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

THE 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. The 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

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

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 our management, including our Chief Executive Officer and Acting Chief Financial Officer, have evaluated the effectiveness of our disclosure controls and procedures, as defined by paragraph (e) of Exchange Act Rules 13a-15 or 15d-15. Based on that evaluation and the material weakness described below, our Chief Executive Officer and Acting Chief Financial Officer concluded that our disclosure controls and procedures were not adequate to enable us to record, process, summarize and report information required to be included in our periodic SEC filings within the required time period.

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 Senior Vice President, Finance and Administration, 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 fiscal year ended December 31, 2006. Nevertheless, we identified certain matters that would constitute material weaknesses (as defined under the Public Company Accounting Oversight Board Auditing Standard No. 2) in our internal controls over financial reporting.

We have identified deficiencies in our system of internal controls, which are considered to be material weaknesses. These material weaknesses have led us to conclude that we currently have an inadequate structure with respect to our financial reporting systems. Until March of 2005, we had no central corporate accounting department. Each of our subsidiaries separately maintained its own books and records and independently controlled its cash disbursements and cash receipts. The decentralized nature of our accounting system limits the effectiveness of our internal control procedures and our ability to detect potential misstatements and incorrect accounting and financial reporting. The subsidiary accounting departments do not have the sophistication to critically evaluate and implement new accounting pronouncements, and stock based transactions for options, warrants and common stock. At times these transactions were not recorded properly and required additional procedures and review and we were required to record adjustments proposed by our independent registered public accounting firm.

Certain of the material weaknesses we identified relate to our limited segregation of duties. Segregation of duties within our company is limited due to the fact that we have not had (until recently) any full-time employees since February 10, 2004 and, until the completion of business combinations during the quarter ended March 31, 2005, our Company's affairs have been managed by our non-executive Chairman and Sole Director Robert E, Yaw, II. In addition, our financial records up until that time were maintained by a former employee who had been providing these services to us on a consulting basis. This condition constituted a material weakness in our financial reporting system and a system of internal controls that has affected our ability to timely close our books on a quarterly and annual basis.

The second material weakness we identified is in our ability to implement the requirements of complex accounting pronouncements. We have had difficulty with ensuring that the accounting for our equity-based transactions is accurate and complete. Since April 30, 2002 (Inception), we have consummated a series of complex equity transactions involving the application of highly specialized accounting principles. The equity based transactions that we have had difficulty with specifically relate to stock to be issued under consulting agreements, the penalty shares to be issued in connection with the Accommodation Agreements, and the common stock to be repurchased in connection with the Allin Settlement Agreement. We also experienced difficulty with applying the requirements of SFAS 141 "Business Combinations" and related pronouncement as it relates to our acquisitions of CSSI, LucidLine and Entelagent. Although we believe that certain of these events are unique and that our equity based transactions in the future are likely to be substantially reduced, we are evaluating certain corrective measures to provide us with the structure we need at such times that we may engage in equity based transactions and consummate additional business combinations in the future.

The third material weakness we identified is in our ability to implement a tax reporting structure to file, on a timely basis, Federal and state tax returns. This material weakness is primarily due to our limited segregation of duties.

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

Through our acquisitions of CSSI, LucidLine and Entelagent, we have significantly increased the number of employees working for us and intend to implement a tax reporting structure to address this deficiency.

We believe these material weaknesses resulted from continued working capital deficiencies and a failure to generate cash flows from operations. Immediately following our acquisitions, we appointed a Chief Executive Officer/Acting Chief Financial Officer who is principally responsible for overseeing our financial affairs. In addition, we increased our number of employees with our acquisitions of Entelagent, LucidLine and CSSI and have begun the process of screening candidates for key positions in our finance department. We believe that the expansion of our operations and increase in the number of employees will enable us to take corrective measures once we finish evaluating our existing capabilities and our available resources to take such corrective measures. Additionally, we expect to hire a Chief Financial Officer with public company experience within the next twelve months and relieve our Chief Executive Officer of his current Acting Chief Financial Officer duties.

We believe that any such risks are partially mitigated by the fact that we had minimal assets and activities during our most recent reporting periods, recordkeeping and authorization function were not being performed by the same individual and the non-executive Chairman reviewed and approved all of our transactions. However, we

45

acknowledge that additional control procedures are necessary to ensure that our transactions are properly recorded and that our assets are appropriately safeguarded.

INTERNAL CONTROL OVER FINANCIAL REPORTING

There were no changes in our internal control over financial reporting or in other factors identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during the nine months ended September 30, 2005 or the four quarters ended December 31, 2004 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

46

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In April of 2005, Richard L. Linting, a former President of the Company's Professional Services Group, filed a complaint against the Company and Robert E. Yaw, II, the Company's non-executive Chairman, in the Circuit Court of Cook County, Illinois alleging breach of his purported employment contract and seeking sums allegedly owed under the employment contract in the amount of \$1,321,809, plus court costs and fees. On August 22, 2005, the Company, Mr. Linting and Mr. Yaw entered into a Settlement Agreement and Release whereby Mr. Linting agreed to release all claims against the Company and Mr. Yaw existing as of that date in consideration for (i) the payment by the Company to Mr. Linting of \$100,000 in cash, (ii) the issuance by the Company of an aggregate of 422,827 shares ("Linting Shares") of the Company's common stock (equivalent to \$192,809

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

divided by \$0.456) to be transferred to Mr. Linting in such numbers and at such times as directed by Mr. Linting subsequent to the registration of the Linting Shares, (iii) the Company's agreement to register the Linting Shares through the filing of a registration statement on or before September 30, 2005, and (iv) the Company's affirmation of the validity of options previously issued to Mr. Linting and agreement to permit exercises of those options for 100,000 shares in each calendar month over a period of 3 years. The Company and Mr. Linting also agreed to the filing of a stipulation to dismiss Mr. Linting's suit with prejudice and without costs with the court retaining jurisdiction to reinstate the case and enforce the terms of the Settlement Agreement and Release in the event the Company defaulted on its obligations under the Settlement Agreement and Release, and to enter judgment, by motion, against the Company for the balance due or appropriate relief. The Company did not make the \$100,000 payment required under the Settlement Agreement and Release, erroneously issued the Linting Shares to Mr. Linting, and did not file a registration statement to register the Linting Shares on or before September 30, 2005. Subsequent to September 30, 2005, Mr. Linting obtained a judgment against the Company for \$100,452 in cash and 422,827 shares of the Company's common stock to be issued to Mr. Linting at his determination upon registration thereof. The Company continues to negotiate with Mr. Linting regarding the amounts owed to him.

In December of 2004, Marie Graul, the Company's former Chief Financial Officer, informed the Company of her intention to assert a claim against the Company for sums allegedly owed under her employment agreement with the Company. On August 31, 2005, the Company and Ms. Graul entered into a Settlement Agreement and Mutual Release whereby Ms. Graul agreed to release all claims against the Company arising from any act or omission occurring on or prior to that date in consideration of (i) the payment by the Company to Ms. Graul of an aggregate of \$176,458 no later than September 30, 2005, \$1,458 of which was payable on execution of the Settlement Agreement and Mutual Release, and (ii) the Company's affirmation of the validity of options previously issued to Ms. Graul. The Company also agreed to confess to a judgment against the Company in a court of Ms. Graul's choosing in the event of the Company's breach of the Settlement Agreement and Mutual Release. The Company did not make the payments required by the Settlement Agreement and Mutual Release. Subsequent to September 30, 2005, Ms. Graul obtained a judgment against the Company for \$176,853 in cash. The Company continues to negotiate with Ms. Graul regarding the amounts owed to her.

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

In connection with the Settlement Agreement and Release entered into among the Company, Robert E. Yaw, II and Richard Linting, the Company erroneously issued 422,827 shares of its common stock to Mr. Linting. The Company is exerting all efforts to obtain the return of the shares.

47

The following unregistered derivative securities (warrants) have been issued by us during the period from July 1, 2005 to September 30, 2005:

DATE OF GRANT 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 -----
July 2005	925,000/Common Stock Purchase Warrants	None	2 Accredited Investors in Interim Bridge

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

Month/Year	Quantity/Instrument	Exercise Price	Investor
July 2005	50,000/Common Stock Purchase Warrants	None	Financing III Advanced Equities Venture Partners I, L.P.
August 2005	225,000/Common Stock Purchase Warrants	None	Apex Investment Fund V, L.P.
August 2005	13,440,000/Common Stock Purchase Warrants	None	33 Accredited Investors in Interim Bridge Financing I
August 2005	17,280,000/Common Stock Purchase Warrants	None	3 Accredited Investors holding Subordinated Notes
September 2005	600,000/Common Stock Purchase Warrants	None	Apex Investment Fund V, L.P.

1. On July 1, 2005, we issued warrants to purchase up to 925,000 shares of our common stock to 2 accredited investors who invested in our Interim Bridge Financing III. The warrants have a term of 5 years and an exercise price of \$0.60 per share.
2. On July 29, 2005, we issued warrants to purchase up to 50,000 shares of our common stock to Advanced Equities Investment Fund V, L.P. who invested in our Interim Bridge Financing III. The warrants have a term of 5 years and an exercise price of \$0.60 per share.
3. On August 19, 2005, we issued warrants to purchase up to 225,000 shares of our common stock to Apex Investment Fund V, L.P. who invested in our Interim Bridge Financing III. The warrants have a term of 5 years and an exercise price of \$0.60 per share.
4. On August 28, 2005, we issued warrants to purchase up to 13,440,000 shares of our common stock to 33 accredited investors who invested in our Interim Bridge Financing I. The warrants have a term of 5 years and may be exercised only by the presentation of the outstanding Interim Bridge Financing I note in payment of the exercise price.
5. On August 25, 2005, we issued warrants to purchase up to 17,280,000 shares of our common stock to 3 accredited investors who received Subordinated Notes in conjunction with our acquisition of Complete Security Solutions, Inc. The warrants have a term of 5 years and may be exercised only by the presentation of the outstanding Subordinated Notes in payment of the exercise price.
6. On September 30, 2005, we issued warrants to purchase up to 600,000 shares of our common stock to Apex Investment Fund V, L.P. who invested in our Interim Bridge Financing III. The warrants have a term of 5 years and an exercise price of \$0.60 per share.

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.

ITEM 6. EXHIBITS

EXHIBIT NUMBER	DESCRIPTION OF EXHIBIT
10.1	Lease Agreement dated August 31, 2005, between Patron Systems, Inc. and Flatiron Boulder Office, Inc.
31.1	Certification of principal executive officer and acting principal financial officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification Pursuant to 18 U.S.C. Section 1350. as Adopted Pursuant

Edgar Filing: PATRON SYSTEMS INC - Form 10QSB

to Section 906 of the Sarbanes-Oxley Act of 2002

48

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: November 21, 2005

PATRON SYSTEMS, INC.

(Registrant)

/S/ ROBERT CROSS

By: Robert Cross
Its: Chief Executive Officer and
Acting Chief Financial Officer

49