

DATA SYSTEMS & SOFTWARE INC
Form 10-K/A
March 14, 2006

**SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549**

**AMENDMENT NO. 2 ON FORM 10-K/A TO
FORM 10-K**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2004

Commission file number: 0-19771

**DATA SYSTEMS & SOFTWARE INC.
(Exact name of registrant as specified in charter)**

Delaware
(State or other jurisdiction of incorporation or
organization)

22-2786081
(I.R.S. Employer Identification No.)

200 Route 17, Mahwah, New Jersey 07430
(Address of principal executive offices) (Zip Code)

(201) 529-2026
Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act: None

**Securities registered pursuant to Section 12(g) of the Act:
Common Stock, par value \$.01 per share
Common Stock Purchase Rights
(Title of Class)**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes /x/ No //

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. //

The aggregate market value of the common stock held by non-affiliates of the registrant at June 30, 2004 was approximately \$13.3 million. The aggregate market value was calculated by using the closing price of the stock on that date on the Nasdaq SmallCap Market.

Number of shares outstanding of the registrant's common stock, as of March 28, 2005: 8,116,691.

DOCUMENTS INCORPORATED BY REFERENCE:

None.

Explanatory Note

This Amendment No. 2 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2004 is being filed in order to insert a conformed signature that was accidentally omitted from the Report of Independent Auditors included with the Comverge, Inc. and Subsidiaries Consolidated Financial Statements. Other than the insertion of the signature there has been no change to the financial statements previously supplied.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1) List of Financial Statements of the Registrant

Report of Kesselman and Kesselman

Report of KPMG LLP

Consolidated Balance Sheets as of December 31, 2003 and 2004

Consolidated Statements of Operations for the years ended December 31, 2002, 2003 and 2004

Consolidated Statements of Changes in Shareholders' Equity for the years ended December 31, 2002, 2003 and 2004

Consolidated Statements of Cash Flows for the years ended December 31, 2002, 2003 and 2004

Notes to Consolidated Financial Statements

(a)(2) List of Financial Statement Schedules

Separate Financial Statements of 50 Percent or Less Owned Persons:

Consolidated Financial Statements of Comverge, Inc.:

Report of PricewaterhouseCoopers LLP

Consolidated Balance Sheets as of December 31, 2004 and 2003

Consolidated Statements of Operations for the years ended December 31, 2004 and 2003

Consolidated Statement of Changes in Shareholders' Equity for the years ended December 31, 2004 and 2003.

Consolidated Statements of Cash Flows for the years ended December 31, 2004 and 2003

Notes to Consolidated Financial Statements

(a)(3) List of Exhibits

No.

- 3.1 Certificate of Incorporation of the Registrant, with amendments thereto (incorporated herein by reference to Exhibit 3.1 to the Registrant's Registration Statement on Form S-1 (File No. 33-70482) (the "1993 Registration Statement")).
- 3.2 By-laws of the Registrant (incorporated herein by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-1 (File No. 33-44027) (the "1992 Registration Statement")).
- 3.3 Amendments to the By-laws of the Registrant adopted December 27, 1994 (incorporated herein by reference to Exhibit 3.3 of the Registrant's Current Report on Form 8-K dated January 10, 1995).
- 4.1 Specimen certificate for the Common Stock (incorporated herein by reference to Exhibit 4.2 to the 1992 Registration Statement).
- 4.2 Warrant to Purchase Common Stock of the Registrant, dated October 12, 1999 (incorporated herein by reference to Exhibit 4.4 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2000 (the "2000 10-K")).
- 4.3 Securities Purchase Agreement, dated as of June 11, 2002, by and among the Registrant, Databit, Inc. and Laurus Master Fund, Ltd. ("Laurus") (including the

forms of convertible note and warrant) (incorporated herein by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated June 11, 2002).

- 4.4 Purchase and Security Agreement, dated as of December 4, 2002, made by and between Comverge ("Comverge") and Laurus (incorporated herein by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated December 5, 2002 (the "December 2002 8-K")).

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- 4.5 Convertible Note, dated December 4, 2002, made by and among Comverge, Laurus and, as to Articles III and V only, the Registrant (incorporated herein by reference to Exhibit 10.2 to the December 2002 8-K).
- 4.6 Common Stock Purchase Warrant, dated December 5, 2002, issued by the Registrant to Laurus (incorporated herein by reference to Exhibit 10.3 to the December 2002 8-K).
- 4.7 Registration Rights Agreement, dated as of December 4, 2002, by and between the Registrant and Laurus (incorporated herein by reference to Exhibit 10.4 to the December 2002 8-K).
- 10.1 Employment Agreement between the Registrant and George Morgenstern, dated as of January 1, 1997 (incorporated herein by reference to Exhibit 10.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1997 (the "1997 10-K")).*
- 10.2 Employment Agreement between the Registrant and Yacov Kaufman, dated as of January 1, 1999 (incorporated herein by reference to Exhibit 10.22 of the Registrants Annual Report on Form 10-K for the year ended December 31, 1999 (the "1999 10-K")).*
- 10.3 1991 Stock Option Plan (incorporated herein by reference to Exhibit 10.4 to the 1992 Registration Statement).*
- **10.4 1994 Stock Incentive Plan, as amended.*
- 10.5 1994 Stock Option Plan for Outside Directors, as amended (incorporated herein by reference to Exhibit 10.5 to the Registrant's Form 10-K for the year ended December 31, 1995 (the "1995 10-K")).*
- **10.6 1995 Stock Option Plan for Non-management Employees, as amended.
- 10.7 Agreement dated January 26, 2002, between the Registrant and Bounty Investors LLC (incorporated herein by reference to Exhibit 10.12 to the 2000 10-K).
- 10.8 Lease Agreement, dated February 5, 2002, between Duke-Weeks Realty Limited Partnership and Comverge, (incorporated herein by reference to Exhibit 10.13 to the 2000 10-K).
- 10.9 Stock Option Agreements, dated as of October 1, 1999, between Powercom Control Systems Ltd. and George Morgenstern, Yacov Kaufman and Harvey E. Eisenberg (and related promissory notes) (incorporated herein by reference to Exhibit 10.14 to the 2000 10-K).*
- 10.10 Share Purchase Agreement, dated as of November 29, 2001, by and among the Registrant, Decision Systems Israel Ltd., Endan IT Solutions Ltd., Kardan Communications Ltd., Neuwirth Investments Ltd., Jacob Neuwirth (Noy) and Adv. Yossi Avraham, as Trustee for Meir Givon (incorporated herein by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated December 13, 2001).

- 10.11 Registration Rights Agreement, dated as of December 13, 2002, by and among the Registrant, Kardan Communications Ltd. and Adv. Yossi Avraham, as Trustee for Meir Givon (incorporated herein by reference to Exhibit 10.2 to the Registrant's Current Report on Form 8-K dated December 13, 2002).
- 10.12 Employment Agreement, dated as of September 1, 2002, by and between Comverge and Robert M. Chiste (incorporated herein by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002).*
- 10.13 Restricted Stock Purchase Agreement, dated as of September 1, 2002, by and between the Registrant and Robert M. Chiste (incorporated herein by reference to Exhibit 10.2 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002).*
- 10.14 Option Agreement, dated as of September 1, 2002, by and between Comverge and Robert M. Chiste (incorporated herein by reference to Exhibit 10.3 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002).*
- 10.15 Contract for Asset Management Services between the Registrant and Malley Associates Capital Management, Inc. (incorporated herein by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002).
- 10.16 Employment Agreement dated as of March 30, 2002 between Comverge and Joseph D. Esteves (incorporated herein by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002).*
- 10.17 Agreement, dated as of January 31, 2002, between Comverge and Bank Leumi USA (incorporated herein by reference to Exhibit 10.21 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001 (the "2001 10-K").
- 10.18 \$6,000,000 Term Note of Comverge dated as of January 31, 2002, payable to Bank Leumi USA (incorporated herein by reference to Exhibit 10.22 to the 2001 10-K).
- 10.19 First Amendment to Employment Agreement, dated as of May 17, 2002, by and between the Registrant and George Morgenstern (incorporated herein by reference to Exhibit 10.23 to the 2001 10-K).*
- 10.20 Agreement, dated as of January 31, 2003, between Comverge and Bank Leumi USA (including form of \$6,000,000 Term Note of Comverge dated as of January 31, 2003, payable to Bank Leumi USA) (incorporated herein by reference to Exhibit 10.24 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2002 (the "2002 10-K").
- 10.21 Agreement, dated as of February 25, 2003, between the Registrant and J.P. Turner & Company, L.L.C. (incorporated herein by reference to Exhibit 10.25 to the 2002 10-K).
- 10.22 Second Amendment to Employment Agreement, dated as of March 12, 2002, between the Registrant and George Morgenstern (incorporated herein by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002).*
- 10.23 Amendment to Employment Agreement, dated as of June 1, 2002, between the Registrant and Yacov Kaufman (incorporated herein by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended

September 30, 2002).*

- 10.24 Guaranty, dated December 4, 2002, made by the Registrant in favor of Laurus (incorporated herein by reference to Exhibit 10.5 to the December 2002 8-K).
- 10.25 Preferred Stock Purchase Agreement, dated as of April 7, 2003, by and among Comverge, the Registrant and the other investors named therein (incorporated herein by reference to Exhibit 10.29 to the 2002 10-K).
- 10.26 Investors' Rights Agreement, dated as of April 7, 2003, by and among Comverge, the Registrant and the investors and Comverge management named therein (incorporated herein by reference to Exhibit 10.30 to the 2002 10-K).
- 10.27 Co-Sale and First Refusal Agreement, dated as of April 7, 2003, by and among Comverge, the Registrant and the investors and stockholders named therein (incorporated herein by reference to Exhibit 10.31 to the 2002 10-K).
- 10.28 Voting Agreement, dated as of April 7, 2003, by and among Comverge, the Registrant and the other investors named therein (incorporated herein by reference to Exhibit 10.32 to the 2002 10-K).

- 10.29 Letter Agreement, dated as of April 1, 2003, by and between the Registrant and Laurus (incorporated herein by reference to Exhibit 10.33 to the 2002 10-K).
- 10.30 Employment Agreement dated as of August 19, 2004 and effective as of January 1, 2004 by and between the Registrant and Shlomie Morgenstern (incorporated herein by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004).*
- 10.31 Restricted Stock Award Agreement dated as of August 19, 2004, by and between the Registrant and Shlomie Morgenstern (incorporated herein by reference to Exhibit 10.2 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004).*
- 10.32 Stock Option Agreement dated as of August 19, 2004, by and between Shlomie Morgenstern and the Registrant (incorporated herein by reference to Exhibit 10.3 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004).*
- 10.33 Second Amended and Restated Co-Sale And First Refusal Agreement dated as of October 26, 2004, by and among Comverge, Inc., the Registrant and other persons party thereto (incorporated herein by reference to Exhibit 10.4 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004).
- **10.34 Third Amendment to Employment Agreement, dated as of December 30, 2004, between the Registrant and George Morgenstern.*
- **10.35 Form of Stock Option Agreement to employees under the 1994 Stock Incentive Plan.
- **10.36 Form of Stock Option Agreement under the 1994 Stock Option Plan for Outside Directors.
- **10.37 Form of Stock Option Agreement under the 1995 Stock Option Plan for Nonmanagement Employees.
- **10.38 Stock Option Agreement dated as of December 30, 2004 by and between George Morgenstern and the Registrant.*
- **10.39 Stock Option Agreement dated as of December 30, 2004 by and between Yacov Kaufman and the Registrant.*
- **10.40 Stock Option Agreement dated as of December 30, 2004 by and between Sheldon Krause and the Registrant.*
- 14.1 Code of Ethics of the Registrant (incorporated herein by reference to Exhibit 14.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003).
- **21.1 List of subsidiaries.
- **23.1 Consent of KPMG LLP.
- **23.2 Consent of Kesselman & Kesselman CPA.
- **23.3 Consent of PricewaterhouseCoopers LLP.
- #31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- #31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- #32.1 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- #32.2 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* This Exhibit includes a management contract, compensatory plan or arrangement in which one or more directors or executive officers of the Registrant participate.

** This Exhibit was previously filed with the Registrants 2004 Annual Report on Form 10-K filed on April 14, 2005.

*** This Exhibit was previously filed with the Registrants Amendment No. 1 on Form 10-K/A filed on May 2, 2005.

This Exhibit is filed or furnished herewith.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Amendment No. 2 to its Annual Report on Form 10-K for the fiscal year ended December 31, 2004 to be signed on its behalf by the undersigned, thereunto duly authorized, in the Township of Mahwah, State of New Jersey, on March 10, 2006.

Data Systems & Software Inc.

By: /s/ Michael Barth

Michael Barth
Chief Financial Officer

Comverge, Inc. and Subsidiaries
Consolidated Financial Statements
December 31, 2004 and 2003

Comverge, Inc. and Subsidiaries
Index
December 31, 2004 and 2003

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Report of Independent Auditors

To Board of Directors and Shareholders of
Comverge, Inc.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, shareholders' deficit and cash flows present fairly, in all material respects, the financial position of Comverge, Inc. and its subsidiaries at December 31, 2004 and 2003, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PriceWaterhouseCoopers LLP
Atlanta, Georgia
March 30, 2005

Comverge, Inc. and Subsidiaries
Consolidated Balance Sheets
December 31, 2004 and 2003

(in thousands of dollars, except per share data)

| | 2004 | 2003 |
|---|-----------|-----------|
| Assets | | |
| Current assets | | |
| Cash and cash equivalents | \$ 8,761 | \$ 4,570 |
| Accounts receivable | 4,620 | 3,021 |
| Inventory | 2,102 | 3,404 |
| Other current assets | 1,057 | 524 |
| Total current assets | 16,540 | 11,519 |
| Property and equipment, net | 5,342 | 2,097 |
| Goodwill and other intangible assets | 726 | 993 |
| Prepaid employee termination benefits | 336 | 375 |
| Other assets | 1,017 | 37 |
| Total assets | \$ 23,961 | \$ 15,021 |
| Liabilities and Shareholders' Deficit | | |
| Current liabilities | | |
| Accounts payable | \$ 2,225 | \$ 2,793 |
| Deferred revenue | 1,963 | 371 |
| Accrued expenses | 986 | 467 |
| Other current liabilities | 468 | 505 |
| Total current liabilities | 5,642 | 4,136 |
| Long-term liabilities | | |
| Long-term trade payable | 1,362 | - |
| Long-term bank debt | - | 1,346 |
| Liability for employee termination benefits | 559 | 644 |
| Other liabilities | 290 | 172 |
| Total long-term liabilities | 2,211 | 2,162 |
| Commitments and Contingencies (Note 10) | | |
| Convertible Preferred Stock | | |
| Series A, \$.001 par value per share, authorized 10,402,000 shares; issued and outstanding 10,401,146 and 8,945,350 shares at December 31, 2004 and 2003, respectively; net of offering costs of \$238 and \$218; liquidation preference of \$32,516 and \$27,995 at December 31, 2004 and 2003, respectively | 21,438 | 18,425 |
| Series A-2, \$.001 par value per share, authorized 36,076 shares; issued and outstanding 36,076 shares at December 31, 2004 and 2003; liquidation preference of \$147 and \$150 at December 31, 2004 and 2003, respectively | 100 | 100 |
| Series B, \$.001 par value per share, authorized 7,875,377 shares; issued and outstanding 5,640,878 and 0 shares at December 31, 2004 and 2003, respectively; net of offering costs of \$31; liquidation preference of \$20,449 | 13,568 | - |
| | 35,106 | 18,525 |
| Shareholders' Deficit | | |
| Common stock \$.001 par value per share | | |

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Authorized 28,185,739 shares; issued and outstanding
5,903,598 and 5,814,748 shares at December 31, 2004
and 2003, respectively

| | | |
|---|-----------|-----------|
| | 6 | 6 |
| Additional paid-in capital | 19,105 | 19,013 |
| Deferred compensation | (30) | - |
| Accumulated deficit | (38,079) | (28,821) |
| Total shareholders' deficit | (18,998) | (9,802) |
| Total liabilities and shareholders' deficit | \$ 23,961 | \$ 15,021 |

The accompanying notes are an integral part of these financial statements.

Comverge, Inc. and Subsidiaries
Consolidated Statements of Operations
Year Ended December 31, 2004 and 2003

(in thousands of dollars)

| | 2004 | 2003 |
|-------------------------------------|-------------|-------------|
| Revenue | | |
| Product | \$ 13,028 | \$ 12,592 |
| Service | 5,131 | 3,050 |
| Total revenue | 18,159 | 15,642 |
| Cost of revenue | | |
| Product | 9,478 | 9,763 |
| Service | 1,078 | 875 |
| Total cost of revenue | 10,556 | 10,638 |
| Gross profit | 7,603 | 5,004 |
| General and administrative expenses | 7,382 | 7,777 |
| Marketing and selling expenses | 7,335 | 4,177 |
| Depreciation and amortization | 869 | 1,166 |
| Research and development expenses | 1,046 | 615 |
| Operating loss | (9,029) | (8,731) |
| Interest and other expense, net | 229 | 586 |
| Net loss | \$ (9,258) | \$ (9,317) |

The accompanying notes are an integral part of these financial statements.

Comverge, Inc. and Subsidiaries
Consolidated Statements of Changes in Shareholders' Deficit
Year Ended December 31, 2004 and 2003

(in thousands of dollars, except share data)

| | Number of Shares | Common Stock | Additional Paid-in Capital | Deferred Compensation | Accumulated Deficit | Total |
|---|---------------------|-----------------|----------------------------------|--------------------------|------------------------|-------------|
| Balances at December 31, 2002 | 4,937,748 | \$ 5 | \$ 8,631 | \$ - | \$ (19,504) | \$ (10,868) |
| Issuance of common stock | 877,000 | 1 | 509 | - | - | 510 |
| Contribution of debt by affiliated investor | - | - | 9,673 | - | - | 9,673 |
| Executive compensation payable by affiliated investor | - | - | 200 | - | - | 200 |
| Net loss | - | - | - | - | (9,317) | (9,317) |
| Balances at December 31, 2003 | 5,814,748 | 6 | 19,013 | - | (28,821) | (9,802) |
| Issuance of common stock | 4,052 | - | 5 | - | - | 5 |
| Repurchase of common stock | (8,000) | - | (14) | - | - | (14) |
| Deferred compensation | - | - | 30 | (30) | - | - |
| Issuance of common stock with series B financing | 92,798 | - | 34 | - | - | 34 |
| Shareholder loans | - | - | 37 | - | - | 37 |
| Net loss | - | - | - | - | (9,258) | (9,258) |
| Balances at December 31, 2004 | 5,903,598 | \$ 6 | \$ 19,105 | \$ (30) | \$ (38,079) | \$ (18,998) |

The accompanying notes are an integral part of these financial statements.

Comverge, Inc. and Subsidiaries
Consolidated Statements of Changes in Shareholders' Deficit
Year Ended December 31, 2004 and 2003

(in thousands of dollars)

| | 2004 | 2003 |
|---|------------|------------|
| Cash flows from operating activities | | |
| Net Income/(loss) | \$ (9,258) | \$ (9,317) |
| Adjustments to reconcile net loss to net cash used in operating activities | | |
| Depreciation and amortization | 1,212 | 1,166 |
| Executive compensation payable by affiliate investor | - | 200 |
| Loss on disposal of property and equipment | 69 | 62 |
| Provision for inventory | 45 | - |
| Changes in operating assets and liabilities | | |
| Accounts receivable | (1,599) | 579 |
| Inventories | 1,256 | (1,364) |
| Prepaid expenses and other assets | (1,474) | (286) |
| Accounts payable | (568) | 1,596 |
| Accrued expenses and other liabilities | 1,774 | 114 |
| Deferred revenue | 1,592 | 117 |
| Net cash used in operating activities | (6,951) | (7,133) |
| Cash flows investing activities | | |
| Purchases of property and equipment | (4,156) | (1,485) |
| Funding of termination benefits | - | (69) |
| Net cash used in investing activities | (4,156) | (1,554) |
| Cash flows from financing activities | | |
| Proceeds from exercise of stock options | 5 | - |
| Repurchase of common stock | (14) | - |
| Proceeds from Series A Preferred Stock issuance, net of \$20 and \$218 of issuance costs, respectively | 3,014 | 18,425 |
| Proceeds from Series A-1 Preferred Stock issuance | - | 2,000 |
| Repurchase of Series A-1 Preferred Stock | - | (2,000) |
| Proceeds from A-2 Preferred Stock issuance | - | 100 |
| Proceeds from Series B Preferred Stock issuance, net of \$31 of issuance costs | 13,602 | - |
| Repayments of long-term debt | (1,346) | (8,200) |
| Proceeds from repayment of shareholder loans | 37 | - |
| Borrowings under credit facility | - | 2,822 |
| Net cash provided by financing activities | 15,298 | 13,147 |
| Net change in cash | 4,191 | 4,460 |
| Cash and cash equivalents at beginning of year | 4,570 | 110 |
| Cash and cash equivalents at end of year | \$ 8,761 | \$ 4,570 |
| Supplemental disclosure of noncash investing and financing activities | | |
| Cash paid for interest | \$ 91 | \$ 190 |
| Recording of asset retirement obligation | \$ 102 | \$ - |
| Increase in fixed assets resulting from transfer of inventory | \$ 686 | \$ 685 |
| Affiliated investor contribution of debt to paid-in-capital | \$ - | \$ 9,673 |
| Assets/liabilities acquired in acquisition: | | |

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| | | | | |
|--|----|---|----|-------|
| Property and equipment | \$ | - | \$ | (472) |
| Identified intangible | \$ | - | \$ | (104) |
| Other current liabilities | \$ | - | \$ | 66 |
| Issuance of shares in respect of acquisition | \$ | - | \$ | 510 |

The accompanying notes are an integral part of these financial statements.

Comverge, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2004 and 2003

(All notes in thousands of dollars, except per share data)

1. Description of Business and Summary of Significant Accounting Policies

Description of Business

Comverge, Inc., a Delaware corporation, and its subsidiaries (collectively, "We" or the "Company"), provides (i) Energy intelligence systems, comprised of hardware, software and installation services, to utilities and other energy customers and (ii) On-call capacity relief to electricity generators and transmitters (Note 14). Prior to April 2003, the Company was a wholly-owned subsidiary of Data Systems & Software, Inc. ("DSSI"). In April 2003 and continuing thereafter, the Company completed a series of equity financings totaling \$35,410 (Note 11). DSSI remained the Company's largest shareholder owning approximately 25 percent and 41 percent of the Company's issued and outstanding voting equity at December 31, 2004 and 2003, respectively.

Liquidity

The Company has experienced losses since inception and expects to generate additional losses in the foreseeable future. During 2004, the Company raised additional financing and management believes this, along with available borrowing capacity, will be sufficient to meet the operating needs of the Company over the next twelve months. Additional financing may be required to help the Company continue to develop its Enterprise business (Note 14).

Use of Estimates in Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the financial statements, and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Foreign Currency Translations

The currency of the primary economic environment in which the operations of the Company are conducted is the United States Dollar ("dollar"). Accordingly, Comverge and its subsidiaries use the dollar as their functional currency. All exchange gains and losses denominated in nondollar currencies are presented on a net basis in operating expense in the consolidated statement of operations when they arise. Foreign currency loss amounted to \$4 and \$15 for the years ended December 31, 2004 and 2003, respectively.

Principles of Consolidation and Presentation

The consolidated financial statements of the Company include the accounts of its subsidiaries. The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America. All intercompany balances and transactions have been eliminated.

Cash and Cash Equivalents

The company considers all highly liquid investments with a remaining maturity of three months or less to be cash equivalents. Cash and cash equivalents consist of cash and demand deposits in banks and short-term investments.

Comverge, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2004 and 2003

(All notes in thousands of dollars, except per share data)

Allowance for Doubtful Accounts

The allowance for doubtful accounts is based on specific identification of accounts considered to be doubtful of collection as well as historical experience. As of December 31, 2004 and 2003 there were no accounts identified as doubtful of collection.

Inventory

Inventories are stated at the lower of cost or market. Inventory cost is determined on the basis of specific identification based on acquisition cost, and due provision is made to reduce all slow-moving, obsolete, or unusable inventories to their estimated useful or scrap values.

Property and Equipment

Property and equipment are presented at the lesser of cost or fair value at the date of acquisition. Depreciation is calculated using the straight-line method over the estimated useful lives of the depreciable assets. In the case of installed assets that are part of long-term contracts, the assets are depreciated over the shorter of the useful life or the expected life of the contract. Leasehold improvements are depreciated over the shorter of the lease term or useful life. Improvements are capitalized while repairs and maintenance are expensed as incurred.

In accordance with Statement on Financial Accounting Standards (SFAS) No. 143, Accounting for Asset Retirement Obligations, the Company recognizes the fair value of liabilities for asset retirement obligations in the period in which it is incurred if a reasonable estimate of fair value can be made. Any associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset and recognized as depreciation expense over the assets useful life. As part of the Company's Enterprise business (Note 14), the Company installs hardware at the places of residence of select utility customers' homes. At the request of the homeowner, the Company is obligated to remove this hardware. Accordingly, in 2004, the Company recognized an asset retirement obligation liability and an associated increase in the value of long-lived assets of \$102. In 2003, the estimated cost of these obligations was immaterial. As such, there was no obligation recognized.

Goodwill and Intangibles

Goodwill represents the excess of cost over the fair value of the net tangible assets of subsidiaries acquired in purchase transactions. Goodwill is not being amortized in accordance with SFAS 142, *Goodwill and Other Intangible Assets*. In accordance with SFAS 142, goodwill and other indefinite-lived intangible assets are tested for impairment on at least an annual basis, on December 31 of each year. Based on the Company's most recent impairment test, there has been no impairment loss recognized for goodwill.

The costs of licensed technology are presented at their fair value at acquisition date. These costs are amortized on a straight-line basis over the term of the license, generally five years.

The costs of registered patents and patents pending acquired from third parties are presented at their fair value at acquisition date. In addition, registration costs and fees for patents are capitalized. Registered patents costs are amortized over the estimated remaining useful life of the patents, from four to fourteen years. Costs for patents pending are not amortized until they are issued.

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Revenue Recognition

In accordance with Staff Accounting Bulletin (SAB) 104, *Revenue Recognition*, the Company recognizes revenues when the following criteria have been met: delivery has occurred, the price is fixed and determinable, collection is probable, and persuasive evidence of an arrangement exists.

In accordance with Emerging Issues Task Force (EITF) 00-21, *Accounting for Revenue Arrangements With Multiple Deliverables*, the Company assesses revenue arrangements to determine when multiple deliverables exist in order to determine if separate accounting is required for these deliverables separately per EITF 00-21.

Revenue from time-and-materials service contracts and other services are recognized as services are provided. Revenue from maintenance contracts is recognized on a straight-line basis over the life of the contract.

In accordance with SAB 104, the Company defers revenues and associated costs of revenues related to certain long term contracts until such time as the contract price is fixed and determinable. These contracts require the Company to provide capacity through our load curtailment solutions to electricity generators, and require a measurement and verification of capacity provided on an annual basis in order to determine final contract consideration for a given year. For the year ended December 31, 2004, the Company deferred \$1,713 of revenues and \$281 of corresponding costs of revenues.

In accordance with EITF issue 00-10, *Accounting for Shipping and Handling Fees and Costs*, the Company reports shipping and handling revenues and their associated costs in Revenue and Cost of Revenue, respectively.

Warranty Provision

Comverge generally warrants its products against certain manufacturing and other defects. These product warranties are provided for specific periods of time and/or usage of the product depending on the nature of the product, the geographic location of its sale and other factors. As of December 31, 2004 and 2003 the Company had accrued \$161 and \$152, respectively, for estimated product warranty costs, which was included in other current liabilities. The accrued product warranty costs were based primarily on estimated costs to satisfy a customer warranty claim. Warranty claims expense for the years ended December 31, 2004 and 2003 were \$91 and \$20, respectively.

| | 2004 | 2003 |
|---|-------------|-------------|
| Warranty provision at beginning of period | \$ 152 | \$ 52 |
| Accruals for warranties issued during the period | 100 | 100 |
| Warranty settlements during the period | (91) | (20) |
| Changes in liability for pre-existing warranties during the period, including expirations | - | 20 |
| Warranty provision at the end of period | \$ 161 | \$ 152 |

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Advertising Expenses

Advertising costs are expensed as incurred. Advertising expense amounted to \$2,816 and \$813 for the years ended December 31, 2004 and 2003, respectively.

Research and Development Expenses

Research and development costs are expensed as incurred.

Stock-Based Compensation

The Company accounts for employee and director stock-based compensation in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. In accordance therewith, the Company records compensation expense on fixed stock options and restricted common stock granted to employees and directors at the date of grant if the current market price of the Company's common stock exceeds the exercise price of the options and restricted common stock. Compensation expense on variable stock option grants is estimated until the measurement date. Deferred compensation is amortized to compensation expense over the vesting period of the underlying options. The Company complies with the disclosure provisions of SFAS 123, *Accounting for Stock-Based Compensation* ("SFAS 123"). As such, the Company provides pro forma net income disclosures for employee and director stock option grants as if the fair-value-based method defined in SFAS 123 had been applied. The Company's stock-based employee compensation plan is described more fully in Note 12.

Total stock-based compensation expense determined under the fair-value method for all awards was \$35 and \$52 for the years ended December 31, 2004 and 2003, respectively. See the pro forma net loss reconciliation in the table below.

| | Fiscal year ended | |
|---|--|------------------------------|
| | December 31, 2004 | December 31, 2003 |
| | (In thousands, except for share numbers) | |
| Net loss as reported | \$ (9,258) | \$ (9,317) |
| Add: | | |
| Stock-based employee compensation expense included in reported net income net of related tax effects | - | - |
| Deduct: | | |
| Total stock-based employee compensation expense determined under fair value method-based methods for all awards, net of tax effects | (35) | (52) |
| Pro forma net loss | \$ (9,293) | \$ (9,369) |

The Company accounts for stock-based compensation issued to consultants on a fair value basis in accordance with SFAS 123 and EITF Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*.

Income Taxes

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes, as well as operating loss, capital loss and tax credit carry forwards. Deferred tax assets and liabilities are classified as current or noncurrent based on the classification of the related assets or liabilities for financial reporting, or according to the expected reversal dates of the specific temporary differences, if not related to an asset or liability for financial reporting. Valuation allowances are established against deferred tax assets if it is more likely than not that they will not be realized.

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Income taxes associated with the undistributed earnings of a subsidiary are provided for in accordance with Accounting Principals Board Opinion No. 23, when the Company has sufficient evidence that the subsidiary has invested or will invest the undistributed earnings indefinitely. If it is determined that the undistributed earnings of a subsidiary will be remitted in the foreseeable future, all taxes related to the remittance of such undistributed earnings are provided for in the current period as income tax expense.

Impairment of Long-Lived Assets

The Company evaluates the recoverability of its long-lived assets and certain identifiable intangible assets in accordance with SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS 144 requires recognition of impairment in the event the net book value of such assets exceeds the future undiscounted cash flows attributable to such assets. If impairment is indicated, the carrying amount of the asset is written down to fair value. The Company has identified no such impairments.

Significant Risks and Uncertainties

The Company's operations are subject to certain risks and uncertainties including, but not limited to; a history of unprofitability and the inability to fund its operations and capital requirements with free cash flow, the continued ability to obtain financing on commercially reasonable terms, operating results that are often volatile and difficult to predict, the ability to develop new products and the market's acceptance of those products, a highly competitive marketplace, the reliance on strategic relationships as distribution channels to market products, the use of technology licensed from third parties, the potential of product defects, the commoditization of products and resulting pricing pressures, lengthy sales cycles of our utility customers, the ability to manage growth, possible disruption in commercial activities due to terrorist activity and armed conflict, delays in product development and related release schedules, the ability to protect intellectual property and the need to retain key personnel. Additionally, the Company has a significant share of a market that is presently very small, making it difficult to achieve internal growth absent a significant market expansion. Any of these factors could impair our ability to expand our operations or to generate significant revenues and cash flows from those markets in which we operate. As a result of the above and other factors, the Company's financial condition can vary significantly from year to year.

Impact of Recent Accounting Pronouncements

On December 16, 2004, the FASB issued SFAS 123 (revised 2004) ("SFAS 123(R)"), *Share-Based Payment*, which is a revision of SFAS 123. SFAS 123(R) supersedes APB 25, and amends SFAS 95, *Statement of Cash Flows*. Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. As permitted by SFAS 123, the Company currently accounts for share-based payments to employees using APB 25's intrinsic value method and, as such, recognizes no compensation cost on grants of employee stock options when the exercise price of an option is at or below the fair market value of the underlying stock. Accordingly, the adoption of SFAS 123(R) could have a significant impact on the Company's results of operations, although it will have no impact on its overall financial position. The impact of adoption of SFAS 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future.

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The Company expects to adopt SFAS 123(R) on January 1, 2006. SFAS 123(R) permits the Company to adopt its requirements using one of two methods:

- A “modified prospective” method in which compensation cost is recognized beginning with the January 1, 2006 adoption date (a) based on the requirements of SFAS 123(R) for all share-based payments granted after January 1, 2006 and (b) based on the requirements of SFAS 123 for all awards granted to employees prior to January 1, 2006 that remain unvested on the adoption date.
- A “modified retrospective” method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

The Company plans to adopt SFAS 123(R) using the modified prospective method.

2. Acquisitions

On April 7, 2003, the Company acquired from an unrelated company, Sixth Dimension, Inc. (“6D”), certain property and equipment and technological know-how (software) relating to its iNET software platform in exchange for 877,000 of its common shares (the “Acquisition”). The Acquisition was accounted for using the purchase method of accounting. The Company acquired a business including property and equipment, intellectual property, certain contracts with customers and all of 6D’s employees. In consideration of the Company’s acquisition, certain 6D investors purchased \$3,750 of the Company’s Series A Preferred Stock. 6D is an early stage Internet-based software company, whose iNET platform enables a broad range of energy services including: upstream facility metering, monitoring, and control; performance-based operations and proactive maintenance; economic demand response and active load curtailment; aggregated distributed generation; power reliability and quality monitoring; and other real-time capital equipment analysis using a low-cost, robust, software for service delivery. The iNET platform adds to Comverge's product offering, technology for upstream monitoring and control of capital assets, by combining real-time, internet-based, data warehousing capabilities with the analytical and metering capabilities of the Company’s PowerCAMP software applications.

The purchase price of the acquired assets was \$510, determined by an independent appraisal of the value of the Company’s common shares issued in respect of the Acquisition as of the Acquisition date. As a result of the Acquisition, the Company recorded an intangible asset, the iNET software, of \$104. This asset will be amortized on a straight line basis over three years from the Acquisition date.

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3. Property and Equipment

Property and equipment, at December 31, 2004 and 2003 consisted of the following:

| | Estimated Useful Life (in years) | 2004 | 2003 |
|--------------------------------|---|-------------|-------------|
| Load control equipment | 3-10 | \$ 4,775 | \$ 973 |
| Computer hardware and software | 3 | 1,259 | 1,807 |
| Office furniture and equipment | 5-7 | 1,660 | 1,657 |
| | Term of | | |
| Leasehold improvements | lease | 177 | 103 |
| | | 7,871 | 4,540 |
| Accumulated depreciation | | 2,529 | 2,443 |
| Property and equipment, net | | \$ 5,342 | \$ 2,097 |

Depreciation in respect of property and equipment amounted to \$946 and \$831 for and the years ended December 31, 2004 and 2003, respectively.

4. Goodwill and Intangible Assets

The Company's goodwill balance as of both December 31, 2004 and 2003 was \$499, which is recorded as part of the Solutions segment (Note 14).

Intangible assets and accumulated amortization as of December 31, 2004 and 2003 consisted of the following:

| | Estimated Useful Life (in years) | 2004 | 2003 |
|---|---|-------------|-------------|
| Technological Know-How | 5 | \$ 1,436 | \$ 1,436 |
| Acquired Software | 3 | 104 | 104 |
| Patents | 4-14 | 287 | 287 |
| | | 1,827 | 1,827 |
| Accumulated amortization | | 1,600 | 1,333 |
| Identified intangible assets with finite lives, net | | \$ 227 | \$ 494 |

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The Company uses the straight line method of computing amortization expense. Amortization expense for the years ended December 31, 2004 and 2003 was \$266 and \$335, respectively. Estimated amortization expense for the next five years is as follows:

| Year Ending December 31, | |
|---------------------------------|-------|
| 2005 | \$ 50 |
| 2006 | 24 |
| 2007 | 15 |
| 2008 | 15 |
| 2009 | 15 |
| Thereafter | 108 |

5. Other Assets

Other assets at December 31, 2004 and 2003 consisted of the following:

| | 2004 | 2003 |
|---------------------|-------------|-------------|
| Long-term inventory | \$ 975 | \$ - |
| Other | 42 | 37 |
| Total other assets | \$ 1,017 | \$ 37 |

The inventory balance of \$975 as of December 31, 2004, represents certain finished goods inventory not anticipated to be sold during the next twelve months primarily due to the necessary completion in 2005 of certain firmware to be integrated into the products. The inventory was obtained pursuant to a purchase agreement with the vendor that provides for extended payment terms (Note 7).

6. Long-Term Debt

On April 7, 2003, in connection with a private equity financing, the Company entered into a \$6,500 credit facility ("Credit Facility") with a major United States commercial bank. The Credit Facility consists of a three-year term loan ("Term Loan") of \$1,500 bearing interest at the prime rate and a \$5,000, three year, revolving credit facility ("Revolving Facility") bearing interest between prime+1.5 percent and prime+2.0 percent per annum. Initial borrowings were used to refinance certain debt. The Term Loan was secured by cash collateral in a like amount pledged by DSSI and was repaid by the Company in December 2003. Interest paid on this Term Loan totaled \$45 in 2003. The Revolving Facility is secured by virtually all of the assets of the Company including the Company's intellectual property. On September 24, 2004, the Company modified the Credit Facility to (i) increase the revolving line credit amount to \$7,000, (ii) increase the letter of credit sublimit to \$3,000 and (iii) extend the maturity date of the Revolving Facility to September 15, 2007. Borrowings under the Revolving Facility can be requested, from time to time, up to an amount that, based on a formula, includes 80 percent of eligible receivables and eligible inventory limited to the lesser of (i) 25 percent of FMV, (ii) 80 percent of net orderly liquidation value or (iii) \$500. At December 31, 2004 and 2003 the Company had \$0 and \$1,346, respectively, of borrowings under the Revolving Facility.

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As of December 31, 2004, the Company had unutilized borrowing availability under its Revolving Facility of approximately \$3,000.

7. Long-Term Trade Payable

At December 31, 2004, the Company owed a trade vendor \$1,362 in consideration of certain inventory obtained pursuant to a purchase agreement executed in September of 2003 (Note 5). Pursuant to an amendment to the terms of the purchase agreement in September 2004, the due date of this trade obligation was extended to March 30, 2006. The amount owed bears no interest and is not secured by any assets of the Company.

8. Liability for Employer Termination Benefits

Under Israeli law and labor agreements, one of the Company's subsidiaries, Comverge Control Systems, is required to make severance and pension payments to dismissed employees and to employees leaving employment in certain other circumstances. The obligation for severance pay benefits, as determined by the Israeli Severance Pay Law, is based upon length of service and last salary. These obligations are substantially covered by regular deposits with recognized severance pay and pension funds and by the purchase of insurance policies. The pension plans are multi-employer and independent of the Company. Pension and severance costs for the years ended December 31, 2004 and 2003 was \$143 and \$217, respectively, and is included in general and administrative expenses.

9. Income Taxes

The Company has Federal, state, and foreign net operating losses of approximately \$25,196, \$15,601 and \$3,036, respectively, at December 31, 2004. The Federal net operating loss carryforwards begin expiring in 2019 and state net operating loss carryforwards begin expiring in 2006. During year ended December 31, 2003, certain substantial changes in the Company's ownership, as defined in the provisions of the Internal Revenue Code, resulted in a limitation on the utilization of a significant portion of the Federal and state net operating losses on an annual basis.

At December 31, 2004, the Company has provided a valuation allowance for the full amount of its net deferred tax asset since realization of any future tax benefit cannot be sufficiently assured.

A reconciliation of income tax expense (benefit) at the statutory federal income tax rate and income taxes as reflected in the consolidated financial statements is as follows:

| | 2004 | 2003 |
|--|-------------|-------------|
| Federal income tax at statutory federal rate | 34.0% | 34.0% |
| State income tax expense | 4.0% | 4.0% |
| Other | (1.4 %) | (0.4%) |
| Valuation allowance | (36.6%) | (37.6%) |
| Effective tax rate | 0% | 0% |

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Deferred tax assets (liabilities) consist of the following:

| | 2004 | 2003 |
|---------------------------------------|-------------|-------------|
| Deferred tax assets | | |
| Net operating loss carryforwards | \$ 10,283 | \$ 7,981 |
| Other | 1,161 | 735 |
| Deferred tax liabilities | | |
| Other | (171) | (185) |
| | 11,273 | 8,531 |
| Valuation allowance | (11,273) | (8,531) |
| Net deferred tax assets (liabilities) | \$ - | \$ - |

10. Commitments and Contingencies

(a) Leases of Property and Equipment

Rental and leasing expenses for the years ended December 31, 2004 and 2003 was \$624 and \$532, respectively. Future minimum rental payments and lease payments on noncancelable operating leases as of December 31, 2004 are as follows:

(in thousands of dollars)

Year Ending December 31,

| | | |
|------------|----|-----|
| 2005 | \$ | 469 |
| 2006 | | 313 |
| 2007 | | 181 |
| 2008 | | 176 |
| 2009 | | 166 |
| Thereafter | | 14 |

(b) Employee Retirement Savings Plan

The Company sponsors a tax deferred retirement savings plan that permits eligible U.S. employees to contribute varying percentages of their compensation up to the limit allowed by the Internal Revenue Service. This plan also provides for discretionary Company contributions. No discretionary contributions were made for the years ended December 31, 2004 or 2003.

(c) Royalties

The Company is committed to pay royalties to the Government of Israel on proceeds from the sale of certain products in which the Government of Israel participated in the research and development by way of grants. Royalties are currently payable at a rate of 4.5 percent of the annual sales of the product. The amount payable as royalties is limited to the amount of the original grant of \$595. The net amount due in respect of these grants amounted to approximately \$418 at December 31, 2004.

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11. Shareholders' Deficit

Contribution of DSSI debt to paid-in-capital

In April of 2003, by agreement, and in consideration of the sale of the Company's Series A and A-1 preferred shares and the placement of a New Credit Facility, DSSI and its affiliated companies (other than the Company) contributed accrued management fees and the principal amount of loans, advances and accrued interest thereon in the amount of \$9,673 to paid in capital.

Common Stock

Holders of the Company's common stock are entitled to dividends if and when declared by the board of directors. The holders of common stock, voting as a separate class, are entitled to elect two members of the Board of Directors at each meeting or pursuant to each consent of the Corporation's stockholders for the election of directors, and to remove from office such directors and to fill any vacancy caused by the resignation, death or removal of such directors.

Convertible Preferred Stock

During 2003, the Company sold to investors (i) 8,945,350 shares of its Series A Convertible Preferred Stock ("Series A Preferred") for \$18,643, (ii) 721,527 shares of its Series A-1 Convertible Preferred Stock ("Series A-1 Preferred") for \$2,000 and (iii) 36,076 of its Series A-2 Convertible Preferred Stock ("Series A-2 Preferred") for \$100. The Company repurchased its Series A-1 Preferred in 2003, pursuant to a put right of an investor for \$2,000 plus accrued dividends of \$74 which dividends were recognized as a financial expense in 2003.

During 2004, the Company sold to investors (i) 1,455,796 of its Series A Preferred for \$3,034 and (ii) 5,640,878 shares of its Series B Convertible Preferred Stock ("Series B Preferred") for \$13,633. As part of the Series B Preferred transaction, the Company issued 92,798 shares of common stock for no monetary consideration to one of the investors. The fair value of these shares, based on an independent third party valuation, is \$34. Accordingly, the Company made a pro rata allocation of the total consideration received to the Series B Preferred and the common stock, resulting in \$13,599 allocated to the Series B Preferred and \$34 to the common stock.

The rights, preferences and privileges attached to the Series A Preferred, Series A-2 Preferred and Series B Preferred (Collectively, the "Preferred Stock") are as follows:

(a) Conversion

The Preferred Stock is convertible into the Company's common stock initially on a one-for-one basis subject to adjustment for the achievement of certain performance criteria. Conversion is mandatory (i) in the event that the holders of at least a majority of the then-outstanding shares of Preferred Stock consent to such conversion or (ii) upon the closing of a firmly underwritten public offering of shares of common stock of the Company at a per share price not less than five times the original per-share purchase price of the Preferred Stock. The holders of Preferred Stock have no mandatory redemption rights.

(b) Board of Directors

The holders of Preferred Stock, voting as a separate class, shall be entitled to elect three members of the Board of Directors at each meeting or pursuant to each consent of the Corporation's stockholders for the election of directors,

and to remove from office such directors and to fill any vacancy caused by the resignation, death or removal of such directors. After December 31, 2004, the board can be increased by no more than two additional seats based on a majority vote of the then members of the board. The additional two seats shall be filled by outside directors, who shall be selected by a majority of the other members of the Board of Directors, including the affirmative vote of at least two of the directors designated by the holders of Preferred Stock.

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(c) Dividends

In the event the Company declares and pays any dividend on its common stock other than stock or other dividends payable solely in shares of common stock, the Company must also pay to the holders of Preferred Stock the dividends that would have been payable had all of the outstanding Preferred Stock been converted to common stock immediately prior to the record date of the dividend.

The holders of shares of Preferred Stock, on a pari passu basis and in preference to the holders of any shares of any other class of capital stock of the Company, shall be entitled to receive, when, as and if declared by the Board of Directors, but only out of funds legally available therefore, dividends at the rate of 8 percent per annum based, in each case, on the original Preferred Stock issue price. Dividends are noncumulative.

(d) Voting

The Preferred Stock shall vote together with all other classes and series of stock of the Company as a single class on all actions to be taken by the stockholders of the Company.

(e) Liquidation Preferences

Upon any liquidation, dissolution or winding up of the Company, whether voluntary or involuntary, the holders of shares of Series A Preferred and the Series B Preferred shall be entitled to be paid, on a pari passu basis, before any distribution or payment is made upon the Series A-2 Preferred Stock or on the common stock an amount equal to 1.5 times the original Series A issue price per share or original Series B price per share, respectively, plus all declared and unpaid dividends. After payment to the holders of Series A Preferred and the Series B Preferred of the full amounts to which they are entitled the holders of Series A-2 Preferred Stock shall be entitled to be paid, before any distribution or payment is made upon the common stock, an amount equal to 1.5 times the original Series A-2 issue price per share plus all declared but unpaid dividends. After the preferential payments have been made in full, any additional remaining assets shall be distributed ratably to the holders of Preferred Stock (on an as-converted basis) and common stock until such holders of Preferred Stock have received, inclusive of their liquidation amount, an amount equal to 5 times their original issue price per share. After payment of all preferential amounts, the entire remaining assets of the Company legally available for distribution, if any, shall be distributed ratably among the holders of its common stock.

Unless otherwise agreed by holders of at least 66 2/3 percent of the then-outstanding shares of Preferred Stock, a liquidation, dissolution or winding up of the Company shall also include (i) the acquisition or sale of the Company unless the Company's stockholders of record as constituted immediately prior to such acquisition or sale will, immediately after such acquisition or sale hold at least 50 percent of the voting power of the surviving or acquiring entity or (ii) a sale, lease or other conveyance or disposition of all or substantially all of the assets of the Company, including a sale of all or substantially all of the assets of the Company's subsidiaries, if such assets constitute substantially all of the assets of the Company and such subsidiaries taken as a whole.

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(f) Anti-dilution Rights

The conversion prices of Preferred Stock are subject to broad-based weighted average anti-dilution adjustments to reduce dilution in the event that the Company issues additional equity securities (other than Board approved employee incentives, including stock options) at a purchase price less than the then-applicable conversion price of the Series A Preferred, Series A-2 Preferred and Series B Preferred, respectively. The conversion price is also subject to proportional adjustment for stock splits, stock dividends, recapitalizations and the like.

(g) Protective Provisions

For so long as at least 100,000 shares of Preferred Stock remain outstanding, consent of the holders of at least 60% of the then outstanding Preferred Stock shall be required to (i) alter or change the rights, preferences or privileges of the Preferred Stock, (ii) create (by reclassification or otherwise) any new class or series of shares having rights, preferences or privileges senior to or on a parity with the Preferred Stock, (iii) amend or waive any provision of the Company's Articles of Incorporation or Bylaws, (iv) increase or decrease the authorized number of shares of common or Preferred Stock, (v) redeem any shares of common stock (other than pursuant to equity incentive agreements with service providers giving the Company the right to repurchase shares upon the termination of services), (vi) consummate any merger, other corporate reorganization, sale of control, or any transaction in which all or substantially all of the assets of the Company are sold, (vii) increase or decrease the authorized size of the Company's Board of Directors or the Compensation Committee of the Board of Directors, (viii) pay or declare any dividend on any shares of common or Preferred Stock, (ix) liquidate or dissolve the Company, (x) increase the number of shares reserved for issuance under the Option Plan, (xi) issue any shares of capital stock of the Company or options to acquire capital stock of the Company under the Option Plan, unless such issuance is approved by the Board of Directors and the Compensation Committee of the Board of Directors, or (xii) authorize or incur any additional indebtedness in excess of \$500 (other than the revolving Credit Facility), unless such incurrence of indebtedness is approved by the Board of Directors, including at least two of the directors designated by the holders of Preferred Stock.

12. Stock Option Plan

The Company's stock option plan provides for the granting to officers, directors and other key employees of options to purchase shares of common stock at not less than 85 percent of the estimated fair value of the Company's common stock on the date of grant. The purchase price must be paid in cash. At December 31, 2004, the Company had 2,600,996 issued and outstanding options under the various plans of which 78,491 options had been exercised by optionees. Options expire between five years and ten years from the date of the grant. The options generally vest over a two to four year period from the date of the grant. At December 31, 2004, 1,260,244 options were available for grant under the various plans.

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A summary status of the Company's option plans as of December 31, 2004 and 2003, as well as changes during the year then ended, is presented below:

| | 2004 | | 2003 | |
|---|-------------------------------------|--|-------------------------------------|--|
| | Number of Options (in Shares) | Weighted Average Exercise Price | Number of Options (in Shares) | Weighted Average Exercise Price |
| Outstanding at beginning of year | 2,216,049 | \$ 1.20 | 943,530 | \$ 1.20 |
| Granted | 980,525 | \$ 0.44 | 1,278,800 | \$ 1.20 |
| Exercised | (4,052) | \$ 1.27 | - | \$ 1.20 |
| Forfeited | (591,526) | \$ 1.06 | (6,281) | \$ 1.20 |
| Outstanding at end of year | 2,600,996 | \$ 0.95 | 2,216,049 | \$ 1.20 |
| Exercisable at end of year | 1,260,078 | \$ 1.13 | 921,094 | \$ 1.16 |

Outstanding as of December 31, 2004

| Exercise Prices | Number Outstanding (In Shares) | Average Remaining Contractual Life (In Years) | Number Exercisable (In Shares) |
|-----------------|--------------------------------------|---|--------------------------------------|
| \$0.29 | 818,700 | 6.72 | 193,948 |
| \$1.20 | 1,695,059 | 4.42 | 978,894 |
| \$1.31 | 52,587 | 6.87 | 52,587 |
| \$2.00 | 10,191 | 1.01 | 10,191 |
| \$4.00 | 24,459 | 1.24 | 24,459 |
| | 2,600,996 | 5.15 | 1,260,098 |

The weighted average grant-date fair value of 980,525 and 1,278,800 options granted during 2004 and 2003, respectively, was zero. The Company utilized the Black-Scholes option pricing model to estimate fair value, utilizing the following assumptions for the respective years (all in weighted averages):

| | 2004 | 2003 |
|------------------------------------|-------|-------|
| Risk-free interest rate | 3.50% | 5.38% |
| Expected life of options, in years | 5.0 | 5.0 |
| Expected annual volatility | 0% | 0% |
| Expected dividend yield | None | None |

During 2002, the Company repriced certain incentive stock options of ten employees. One of these employee's options were repriced, pursuant to his employment agreement, from \$4.00 to \$1.20 per share. The Company also repriced certain incentive stock options of ten employees (including the aforementioned employee) who held certain anti-dilution options from \$1.94 to \$1.31 per share. As a result of these repricings, the options are accounted for as variable awards with a compensation charge recognized for periodic changes in the intrinsic value of the option until the award expires, is exercised, or is forfeited. No compensation charge was recognized during 2004 or 2003 related to

these repriced option grants since the fair market value of the common stock was below the exercise prices. During 2004, the Company incurred \$30 in deferred compensation related to option grants which will be recognized into expense over the vesting period of the awards

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13. Major Customers

During the year ended December 31, 2004, the Company had two customers which accounted for 15.4% and 10.7% of the Company's total revenue. The total accounts receivable from these customers were \$256 and \$129, respectively, at December 31, 2004. During the year ended December 31, 2003, the Company had one customer which accounted for 18.5% of the Company's total revenue. The total accounts receivable from this customer was \$172 at December 31, 2003. No other customer accounted for more than 10 percent of the Company's total revenue in 2004 or 2003.

14. Segment Information

We have two operating segments by which we evaluate our business and for which we have discrete financial information available. These operating segments are (1) Solutions sales, consisting of energy intelligence systems comprised of hardware and software sold to utilities and other customers and (2) Enterprise sales, consisting of long-term, turnkey contracts to provide capacity relief to electricity generators and transmitters. In evaluating financial performance, we focus on operating income as a measure of a segment's profit or loss. Operating income for this purpose is income before interest, taxes and allocation of certain corporate expenses. Operating income is significant as it includes the revenue and related costs that apply to the individual segments. We do not utilize total assets as a measure of a segment's performance. Total assets are reviewed at the enterprise level and thus are not included in our segment disclosure.

Capital requirements of our Enterprise segment are significant and consist of hardware devices and control equipment that allow us to provide energy capacity to our generation and transmission customers during periods of peak electricity demand.

The following table includes financial information for 2004 and 2003 related to our segments. The information presented below may not be indicative of results if the segments were independent organizations.

| | For the Year Ended 2004 | | |
|-------------------------------|--------------------------------|-------------------|--------------|
| | Solutions | Enterprise | Total |
| External revenues | \$ 17,002 | \$ 1,157 | \$ 18,159 |
| Operating loss | (6,905) | (2,124) | (9,029) |
| Identifiable long term assets | 724 | 4,618 | 5,342 |
| Depreciation expense | 589 | 357 | 946 |
| Capital expenditures | 434 | 3,722 | 4,156 |
| Net loss | (7,595) | (1,663) | (9,258) |

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| | For the Year Ended 2003 | | |
|-------------------------------|--------------------------------|-------------------|--------------|
| | Solutions | Enterprise | Total |
| External revenues | \$ 15,394 | \$ 248 | \$ 15,642 |
| Operating loss | (8,234) | (497) | (8,731) |
| Identifiable long term assets | 704 | 1,393 | 2,097 |
| Depreciation expense | 778 | 53 | 831 |
| Capital expenditures | 312 | 1,173 | 1,485 |
| Net loss | (9,184) | (133) | (9,317) |

15. Related Party Transactions and Balances

An affiliate of DSSI charged the Company's Israeli subsidiary, Comverge Control Systems, \$138 and \$138 in 2004 and 2003, respectively, in consideration of it providing office space and certain accounting and administrative services which amounts are included in general and administrative expense. Also, DSSI paid a cash bonus of \$200 to an executive officer of the Company in January 2004 related to performance metrics achieved during 2003. This amount was recognized in the Company's Statement of Operations as compensation expense in 2003. Because the Company had no obligation to reimburse DSSI for such bonus payment, it is classified on the Company's balance sheet as a contribution to paid-in-capital. Additionally, in January of 2003, DSSI granted the Company's Chief Executive Officer a restricted stock grant of 50,000 shares of common stock of DSSI. Also, in 2003, the Company purchased \$100 of computers and other equipment from an affiliate of DSSI of which \$62 is recorded in property and equipment and \$38 is recorded as a general and administrative expense.

Prior to April 2003, DSSI charged the Company \$130 in consideration of certain management fees and interest on advances and loans made by DSSI to the Company and included in selling and administrative services. Such amount was classified on the Company's balance sheet as a liability to DSSI. By agreement, in April 2003, such amount was contributed to the Company's paid in capital (Note 11). Also by agreement, subsequent to April 2003, no management fees are payable to DSSI.

The Company extended loans of \$10 each to both the Chief Executive Officer and Chief Financial Officer of DSSI. The loans had an initial maturity date of January 3, 2002, and were extended at that time to mature on January 3, 2004. The loans bear interest at 4.25 percent per annum. The balance of the loans and accrued interest at December 31, 2003 were \$26. The loans were repaid in 2004.

The Company has 4,637 stock options outstanding and issued to an executive officer of an affiliated company.