VIRTRA SYSTEMS INC
Form 10QSB
November 15, 2004

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

(Mark One)

|X| QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES

EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2004

or

|_| TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES

EXCHANGE ACT OF 1934

For the transition period from ________________ to ______________________

Commission File Number 000-28381

VIRTRA SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Texas	93-1207631
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
440 North Center, Arlington, TX	76011
(Address of principal executive offices)	(Zip Code)

(817) 261-4269

(Registrant's telephone number, including area code)

Check 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 |_|

As of November 10, 2004, the Registrant had outstanding 52,261,235 shares of common stock, par value $.005 per share.

PART I. FINANCIAL INFORMATION

Item 1.

Financial Statements.

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BALANCE SHEET

September 30, 2004 and December 31, 2003

ASSETS	**September 30, 2004 (Unaudited)**	**December 31, 2003 (Note)**
Current assets:		
Cash and cash equivalents	$ -	$ 80,870
Accounts receivable	223,600	162,174
Costs and estimated earnings in excess of billings on uncompleted contracts	270,911	153,100
Total current assets	494,511	396,144
Property and equipment, net	223,730	206,232
Product development costs	104,130	-
Note receivable-related party	67,885	67,885
Intangible assets, net	4,537	18,133
Total assets	$ 894,793	$ 688,394

LIABILITIES AND STOCKHOLDERS DEFICIT

Current liabilities:		
Notes payable	$ 877,821	$ 778,722
Obligations under product financing arrangements	6,612,076	6,045,083
Notes payable-stockholders	910,031	910,031
Book overdraft	34,346	-
Accounts payable	827,494	1,118,580

Accrued liabilities	817,502	703,501
Billings in excess of costs and estimated earnings on uncompleted contracts	-	32,340
Total current liabilities	10,079,270	9,588,257
Redeemable common stock, 490,760 shares at $.005 par value	2,454	2,454
Stockholders deficit:		
Common stock, $.005 par value, 100,000,000 shares authorized, 52,261,235 and 48,568,628 shares issued and outstanding at September 30, 2004 and December 31, 2003, respectively	261,306	242,843
Additional paid-in capital	5,147,049	4,174,747
Accumulated deficit	(14,595,286)	(13,319,907)
Total stockholders deficit	(9,186,931)	(8,902,317)
Total liabilities and stockholders deficit	$ 894,793	$ 688,394

See accompanying notes to financial statements.

VIRTRA SYSTEMS, INC.

STATEMENT OF OPERATIONS

for the three months and nine months ended September 30, 2004 and 2003

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	**2003**	**2004**	**2003**
Revenue:				
Custom applications:				
Training/simulation	$ 326,819	$ -	$ 711,073	$ -
Advertising/promotion	12,501	218,911	276,993	644,435
Other revenue	11,125	-	33,375	17,080
Total revenue	350,445	218,911	1,021,441	661,515
Cost of sales and services	156,229	122,014	454,108	296,115
Gross margin (loss)	194,216	96,897	567,333	365,400
General and administrative expenses	467,463	393,730	1,379,603	944,344
Loss from operations	(273,247)	(296,833)	(812,270)	(578,944)
Other income (expenses):				
Interest income	16	-	16	-
Interest expense and finance charges	(244,859)	(242,698)	(764,708)	(720,189)
Gain (loss) on sale of asset	-	18,908	500	(16,281)
Other income	301,083	37,264	301,083	37,264
Total other income (expenses)	56,240	(186,526)	(463,109)	(699,206)
Net loss from continuing operations	(217,007)	(483,359)	(1,275,379)	(1,278,150)
Income (loss) from discontinued operations	-	-	-	(53,453)

Net loss	$ (217,007)	$ (483,359)	$(1,275,379)	$(1,331,603)
Weighted average shares outstanding	51,989,468	44,413,497	50,759,939	40,574,782
Basic and diluted net loss per common share	$ (0.00)	$ (0.01)	$ (0.03)	$ (0.03)

See accompanying notes to financial statements.

VIRTRA SYSTEMS, INC.

STATEMENT OF CASH FLOWS

for the nine months ended September 30, 2004 and 2003

	Nine Months Ended September 30, 2004	2003
Cash flows from operating activities:		
Net loss	$(1,275,379)	$(1,331,603)
Less: net loss from discontinued operations	-	(53,453)
Net loss from continuing operations	(1,275,379)	(1,278,150)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	74,747	66,809
Gain (loss) on sale of assets	(500)	16,281
Gain from write off of liabilities	(281,093)	-
Bad debt expense	72,321	-
Amortization of debt issuance costs and increase in obligation under product financing arrangements	566,993	602,306
Stock issued for interest and financing fees	-	7,786
Stock issued as compensation for services	9,900	70,000
Change in operating assets and liabilities	(131,634)	(21,398)
Net cash used in operating activities	(964,645)	(536,366)
Cash flows from investing activities:		
Purchase of property and equipment	(78,649)	(48,970)
Proceeds from sale of assets	500	120,000
Increase in product development costs	(104,130)	-
Net cash provided by investing activities	(182,279)	71,030
Cash flows from financing activities:		

Proceeds from notes payable	240,000	35,000
Payments on notes payable	(140,901)	(107,012)
Increase (decrease) in book overdraft	34,346	7,266
Proceeds from issuance of common stock	932,609	452,404
Net cash provided by financing activities	1,066,054	387,658
Net cash provided by (used in) discontinued operations	-	(20,764)
Net increase (decrease) in cash and cash equivalents	(80,870)	(98,442)
Cash and cash equivalents at beginning of period	80,870	98,442
Cash and cash equivalents at end of period	$ -	$ -
Supplemental disclosure of cash flow information:		
Interest paid	$ 34,702	$ 30,607
Income taxes paid	$ -	$ -
Non-cash investing and financing activities:		
Common stock issued upon conversion of debentures	$ -	$ 204,598
Common stock issued as settlement of accounts payable	$ 48,256	$ -

See accompanying notes to financial statements.

VIRTRA SYSTEMS, INC.

STATEMENTS OF STOCKHOLDERS DEFICIT

for the nine months ended September 30, 2004

	Common Stock		Additional Paid-In	Accumulated	
	Shares	**Amount**	**Capital**	**Deficit**	**Total**
Balance at December 31, 2003	48,568,628	$ 242,843	$4,174,747	$(13,319,907)	$(8,902,317)
Common stock issued for services	30,000	150	9,750	-	9,900
Common stock issued for cash	3,437,607	17,188	915,421	-	932,609
Common stock issued as settlement of					
accounts payable	225,000	1,125	47,131	-	48,256
Net loss	-	-	-	(1,275,379)	(1,275,379)
Balance at September 30, 2004	52,261,235	$ 261,306	$5,147,049	$(14,595,286)	$(9,186,931)

See accompanying notes to financial statements.

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VIRTRA SYSTEMS, INC.

NOTES TO FINANCIAL STATEMENTS

1.

Basis of Presentation

The accompanying unaudited interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules of the U.S. Securities and Exchange Commission, and should be read in conjunction with the audited financial statements and notes thereto for the year ended December 31, 2003. They do not include all information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. However, except as disclosed herein, there has been no material change in the information disclosed in the notes to the financial statements for the year ended December 31, 2003 included in the Company s Form 10-KSB and Form DEF 14A filed with the Securities and Exchange Commission. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of financial position and the results of operations for the interim periods presented have been included. Operating results for the interim periods are not necessarily indicative of the results that may be expected for the respective full year.

2.

Use of Estimates

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 reported amounts and related disclosures. Actual results could differ from those estimates.

3.

Income Taxes

The difference between the 34% federal statutory income tax rate and amounts shown in the accompanying interim financial statements is primarily attributable to an increase in the valuation allowance applied against the tax benefit from the future utilization of net operating loss carryforwards.

4.

Discontinued Operations

On April 30, 2003, VirTra Systems, Inc. (the Company) entered into an agreement to sell its contracts and the assets used in its theme park operations for $120,000, payable in four equal installments of $30,000 upon signing of the term sheet; $30,000 on April 30, 2003; $30,000 on May 31, 2003; and $30,000 on June 30, 2003. The transaction resulted in a gain on sale of assets of $2,628.

The financial statements have been presented to reflect the sale of the Company s assets related to its theme park operations. Accordingly, the financial statements reflect the theme park operations as discontinued operations for each of the periods presented.

Total revenues included in discontinued operations was $-0- and $32,060 for the nine months ended September 30, 2004 and 2003, respectively. There was no effect on basic and diluted net loss per common share, reported in the accompanying statement of operations, from the results of the discontinued operations.

5.

Reclassification

Certain amounts reported in the prior period financial statements have been reclassified to the current period presentation.

6.

Other Income

During the three months ended September 30, 2004 the Company settled and wrote off certain notes and accounts payable. Included in other income in the accompanying statement of operations is $301,083 related to these settlements and write offs.

7.

Common Stock

In July 2002, the Company entered into an agreement for up to a maximum $5,000,000 sale of its common stock to Dutchess Private Equities Fund, LP (Dutchess). Under this investment agreement the Company has the right to issue a put notice to Dutchess to purchase the Company s common stock. Put notices cannot be issued more frequently than every seven days. The required purchase price is equal to 92% of the average of the four lowest closing bid prices of the common stock during the five-day period immediately following the issuance of the put notice. Each individual put notice is subject to a maximum amount equal to 175% of the daily average volume of the common stock for the 40 trading days before the issuance of the put notice multiplied by the average of the closing bid prices of the common stock for the three trading days immediately preceding the put notice date. Regardless of the amount stated in a put notice, the maximum amount that Dutchess is required to purchase is the lesser of the amount stated in the put notice or an amount equal to 20% of the aggregate trading volume of the common stock during the five days immediately following the date of the put notice times 92% of the average of the four lowest closing bid prices of the common stock during this five-day period. During the nine months ended September 30, 2004 the Company sold 3,437,607 shares of its common stock for net proceeds of $932,609 under this agreement.

8.

Stock Options and Warrants

The Company periodically issues incentive stock options to key employees, officers, directors and outside consultants to provide additional incentives to promote the success of the Company s business and to enhance the ability to attract and retain the services of qualified persons. There were no stock options or warrants issued during the nine months ended September 30, 2004.

In 1997 and 1998 the Company granted incentive stock options to certain officers and members of the Company s board of directors to purchase 1,499,000 shares of the Company s common stock at par value of $.005 per share. These options are exercisable based on various levels of the Company s stock price: (i) options to purchase 333,000 shares at par value are exercisable if the Company s stock is trading at $1.50 per share; (ii) options to purchase 583,000 shares at par value are exercisable if the Company s stock is trading at $3.00 per share; (iii) options to purchase 333,000 shares at par value are exercisable if the Company s stock is trading at $4.50 per share; and (iv) options to purchase 250,000 shares at par value are exercisable if the Company s common stock is trading at $5.00 per share. In 1999, options to purchase 300,000 shares of common stock were exercised. There is no expiration date on these options; however, these options were cancelled during 2004.

In September 2001 the Company granted incentive stock options to certain officers and members of the Company s board of directors to purchase 1,499,000 shares of the Company s common stock at par value of $.005 per share. These options are exercisable based on various levels of the Company s stock price: (i) options to purchase 333,000 shares at par value are exercisable if the Company s stock is trading at $1.50 per share; (ii) options to purchase 583,000 shares at par value are exercisable if the Company s stock is trading at $3.00 per share; (iii) options to purchase 333,000 shares at par value are exercisable if the Company s stock is trading at $4.50 per share; and (iv) options to purchase 250,000 shares at par value are exercisable if the Company s common stock is trading at $5.00 per share. There is no expiration date on these options; however, these options were cancelled during 2004.

A summary of the Company s stock option activity and related information for the nine months ended September 30, 2004 and the year ended December 31, 2003 follows:

	Number of Shares Under Options	**Weighted-Average Exercise Price**
Outstanding - December 31, 2002	3,523,000	$0.12
Granted	-	
Exercised	-	
Forfeited	(350,000)	$0.15
Outstanding December 31, 2003	3,173,000	$0.12
Granted	-	
Exercised	-	
Forfeited	(2,698,000)	$0.005
Outstanding September 30, 2004	475,000	$0.42
Exercisable September 30, 2004	475,000	$0.42

Following is a summary of outstanding stock options at September 30, 2004:

Number of Shares	Vested	Expiration Date	Weighted Average Exercise Price
150,000	150,000	2006	$0.81
100,000	100,000	-	$0.49
75,000	75,000	-	$0.005
150,000	150,000	2012	$0.21
475,000	$ 475,000		

9.

Going Concern Considerations

During the nine months ended September 30, 2004 and 2003, the Company has defaulted on its notes payable and obligations under product financing arrangements, has continued to accumulate payables to its vendors and has experienced negative financial results as follows:

	2004	2003
Net loss for the nine months ended September 30	$(1,275,379)	$(1,331,603)
Negative cash flows from operations	$ (964,645)	$ (536,366)
Negative working capital	$(9,584,759)	$(9,192,113)

Accumulated deficit	$(14,595,286)	$(13,319,907)
Stockholders deficit	$(9,186,931)	$(8,902,317)

Management has developed specific current and long-term plans to address its viability as a going concern as follows:

The Company s anticipated entry into the training/simulation market was advanced by the aftermath of September 11, 2001. The Company is currently in advanced discussions with representatives of various government authorities regarding use of the Company s technology in detecting and mitigating the risk of similar problems in the future.

The Company is also attempting to raise funds through debt and/or equity offerings. If successful, these additional funds would be used to pay down debt and for working capital purposes.

In the long-term, the Company believes that cash flows from continued growth in its operations will provide the resources for continued operations.

There can be no assurance that the Company s debt reduction plans will be successful or that the Company will have the ability to implement its business plan and ultimately attain profitability. The Company s long-term viability as a going concern is dependent upon three key factors, as follows:

The Company s ability to obtain adequate sources of debt or equity funding to meet current commitments and fund the continuation of its business operations in the near term.

The ability of the Company to control costs and expand revenues from existing or new businesses.

The ability of the Company to ultimately achieve adequate profitability and cash flows from operations to sustain its operations.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The statements contained in this report that are not historical are forward-looking statements, including statements regarding our expectations, intentions, beliefs or strategies regarding the future. Forward-looking statements include our statements regarding liquidity, anticipated cash needs, and availability and anticipated expense levels. All forward-looking statements included in this report are based on information available to us on this date, and we assume no obligation to update any such forward-looking statement. It is important to note that our actual results could differ materially from those in such forward-looking statements. The following discussion and analysis should be read in conjunction with the financial statements and accompanying notes appearing elsewhere in this report.

Overview

Effective May 6, 2002, our name was changed from GameCom, Inc. to VirTra Systems, Inc., pursuant to authority granted to the board of directors by the shareholders at their September, 2001 meeting.

VirTra Systems, Inc. was organized in 1996 to operate theme concept microbrewery restaurants. We closed our microbrewery operations in early 1999.

From 1999, when we closed our microbrewery operations, until we acquired Ferris Productions, Inc. as described below, we devoted substantially all of our efforts to developing our 'Net GameLink™ product.

In February, 2000, we changed our jurisdiction of incorporation from Nevada to Texas.

In September, 2001, we completed the acquisition of Ferris Productions, Inc., a leading developer and operator of virtual reality devices. Ferris designed, developed, distributed, and operated technically-advanced products for the entertainment, simulation, promotion, and education markets. The acquisition provided us with a wider array of products within our industry, an experienced management team, an existing revenue stream, and established distribution channels.

The Ferris acquisition was accounted for as a pooling of interests. Ferris was much larger than GameCom in terms of assets, and had substantial revenues whereas GameCom had essentially no revenues at the time of the acquisition.

Our *"immersive virtual reality™"* devices are computer-based, and allow participants to view and manipulate graphical representations of physical reality. Stimulating the senses of sight, sound, touch, and smell simultaneously, our virtual reality devices envelop the participant in dynamic filmed or computer-generated imagery, and allow the participant to interact with what he or she sees using simple controls and body motions. Our historic areas of application have included the entertainment/amusement, advertising/promotion, and training/simulation markets.

We sold our entertainment/amusement sector -- our VR Zones -- in the spring of 2003, in order to more fully focus on the advertising/promotional and training/simulation markets.

We entered the advertising/promotion market with our 2000 *"Drive With Confidence Tour™"* for Buick, featuring a virtual reality "test-drive" of a Buick LeSabre with PGA professional Ben Crenshaw accompanying the participant. This project led us to additional projects within this market, such as:

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a virtual reality bi-plane experience for Red Baron® Pizza,

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a virtual reality ski jump promotional program for Chevrolet in conjunction with its *"Olympic Torch City Celebration Tour™,"*

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an interactive promotional project for Shell Oil Product's Pennzoil® division's *"Vroom Tour*™", which featured Jay Leno "inside" an automobile engine demonstrating how oil functions inside an automobile engine, and ended with the visitor driving Pennzoil's Formula One car around the Las Vegas Motor Speedway at speeds in excess of 220 miles per hour,

.

a 50-seat, 3-D immersive theatre for Red Baron® Pizza's *"3-D Flying Adventure™,"* which featured special glasses, Dolby® 5.1 sound, and special effects that literally jump off the screen, and

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a recruitment tool for the United States Army, in which participants ride in an Army Black Hawk helicopter performing an exciting rescue mission.

In May of 2004 we announced our new non-headset virtual reality delivery system for the advertising/promotional market, named the Immersa-Dome™." We hold exclusive rights to the patent behind the Immersa-Dome's technology, and in June of 2004 recently delivered our initial sale of four Immersa-Domes to Buick for display in conjunction with its sponsorship of the PGA Tour. Since June, we have sold an additional six Immersa-Dome systems, three to the U.S. Army to assist in its recruiting efforts, and three to Red Baron™ Pizza for upgrading its Red Baron museum. In October of 2004 we completed a mobile promotional tour by which we demonstrated the Immersa-Dome s capabilities to 134 individuals at 20 Fortune 500 companies and major advertising agencies. We are currently in advanced discussions regarding sales of the Immersa-Domes to, among others, several large advertising agencies, major automobile manufacturers, a major brewer, the United States Army, and the United States Navy.

Our long-planned entry into the training/simulation market was advanced by the aftermath of September 11, 2001. During the past two and one-half years, we have gained valuable market feedback from direct contact, meetings with, and demonstrations to several governmental agencies that resulted in completing the design of our patent-pending virtual reality-based training systems for judgmental use-of-force and tactical judgment objectives. The systems provide the law enforcement, military, and security markets with a first-of-its-kind 360-degree immersive training environment. Our projection-based, patent-pending IVR HD™ series was completed in January of 2004, and was publicly debuted to the domestic law enforcement market in late March of 2004 at the industry's Trexpo West trade show in Long Beach, California. We announced our initial sale in this market in September of 2003, and, as of November 1, 2004, we have announced orders for 27 systems, all variations of the IVR HD series, to the United States Air Force, the United States Army, an undisclosed United States military branch, and to federal, state, and municipal police organizations in the United States, Mexico, and India. We have made proposals and/or are in current discussions and negotiations for the sale of as many as 149 additional IVR HD systems.As of November 1, 2004, we had shipped and/or delivered and installed seven systems, a demonstration system in Mexico City, to regional law enforcement training centers in Mexico City and Veracruz, Mexico, two deliveries to the United States Air Force, and an initial delivery to the United States Army.

We intend to unveil our most recent training system, the IVR 4G™ series, designed for "fourth-generation" warfare, at the industry-leading I/ITSEC tradeshow in early December. The IVR 4G simulator is an advanced military-type system, allowing full squad training.

We have developed significant ongoing relationships with numerous domestic and international security-related municipal, state, and federal agencies, and branches of the military, which have resulted in the submission of numerous confidential proposals currently under review, as well as strategic relationships with large federal defense contractors. We have numerous scheduled demonstrations over the next few months to branches of the United States and foreign militaries, as well as to domestic and international law enforcement agencies.

We face all the risks, expenses, and difficulties frequently encountered in connection with the expansion and development of a business, difficulties in maintaining delivery schedules if and when volume increases, the need to develop support arrangements for systems at widely dispersed physical locations, and the need to control operating and general and administrative expenses. While the Ferris acquisition provided an established stream of revenues and historically favorable gross margins, Ferris had not yet generated a profit, and substantial additional capital, or major highly-profitable custom applications, will be needed if those operations are to become profitable.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue, and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. These estimates and assumptions provide a basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions, and these differences may be material.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements.

Revenue Recognition

Revenue from custom application contracts are recognized on a percentage-of-completion basis, measured by the percentage of costs incurred to date to total estimated costs for each contract. Contract costs include all direct material and labor costs, and those indirect costs related to contract performance, such as indirect labor, supplies, tools, repairs, and depreciation costs. General and administrative costs are charged to expense as incurred.

Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions, and estimated profitability may result in revisions to costs and income, and are recognized in the period in which the revisions are determined. An amount equal to contract costs attributable to claims is included in revenue when realization is probable and the amount can be reliably estimated.

Costs and estimated earnings in excess of billings on uncompleted contracts represent revenue recognized in excess of amounts billed. Billings in excess of costs and estimated earnings on uncompleted contracts represent amounts billed in excess of revenue recognized.

<u>Loss Per Share</u>

Basic and diluted loss per share is computed on the basis of the weighted average number of shares of common stock outstanding during each period. Common equivalent shares from common stock options and warrants are excluded from the computation as their effect would dilute the loss per share for all periods presented.

<u>Stock-Based Compensation</u>

We account for our stock compensation arrangements under the provisions of Accounting Principles Board (APB) No. 25 Accounting for Stock Issued to Employees. We provide disclosure in accordance with the disclosure-only provisions of Statement of Financial Accounting Standard (SFAS) No. 123 Accounting for Stock-Based Compensation.

Results of Operations

Three Months Ended September 30, 2004 Compared to Three Months Ended September 30, 2003

Two major factors affected our results of operations for the three months ended September 30, 2004, compared to the corresponding period of 2003. First, revenue increased. Second, we incurred a gain of $301,083 as the result of writing off a note payable and certain accounts payable.

Revenues from our virtual reality product lines are somewhat unpredictable. Our products are custom made to a particular client s needs and delivery schedules. Thus, our products tend to consist of a few large projects at any time, and the stage of completion of any particular project can significantly affect revenue. We had total revenue of $350,445 for the three months ended September 30, 2004, compared to $218,911 for the corresponding three months of 2003. Our revenue is now broken down in our statement of operations into our two markets, training/simulation and advertising/promotion. Revenue for the period consisted of a) $326,819 for the training/simulation market, primarily of monies received for two IVR HD-300 training simulators recently delivered to the United States Army and the United States Air Force, and initial preparation of the multi-system sale to Mexico, and b) $12,501 for the advertising/promotional market, primarily of monies received from Schwans/Red Baron Pizza for the Red Baron museum and warranty for the Red Baron promotional system. Cost of sales and services increased less than proportionally to our increased revenue, primarily due to increased efficiency and economies of scale in constructing our IVR HD simulators.

General and administrative expense increased to $467,463 for the three months ended September 30, 2004, compared to $393,730 for the corresponding period of 2003, primarily due to increase in payroll as we increase our staff in order to handle future sales. Interest expense and finance charges remained essentially the same at $244,859 for the three months ended September 30, 2004, compared to $242,698 for the corresponding period of 2003.

Nine months Ended September 30, 2004 Compared to Six Months Ended September 30, 2003

Four major factors affected our results of operations for the nine months ended September 30, 2004, compared to the corresponding period of 2003. First, revenues increased. Second, cost of sales increased. Third, general and administrative expense increased. Finally, we incurred a gain on the write-off of liabilities.

We had revenue of $1,021,441 for the nine months ended September 30, 2004, compared to $661,515 for the corresponding nine months of 2003. Revenue consisted of a) $711,073 for the training/simulation market, primarily of monies received for five IVR HD-300 training simulators recently delivered to Mexico City, Vera Cruz, Mexico, the United States Air Force, and the United States Army, and initial preparation of the multi-system sale to Mexico, and b) $276,993 for the advertising/promotional market, primarily of monies received from Schwans (Red Baron Pizza™) for a promotional experience at its new flight museum, from our project for Bombardier's Sea Doo division, from the United States Army for the Black Hawk helicopter recruitment project, and from Buick for the recently-delivered Immersa-Dome system. Cost of sales and services increased less than proportionally to our increased revenue, primarily due to increased efficiency and economies of scale in constructing our IVR HD simulators.

General and administrative costs of $1,379,603 for the nine months ended September 30, 2004, compared to $944,344 for the nine months ended September 30, 2003, increased primarily due to an increase in payroll as we staff up to handle future sales. Interest expense and finance charges increased to $764,708 for the nine months ended September 30, 2004, compared to $720,189 for the corresponding period of 2003.

Liquidity and Plan of Operations

As of September 30, 2004, our liquidity position was extremely precarious. We had current liabilities of $10,079,270, including $6,612,076 in obligations under the lease financing for the old Ferris Productions virtual reality systems, $827,494 in accounts payable, and short-term notes payable of $1,787,852, some of which were either demand indebtedness or were payable at an earlier date and were in default. As of September 30, 2004, there was only $494,511 in current assets available to meet those liabilities.

To date we have met our capital requirements by acquiring needed equipment under the Ferris non-cancelable leasing arrangements, through capital contributions, loans from principal shareholders and officers, certain private placement offerings, and through our convertible debenture and equity line financing with Dutchess Private Equities Fund, L.P.

For the nine months ended September 30, 2004, our net loss was $(1,275,379). After taking into account the non-cash items included in that loss, our cash requirements for operations were $964,645. In addition, we made capital expenditures of $78,649 and repaid notes in the amount of $140,901. To cover these cash requirements, we used existing cash, borrowed $240,000 on a promissory note, and issued 3,437,607 shares of our common stock under the Dutchess equity line, for net cash proceeds of $932,609.

The opinion of our independent auditor for the year ended December 31, 2003 expressed substantial doubt as to our ability to continue as a going concern. We will need substantial additional capital or new lucrative custom application projects to become profitable. In July of 2002, we entered into a financial contract with Dutchess Private Equities Fund, L.P. Under this arrangement, Dutchess is to purchase up to $5 million of our common stock over the next two years under an equity line. The number of shares we may sell to Dutchess is based upon the trading volume of our stock. Dutchess and several other investors also participated in a private placement of $450,000 in convertible debentures, which has been repaid in full. We recently borrowed an additional $240,000 from Dutchess on a promissory note, to be repaid in full on or before December 23, 2004. Based on recent increases in the stock's trading volume following our entry into the training/simulation market, management believes that this equity line will allow us to continue our operations for at least the next twelve months.

However, operations will require the continued forbearance of the holders of various notes and equipment leases that are currently in default. On November 9, 2004, we forwarded to the holders of our old Ferris equipment leasing arrangements, and to our old GameCom promissory noteholders, an exchange offer, under which these leaseholders and noteholders may convert their leases and notes to shares of our common stock. If our proposal is accepted by 85 percent in interest of these leaseholders and noteholders, it would eliminate approximately $7,800,000 of liability from our balance sheet, save us approximately $225,000 in accrued interest per quarter, and make it much more likely that we could conclude on acceptable terms an offering of our common shares in the public market, or attract investment capital on acceptable terms. However, there can be no assurance that we will achieve the required 85 percent approval by the exchange offer s stated termination date of November 30, 2004.

Item 3.

Controls and Procedures

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our chief executive officer and the chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures in accordance with Rule 13a-15 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based on this evaluation, our chief executive officer and the chief financial officer concluded that our disclosure controls and procedures are effective for gathering, analyzing and disclosing the information that we are required to disclose in the reports we file under the Exchange Act, within the time periods specified in the SEC's rules and forms. Our chief executive officer and the chief financial officer also concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to our company required to be included in our periodic SEC filings.

There have been no significant changes in our internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K.

(a) Exhibits

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Chief Executive Officer and Chief Financial Officer - Rule 13a-15(e) Certification

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Chief Executive Officer and Chief Financial Officer - Sarbanes-Oxley Act Section 906 Certification

(b) We have not filed any reports on Form 8-K during the last quarter of the period covered by this report.

SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

VIRTRA SYSTEMS, INC.

Date: November 15, 2004	/s/ L. Kelly Jones
	L. Kelly Jones
	chief executive officer and chief financial 0fficer