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NIGHTHAWK SYSTEMS INC  
Form 10QSB  
May 20, 2005

U.S. SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-QSB

(Mark One)

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

For the quarterly period ended March 31, 2005

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-30786

NIGHTHAWK SYSTEMS, INC  
-----

(Exact name of small business issuer as specified in its charter)

Nevada  
-----

87-0627349  
-----

(State or other jurisdiction of  
incorporation or organization)

(I.R.S  
Employer Identification No.)

10715 Gulfdale, Suite 200  
San Antonio, TX 78216  
-----

(Address of principal executive offices)

210 341-4811  
-----

(Issuer's telephone number)

\_\_\_\_\_  
(Former name, former address and former fiscal year, if changed since last  
report)

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

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY  
PROCEEDINGS DURING THE PRECEDING FIVE YEARS

Check whether the registrant filed all documents and reports required to be  
filed by Section 12, 13 or 15(d) of the Exchange Act after the distribution of  
securities under a plan confirmed by a court. Yes  No

APPLICABLE ONLY TO CORPORATE ISSUERS

As of May 5, 2005 there were 37,025,035 shares of common stock, par value \$.001  
per share, of the registrant issued and outstanding.

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

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## PART I - FINANCIAL INFORMATION

### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors  
Nighthawk Systems, Inc.

We have reviewed the accompanying condensed consolidated balance sheet of Nighthawk Systems, Inc. and subsidiary as of March 31, 2005, the related condensed consolidated statements of operations for the three-month periods ended March 31, 2005 and 2004, the condensed consolidated statement of stockholders' deficit for the three-month period ended March 31, 2005, and the condensed consolidated statements of cash flows for the three-month periods ended March 31, 2005 and 2004. These interim condensed consolidated financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying condensed consolidated financial statements referred to above for them to be in conformity with accounting principles generally

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accepted in the United States of America.

GHP Horwath, P.C.

Denver, Colorado

May 12, 2005

### Nighthawk Systems, Inc. Condensed Consolidated Balance Sheet March 31, 2005

#### ASSETS

##### Current assets:

Cash . . . . .	\$	47,099
Accounts receivable, net of allowance for doubtful accounts of \$134	\$	81,508
Inventories . . . . .		36,685
Prepays. . . . .		102,750
		-----
Total current assets. . . . .		268,042
		-----

Furniture, fixtures and equipment, net . . . . .		13,359
Intangible and other assets. . . . .		13,742
		-----
	\$	295,143
		=====

#### LIABILITIES AND STOCKHOLDERS' DEFICIT

##### Current liabilities:

Accounts payable . . . . .	\$	383,515
Accrued expenses . . . . .		211,708
Line of credit . . . . .		19,792
Notes payable:		
Related parties. . . . .		15,190
Other. . . . .		774,747
		-----
Total current liabilities . . . . .		1,404,952
		-----

##### Long-term liabilities:

Convertible debt. . . . .		183,145
		-----

##### Commitments and contingencies

##### Stockholders' deficit:

Preferred stock, \$0.001 par value; 5,000,000 shares authorized; 5,000 issued and outstanding; liquidation preference \$12,500 . . . . .		12,500
Common stock; \$0.001 par value; 200,000,000 shares authorized; 35,394,735 issued and outstanding. . . . .		35,395

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Special warrants . . . . .	188,775
Additional paid- in capital. . . . .	4,453,998
Accumulated deficit. . . . .	(5,983,622)
	-----
Total stockholders' deficit . . . . .	(1,292,954)
	-----
	\$ 295,143
	=====

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

Nighthawk Systems, Inc.  
Condensed Consolidated Statements of Operations  
Three months ended March 31,

	2005	
	-----	-----
Revenue. . . . .	\$ 171,222	\$ 102,000
Cost of goods sold . . . . .	104,524	72,000
	-----	-----
Gross profit. . . . .	66,698	30,000
Selling, general and administrative expenses . . . . .	561,660	276,000
	-----	-----
Loss from operations. . . . .	(494,962)	(246,000)
Interest expense:		
Related parties . . . . .	691	3,000
Other . . . . .	130,627	18,000
	-----	-----
Total interest expense. . . . .	131,318	21,000
	-----	-----
Net loss . . . . .	(626,280)	(267,000)
Less: preferred stock dividends. . . . .	(219)	-
	-----	-----
Net loss to common stockholders. . . . .	\$ (626,499)	\$ (267,000)
	=====	=====
Net loss per basic and diluted common share. . . . .	\$ (0.02)	\$ (0.02)
	=====	=====
Net loss to common stockholders per basic and diluted common share . . . . .	\$ (0.02)	\$ (0.02)
	=====	=====
Weighted average common shares outstanding - basic and diluted . . . . .	33,733,867	24,958,000

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

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Nighthawk Systems, Inc.

Condensed Consolidated Statements of Stockholders' Deficit

Three months ended March 31, 2005

	Preferred Stock		Common stock			Additional paid-in capital	Special Warrants
	Shares	Amount	Shares	Amount			
Balances, December 31, 2004	5,000	\$ 12,500	31,959,247	\$ 31,960		\$3,884,516	\$ 188,77
Common stock issued, and puts and warrants exercised for cash . . . . .			1,971,310	1,971		310,576	
Common stock issued as incentive for notes payable			250,000	250		52,250	
Common stock and options issued for consulting services			650,000	650		119,350	
Conversion of accrued expenses to common stock			313,100	313		56,307	
Conversion of notes payable to common stock. .			250,000	250		31,000	
Series A preferred dividend . . . . .			1,078	1		(1)	
Net loss . . . . .							
Balances, March 31, 2005. .	5,000	\$ 12,500	35,394,735	\$ 35,395		\$4,453,998	\$ 188,77

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

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NIGHTHAWK SYSTEMS, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 THREE MONTHS ENDED MARCH 31,

	2005	2004
	-----	-----
Cash flows from operating activities:		
Net loss . . . . .	\$ (626,280)	\$ (267,199)
	-----	-----
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization . . . . .	1,681	1,928
Amortization of loan discounts and warrants . . . . .	66,063	-
Common stock issued for consulting services . . . . .	15,000	33,060
Amortization of incentive interest on notes payable . . . . .	50,250	-
Amortization of prepaid consulting expenses . . . . .	121,666	-
Changes in assets and liabilities:		
(Increase) decrease in accounts receivable . . . . .	(35,754)	28,955
(Increase) decrease in inventories . . . . .	(9,976)	25,183
Decrease in prepaids . . . . .	23,596	-
Decrease in other assets and liabilities . . . . .	-	665
Decrease in accounts payable . . . . .	(38,739)	(51,595)
Increase in accrued expenses . . . . .	24,275	88,313
	-----	-----
Total adjustments . . . . .	218,062	126,509
	-----	-----
Net cash used in operating activities of continuing operations.	(408,218)	(140,690)
	-----	-----
Cash flows from investing activities:		
Purchases of furniture, fixtures and equipment . . . . .	(1,973)	-
	-----	-----
Net cash used in investing activities . . . . .	(1,973)	-
	-----	-----
Cash flows from financing activities:		
Cash overdraft . . . . .	-	(3,902)
Proceeds from the sale of preferred stock . . . . .	-	7,500
Proceeds from notes payable, related parties . . . . .	339	-
Payments on notes payable, related parties . . . . .	(550)	(9,169)
Proceeds from notes payable, other . . . . .	225,000	-
Payments on notes payable, other . . . . .	(127,765)	(9,299)
Payments on long term notes payable . . . . .	(13,399)	-
Payments on other related party payable . . . . .	-	(18,750)
Net proceeds from the sale of common stock, and the exercise of puts and warrants . . . . .	312,547	177,350
	-----	-----
Net cash provided by financing activities . . . . .	396,172	143,730
	-----	-----
Net (decrease) increase in cash . . . . .	(14,019)	3,040
	-----	-----
Cash, beginning balance . . . . .	61,118	-
	-----	-----
Cash, ending balance . . . . .	\$ 47,099	\$ 3,040
	=====	=====

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CONDENSED CONSOLIDATE STATEMENTS OF CASH FLOWS  
(CONTINUED)

Supplemental disclosures of cash flow information: . . . . .	THREE MONTHS END 2005 -----
Cash paid for interest . . . . .	\$ 18,312 =====
Supplemental disclosure of non-cash investing and financing activities:	
Common shares issued as incentive interest on notes payable . . . . .	\$ 52,500 =====
Common shares issued for prepaid consulting agreements . . . . .	\$ 105,000 =====
Conversion of accrued expenses to common stock . . . . .	\$ 56,620 =====
Conversion of notes payable and accrued interest to common stock	
Notes payable . . . . .	\$ 29,498
Accrued interest. . . . .	1,752 -----
Total amount converted . . . . .	\$ 31,250 =====
Preferred stock dividends issued in common stock . . . . .	\$ 219 =====

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

NIGHTHAWK SYSTEMS, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
THREE MONTHS ENDED MARCH 31, 2005 AND 2004  
(unaudited)

1. Organization, going concern, results of operations and management's plans

Organization

Nighthawk Systems, Inc. ("the Company") designs and manufactures intelligent remote power control products that are easy to use, inexpensive and can remotely control virtually any device from any location. The Company's proprietary, wireless products are ready to use upon purchase, so they are easily installed by anyone, regardless of technical ability, and are also easily integrated into third-party products, systems and processes. They allow for intelligent control by interpreting instructions sent via paging and satellite media, and executing the instructions by 'switching' the electrical current that powers the device, system or process. Nighthawk's intelligent products can be activated individually, in pre-defined groups, or en masse, and for specified time periods with a simple click of a mouse or by dialing a telephone number.

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Going concern, results of operations and management's plans

The Company incurred a net loss of approximately \$1.38 million during the year ended December 31, 2004 and a net loss of approximately \$626,000 during the quarter ended March 31, 2005. The Company had a stockholders' deficit and working capital deficiency of approximately \$1.24 million and \$1.04 million, respectively, as of December 31, 2004 and \$1.29 million and \$1.14 million respectively, as of March 31, 2005. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Although no assurance can be given that such plans will be successfully implemented, management's plans to address these concerns include:

1. Raising working capital through additional borrowings.
2. Raising equity funding through sales of the Company's common stock.
3. Implementation of a sales and marketing plan.

In August 2004, the Company signed a financing arrangement with Dutchess Private Equities, II, L.P. ("Dutchess") which was amended on August 26, 2004 and on September 24, 2004. Under the terms of the amended arrangement, the Company received \$100,000 under a convertible debenture on August 11, 2004, \$25,000 on August 26, 2004, and \$125,000 under the debenture on September 27, 2004. Interest accrues on the debenture at an annual rate of 8%. The debenture can be converted into common shares anytime prior to its maturity on August 10, 2007 at the lesser of (i) 73% of the lowest closing bid price on the date of conversion, or (ii) twelve and a half cents (\$0.125). Any portion of the debenture that remains outstanding at August 10, 2007 will automatically convert into common shares. The number of shares converted at any time is limited so as not to exceed 4.99% of the outstanding shares of Nighthawk common stock outstanding. In addition, Dutchess was issued a warrant to purchase up to 250,000 shares of common stock at a price of twelve and a half cents (\$0.125) for a period of up to five years. Dutchess also required the Company to hire Edgarization, LLC for consulting services and Nighthawk issued the consulting company 500,000 shares of common stock. The Company recorded the fair value of these shares as prepaid consulting and will expense their value over the term of the agreement. The Company also signed an investment agreement under which Dutchess agreed to purchase up to \$10.0 million in common stock from the Company, at the Company's discretion, over the next three years, subject to certain limitations including the Company's then current trading volume.

Although the amount and timing of specific cash infusions available under the entire financing arrangement cannot be predicted with certainty, the arrangement represents a contractual commitment by Dutchess to provide funds to the Company.

On December 3, 2004 Dutchess loaned the Company an additional \$250,000. The note had no stated interest rate but had a face amount of \$300,000 and matured April 3, 2005. Under the terms of the note, Dutchess was issued 250,000 incentive shares of common stock. The Company recorded the fair value of these incentive shares as prepaid interest, and will expense their value over the term of the note. Dutchess also required the Company to hire Edgarization, LLC for consulting services and Nighthawk issued the consulting company 500,000 shares of common stock. The Company recorded the fair value of these shares as prepaid consulting and will expense their value over the term of the agreement. The implied annual rate of interest is 119.7%. The note was intended to be repaid via puts exercised under the investment agreement with the Company making payments of the greater of \$75,000 every 30 days or 50% of each put until the note is paid in full. The note was repaid on April 7, 2005 with a partial use of the proceeds of a new note.

On January 18, 2005, Dutchess loaned the Company an additional \$225,000. The note has no stated interest rate but has a face amount of \$270,000 and matures on May 18, 2005. Under the terms of the note, Dutchess was issued 250,000 incentive shares of common stock. The Company recorded the fair value of these



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incentive shares as prepaid interest, and will expense their value over the term of the note. Dutchess also required the Company to hire Edgarization, LLC for consulting services and Nighthawk issued the consulting company 500,000 shares of common stock. The Company recorded the fair value of these shares as prepaid consulting and will expense their value over the term of the agreement. The implied annual rate of interest is 194.5%.

On April 7, 2005, Dutchess loaned the Company an additional \$488,500. The note has no stated interest rate but has a face amount of \$586,200 and matures on June 7, 2005. A portion of the proceeds of this loan was used to repay the note dated December 3, 2004 with a face amount of \$300,000, which matured on April 3, 2005. Under the terms of the note, Dutchess was issued 250,000 incentive shares of common stock. The Company recorded the fair value of these incentive shares as prepaid interest, and will expense their value over the term of the note. Dutchess also required the Company to hire Edgarization, LLC for consulting services and Nighthawk issued the consulting company 300,000 shares of common stock. The Company recorded the fair value of these shares as prepaid consulting and will expense their value over the term of the agreement.

During the period from January 1, 2005 through March 31, 2005, the Company exercised five (5) puts to Dutchess totaling 1,071,310 shares for net proceeds of \$183,797. Of the total proceeds, \$125,633 was used to repay portions of previously issued notes to Dutchess and \$58,164 went to the Company.

On March 9, 2005, Dutchess exercised 250,000 warrants at \$0.125 each, for total proceeds of \$31,250, \$15,000 of which was applied to outstanding notes.

Also during the period from January 1, 2005 through March 31, 2005, Dutchess elected to convert a total of \$31,250 of the 36-month convertible note for 250,000 shares of the Company's common stock.

During the period from April 1, 2005 through May 5, 2005, the Company exercised one (1) put to Dutchess totaling 205,300 shares for proceeds of \$29,255.

During the period from April 1, 2005 through May 5, 2005, Dutchess elected to convert a total of \$76,250 of the 36-month convertible note for 625,000 shares of the Company's common stock.

Although no assurance may be given that it will be able to do so, the Company expects to be able to continue to access funds under this arrangement to help it fund near-term and long-term sales and marketing efforts, and to cover cash flow deficiencies.

The sales and marketing plan for 2005 includes the following:

- Hiring sales and marketing personnel. The Company increased its sales force in the first quarter of 2005 with experienced salespeople with the goal of effectively targeting existing and new markets.
- Product marketing including print media and attendance at trade shows. This method has proved the most effective for the Company to date, and it plans to increase its presence in these areas to attract new customers.
- An improved Internet presence. The Company launched a new website in May 2005 to improve content and to make the site more friendly to search engines. The Company has plans to add e-commerce functionality at a future date.
- Leveraging existing customer relationships by up-selling new products or fully integrating systems with the Company's products.

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- The establishment of distribution and dealer networks. Through an effective dealer network, the Company can increase awareness in its products and utilize a dealer's sales force to actively promote its products.
- New applications in irrigation control, civil defense and emergency management. The current product design can be altered with little cost to the Company to be effectively implemented into a wide array of fields. Through the commitment of funding, the Company can now research all possible applications and begin to market directly to new customers.
- The development and launch of a product designed to be used for multiple purposes by consumers.

In addition to the marketing and sales objectives, the Company has identified the following strategic goals for 2005:

- Joint ventures with wireless service providers and equipment manufacturers.
- The identification of complementary products and companies for potential acquisition.

The accompanying financial statements do not include any adjustments relating to the recoverability and classification of assets or the amounts of liabilities that might be necessary should the Company be unsuccessful in implementing these plans, or otherwise be unable to continue as a going concern.

### 2. Basis of presentation

The accompanying unaudited condensed consolidated financial statements, which include the accounts of Nighthawk Systems, Inc. and its subsidiary PCT (collectively referred to herein as "the Company"), have been prepared in accordance with accounting principles generally accepted in the U.S. for interim financial information. In the opinion of management, all adjustments (consisting of only normal recurring items), which are necessary for a fair presentation have been included. The results for interim periods are not necessarily indicative of results that may be expected for any other interim period or for the full year. These condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-KSB for 2004 filed with the Securities and Exchange Commission (the "SEC").

### 3. Significant accounting policies

#### Revenue recognition

Revenue from product sales is recognized when all significant obligations of the Company have been satisfied. Revenues from equipment sales are recognized either on the completion of the manufacturing process, or upon shipment of the equipment to the customer, depending on the Company's contractual obligations. The Company occasionally contracts to manufacture items, bill for those items and then hold them for later shipment to customer-specified locations. The Company had no bill and hold sales at December 31, 2004 or March 31, 2005. Revenue related to airtime billing is recognized when the service is performed. Some customers pre-pay airtime on a quarterly or annual basis and the pre-paid portion is recorded as deferred revenue. Deferred revenue, included in accrued expenses on the balance sheet at March 31, 2005, is approximately \$15,800.

#### Provision for doubtful accounts

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The Company reviews accounts receivable periodically for collectibility and establishes an allowance for doubtful accounts and records bad debt expense when deemed necessary.

### Concentrations

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of trade accounts receivable. Receivables arising from sales to customers are not collateralized and, as a result, management continually monitors the financial condition of its customers to reduce the risk of loss. At March 31, 2005, the Company had approximately \$81,500 in accounts receivable, net of the allowance for doubtful accounts. Approximately \$37,655 of this balance was from one customer, which was collected subsequent to March 31, 2005.

During the three months ended March 31, 2005, one customer accounted for approximately 46% of total revenue. During the three months ended March 31, 2004, one customer accounted for approximately 53% of total revenue.

During the three months ended March 31, 2005, the Company's largest supplier accounted for approximately 68% of the Company's purchases of pre-manufactured component materials.

### Inventories

Inventories consist of parts and pre-manufactured component materials and finished goods. Inventories are valued at the lower of cost or market using the first-in, first-out (FIFO) method.

### Income taxes

Deferred tax assets and liabilities are recorded for the estimated future tax effects of temporary differences between the tax basis of assets and liabilities and amounts reported in the accompanying balance sheets, and for operating loss and tax credit carry forwards. The change in deferred tax assets and liabilities for the period measures the deferred tax provision or benefit for the period. Effects of changes in enacted tax laws on deferred tax assets and liabilities are reflected as adjustments to the tax provision or benefit in the period of enactment. The Company's deferred tax assets have been completely reduced by a valuation allowance because management does not believe realization of the deferred tax assets is sufficiently assured at the balance sheet date.

### Net loss per share

Basic net loss per share is computed by dividing the net loss applicable to common stockholders by the weighted-average number of shares of common stock outstanding for the year. Diluted net loss per share reflects the potential dilution that could occur if dilutive securities were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Company, unless the effect of such inclusion would reduce a loss or increase earnings per share. For the quarter ended March 31, 2005 and the year ended December 31, 2004, the effect of the inclusion of dilutive shares would have resulted in a decrease in loss per share. Accordingly, the weighted average shares outstanding have not been adjusted for dilutive shares.

### Use of estimates

The preparation of the financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses

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during the reporting period. Actual results could differ from those estimates.

### Reclassifications

Certain amounts reported in the consolidated financial statements for the three months ended March 31, 2004 have been reclassified to conform to the March 31, 2005 presentation.

### Stock-based compensation

The Company has adopted Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). The provisions of SFAS 123 allow companies to either expense the estimated fair value of stock options or to continue to follow the intrinsic value method set forth in Accounting Principles Bulletin Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") but disclose the pro forma effects on net income (loss) had the fair value of the options been expensed. The Company has elected to continue to apply APB 25 in accounting for its employee stock option incentive plans.

Under APB 25, where the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation is recognized. As all employee options were issued at or above market during 2004 and the first quarter of 2005, no compensation expense was recognized in either of the periods. If compensation expense for the Company's stock-based compensation plans had been determined consistent with SFAS 123, the Company's net loss and net loss per share including pro forma results would have been the amounts indicated below:

	Three months ended March 31,	
	2005	2004
Net loss applicable to common stockholders:		
As reported . . . . .	\$ (626,499)	\$ (267,199)
Total stock-based employee compensation expense determined under fair value based method for all employee awards, net. . . . .	(6,148)	(3,454)
Pro forma net loss. . . . .	\$ (632,647)	\$ (270,653)
 Net loss per share:		
As reported:		
Basic and diluted . . . . .	\$ (0.02)	\$ (0.01)
Pro forma:		
Basic and diluted . . . . .	\$ (0.02)	\$ (0.01)

The pro forma effect on net loss may not be representative of the pro forma effect on net income or loss of future years due to, among other things: (i) the vesting period of the stock options and the (ii) fair value of additional stock options in future years.

For the purpose of the above table, the fair value of each option grant is estimated as of the date of grant using the Black-Scholes option-pricing model

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with the following assumptions:

Three months ended March 31,  
-----

### Black-Scholes Assumptions

	2005 -----	2004 -----
Dividend yield . . . . .	0.00%	0.00%
Expected volatility . . .	1.31	1.122
Risk-free interest rate .	4.50%	4.50%
Expected life in years . .	2 years	3 years

The weighted average fair value at date of grant for options granted during the first quarter of 2005 was \$0.132 per share using the above assumptions. There were no options granted to employees during the first quarter of 2004.

### Recently issued accounting pronouncements

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123R "Share-Based Payment", which addresses the accounting for share-based payment transactions. SFAS 123R eliminates the ability to account for share-based compensation transactions using APB 25, and instead, generally requires that such transactions be accounted and recognized in the statement of operations based on their fair value. SFAS No. 123R will be effective for small business issuers as of the beginning of the first interim or annual reporting period that begins after December 15, 2005. SFAS No. 123R offers the Company alternative methods of adopting this standard. The Company has not yet determined which alternative method it will use. Depending upon the number and terms of options that may be granted in future periods, the implementation of this standard could have a material impact on the Company's financial position and results of operations.

### 3. Related party transactions

During the year ended December 31, 2004, a business partner of the Company's Chairman billed the Company \$20,000 for consulting services. The liability was settled for 175,000 shares of the Company's common stock in the first quarter of 2005.

### 4. Notes payable

At March 31, 2005, notes payable consist of the following:

#### Related parties:

Note payable, officer; unsecured; interest at prime rate plus 5.5% (10.5% at March 31, 2005); due on demand . . . . .	\$ 10,107
Note payable, officer; unsecured; interest at 23.99%, revolving. . . . .	5,083
	-----

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\$ 15,190  
 =====

Other:

Convertible note payable to stockholder, 8% interest rate, in default as of the date of this report (1) . . . . .	\$160,000
Notes payable to stockholder, 8% interest rate, in default as of the date of this report (1) . . . . .	165,000
Unsecured note with a financial institution, 14.99% interest rate, revolving . . .	23,380
Note payable, \$300,000 face amount, no stated interest rate but with an implied annual rate of 119.7%, due April 3, 2005 (2) . . . . .	300,000
Note payable, \$270,000 face amount, no stated interest rate but with an implied annual rate of 194.5%, due May 18, 2005 (2) . . . . .	126,367
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	\$774,747
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Long Term:

Convertible debenture, 8% interest rate, due July 11, 2007 (2) . . . . .	\$183,144
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