VirTra Systems, Inc.

FINANCIAL STATEMENTS

For the years ended December 31, 2012 and 2011

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Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
VirTra Systems, Inc.

We have audited the accompanying balance sheets of VirTra Systems, Inc. as of December 31, 2012 and 2011 and the related statements of operations, stockholders' deficit, and cash flows for the years then ended. 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 in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also 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, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of VirTra Systems, Inc. at December 31, 2012 and 2011, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Semple, Marchal & Cooper, LLP

Certified Public Accountants

Phoenix, Arizona
March 28, 2013

VIRTRA SYSTEMS, INC.
BALANCE SHEETS
as of DECEMBER 31, 2012 and 2011

	2012	2011
Assets		
Current assets:		
Cash and cash equivalents	$ 372,119	$ 144,051
Accounts receivable, net	462,942	365,720
Inventory	370,019	804,548
Prepaid expenses and other current assets	65,558	157,180
Total current assets	1,270,638	1,471,499
Property and equipment, net	612,380	799,189
Total assets	$ 1,883,018	$ 2,270,688
Liabilities and Stockholders' Deficit		
Current liabilities:		
Accounts payable	$ 227,331	$ 271,734
Accounts payable - related party	-	35,048
Accrued compensation and related costs	335,879	292,028
Accrued expenses and other current liabilities	118,081	131,437
Term loan - short-term	80,499	-
Deferred revenue	1,173,449	1,987,162
Total current liabilities	1,935,239	2,717,409
Long-term liabilities:		
Term loan - long-term	143,636	-
Accrued rent liability - long-term	131,358	114,023
Total liabilities	2,210,233	2,831,432
Commitments and contingencies		
Stockholders' deficit:		
Preferred stock $0.005 par value; 2,000,000 shares authorized; no shares issued or outstanding as of December 31, 2012 and 2011	-	-
Common stock $0.005 par value; 500,000,000 shares authorized; 158,328,245 shares issued and 158,285,045 shares outstanding as of December 31, 2012 and 2011 respectively	791,641	791,641
Additional paid-in capital	13,032,498	12,912,365
Treasury stock at cost, 43,200 common shares as of December 31, 2012 and 2011 respectively	(2,981)	(2,981)
Accumulated deficit	(14,148,373)	(14,261,769)
Total stockholders' deficit	(327,215)	(560,744)
Total liabilities and stockholders' deficit	$ 1,883,018	$ 2,270,688

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

VIRTRA SYSTEMS, INC.
STATEMENTS OF OPERATIONS
For the Years Ended DECEMBER 31, 2012 and 2011

	2012	2011
Net revenues	$ 8,829,555	$ 7,861,780
Cost of products sold	3,280,211	3,797,377
Gross margin	5,549,344	4,064,403
General and administrative expenses	5,411,333	4,754,593
Income/(loss) from operations	138,011	(690,190)
Other income/(expense):		
Other income	2,203	17,249
Other expense	(26,818)	(19,820)
Net other income/(expense)	(24,615)	(2,571)
Income/(loss) before income taxes	113,396	(692,761)
Income tax expense/(benefit)	-	-
Net income/(loss)	$ 113,396	$ (692,761)
Weighted average of common and common equivalent shares outstanding:		
-Basic	158,285,045	158,285,045
-Diluted	161,637,802	158,285,045
Net income/(loss) per common and common equivalent share:		
-Basic	$ 0.00	$ (0.00)
-Diluted	$ 0.00	$ (0.00)

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

VIRTRA SYSTEMS, INC.
STATEMENTS OF STOCKHOLDERS' DEFICIT
For the Years Ended December 31, 2012 and 2011

	Common stock					
	Shares	**Amount**	**Additional paid in capital**	**Treasury Stock**	**Accumulated Deficit**	**Total**
Balance at January 1, 2011,……….	158,328,245	$791,641	$ 12,796,853	$ -	$(13,569,008)	$ 19,486
Net Loss…………………………….	-	-	-	-	(692,761)	(692,761)
Stock-based compensation..………	-	-	115,512	-	-	115,512
Purchase of Common stock……….	(43,200)	-	-	(2,981)	-	(2,981)
Balance at December 31, 2011……	158,285,045	791,641	12,912,365	(2,981)	(14,261,769)	(560,744)
Net Income…………………………	-	-	-	-	113,396	113,396
Stock-based compensation..………	-	-	120,133	-	-	120,133
Balance at December 31, 2012……	158,285,045	$791,641	$ 13,032,498	$ (2,981)	$(14,148,373)	$ (327,215)

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

VIRTRA SYSTEMS, INC.
STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Net income/(loss)	$ 113,396	$ (692,761)
Adjustments to reconcile net income/(loss) to net cash provided by/(used in) operating activities:		
Depreciation and amortization	227,492	202,686
Stock-based compensation	120,133	115,512
Changes in operating assets and liabilities:		
Accounts receivable	(97,222)	(51,654)
Inventory	434,529	197,073
Prepaid expenses and other assets	91,622	(97,227)
Accounts payable and other accrued expenses	3,427	94,313
Deferred revenue	(813,713)	131,295
Due to related parties	(35,048)	(118)
Net cash provided by/(used in) operating activities	44,616	(100,881)
Cash flows from investing activities:		
Purchase of property and equipment	(40,683)	(292,995)
Net cash used in investing activities	(40,683)	(292,995)
Cash flows from financing activities:		
Draws on line of credit	1,655,000	750,000
Repayments of line of credit	(1,655,000)	(750,000)
Proceeds from term loan	250,000	-
Payments on term loan	(25,865)	-
Purchase of common stock	-	(2,981)
Net cash provided by/(used in) financing activities	224,135	(2,981)
Increase/(decrease) in cash and cash equivalents	228,068	(396,857)
Cash and cash equivalents, beginning of period	144,051	540,908
Cash and cash equivalents, end of period	$ 372,119	$ 144,051
Cash paid during the period for:		
Interest	$ 24,429	$ 3,200
Taxes	$ -	$ -

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

VIRTRA SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS

1. Significant Accounting Policies

Organization and Business Operations

VirTra Systems, Inc. (the "Company" or "VirTra") is engaged in the sale and development of judgmental use of force training simulators and firearms training simulators for law enforcement, military and commercial uses. The Company sells simulators worldwide through a direct sales force and international distribution partners. The original business started in 1993 as Ferris Productions, Inc. In September 2001, Ferris Productions, Inc. merged with GameCom, Inc. to ultimately become VirTra Systems, Inc., a Texas Corporation. The corporate office is located in Tempe, Arizona. All transactions are denominated in US dollars.

Basis of Presentation and Use of Estimates

The Company's financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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 period. Significant accounting estimates in these financial statements include valuation assumptions for share-based payments, allowance for doubtful accounts receivable, inventory reserves, accrual for warranty reserves, the carrying value of long-lived assets, income tax valuation allowances and capitalization of labor and overhead to inventory for work in progress. Actual results could differ significantly from those estimates.

Fair Value of Financial Instruments

The fair value of financial instruments approximates their carrying values at December 31, 2012 and 2011 due to their short maturities or for long-term debt based on borrowing rates currently available to the Company for loans with similar terms and maturities. These financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable, accrued liabilities, and debt.

Cash and Cash Equivalents

The Company considers all highly liquid investments with a maturity of 90 days or less at the time of purchase to be cash equivalents.

Accounts Receivable and Allowance for Doubtful Accounts

The Company recognizes an allowance for losses on accounts receivable based on an analysis of historical bad debt experience, current receivables aging, and expected future write-offs, as well as an assessment of specific identifiable customer accounts considered at risk or uncollectible. Accounts receivable are charged off after all reasonable collection efforts have been exhausted. As of December 31, 2012 and 2011, management has determined all receivable balances to be fully collectible and accordingly, no allowance was recognized at such time. Accounts receivable are non-interest bearing and are generally unsecured.

Inventories

Inventories are stated at the lower of cost or market with cost being determined on the first-in, first-out method. Work in progress and finished goods inventory includes an allocation for capitalized labor and overhead. Capitalized labor and overhead included in inventory at December 31, 2012 and 2011 are $2,299 and $98,965, respectively. The Company routinely evaluates the carrying value of inventory and provides reserves when appropriate to reduce inventory to the lower of cost or market to reflect estimated net realizable value. As of December 31, 2012 and 2011, management has determined all inventory is salable at prices greater than cost and accordingly, no reserve has been recognized at December 31, 2012 or 2011.

Property and Equipment

Property and equipment are carried at cost, net of depreciation. Gains or losses related to retirements or disposition of fixed assets are recognized in operations in the period incurred. Costs of normal repairs and maintenance are charged to expense as incurred, while betterments or renewals are capitalized. Depreciation commences at the time the assets are placed in service. Depreciation is provided using the straight-line method over the estimated economic lives of the assets or for leasehold improvements, over the shorter of the estimated useful life or the lease term, which are summarized as follows:

Computer equipment…………………………………………………………	3 - 5 years
Furniture and office equipment……………………………………………….	5 - 7 years
Leasehold improvements………………………………………………………	7 years

Revenue Recognition and Deferred Revenue

Net revenues include sales of products and services. Product sales consist of simulators, upgrade components, recoil kits, Threat-Fire® and other accessories. Services include limited warranties and related support. The Company recognizes revenue for these products and services when it is realized or realizable and earned. Revenue is considered realized and earned when: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred and/or services have been rendered; (iii) the price is fixed and determinable; and (iv) collection of the resulting receivable is reasonably assured. Shipping fees are charged to customers and recorded as a component of net revenues.

Products

Revenue from the sale of products is recognized when title and risk of loss passes to the customer. Delivery is considered complete when products have been shipped to the customer, title and risk of loss has transferred to the customer and customer acceptance has been satisfied. For customers other than United States federal agencies, the Company generally requires deposits in advance of shipment for customer sales orders. Customer deposits are recorded as a current liability under deferred revenue on the accompanying balance sheet and totaled $865,205 and $1,822,532 as of December 31, 2012 and 2011, respectively.

Services

Services include separately priced extended limited warranties on parts and labor, and technical support. Revenue is recognized for service contracts as earned, which is generally on a straight-line basis over the term of the contract. The Company does warranty its products from manufacturing defects on a limited basis for a period of one year after purchase, but also sells separately priced extended warranties for periods of up to four years after the expiration of the standard one year warranty. After the one year standard warranty expires and during the term of the extended warranty, if the device fails to operate properly from defects in materials and workmanship, the Company will fix or replace the defective product. Deferred revenue for separately priced extended warranties totaled $308,244 and $164,630 as of December 31, 2012 and 2011, respectively. The Company's accrual for the one-year manufacturer's warranty liability totaled $40,000 as of December 31, 2012 and 2011.

Cost of products sold

Cost of products sold represents manufacturing costs, consisting of materials, labor and overhead related to finished goods and components. Shipping costs incurred related to product delivery are included in cost of products sold.

Advertising Costs

Costs associated with advertising are expensed as incurred. Advertising expense was approximately $287,000 and $481,000 for the years ended December 31, 2012 and 2011, respectively. These costs include domestic and international tradeshows, website, and sales promotional materials.

Research and Development Costs

Research and development costs are expensed as incurred. Research and development costs primarily include expenses directly related to research and development support. Research and development costs were approximately $1,298,000 and $1,135,000 for 2012 and 2011, respectively.

Concentration of Credit Risk and Major Customers and Suppliers

Financial instruments that potentially subject the Company to concentrations of credit risk consist of cash and cash equivalents and accounts receivable. The Company's cash and cash equivalents are maintained with financial institutions with high credit standings. As of December 31, 2012 and 2011, the Federal Deposit Insurance Corporation ("FDIC") fully insures all non-interest bearing accounts and insures interest bearing accounts not to exceed $250,000 due to a temporary federal program in effect for December 31, 2010 through December 31, 2012. As of December 31, 2012 and 2011, the Company had no uninsured cash and cash equivalents. Sales are typically made on credit and the Company generally does not require collateral. Management performs ongoing credit evaluations of its customers' financial condition and maintains an allowance for estimated losses. Historically, the Company has experienced minimal charges relative to doubtful accounts.

The Company sells its products primarily to federal and state agencies in the United States. In 2012 two customers comprised 14.3% and 12.0% of total net sales. In 2011 one customer represented 24.3% of total net sales. No other single customer exceeded 10% of net sales for 2012 and 2011, respectively. As of December 31, 2012, the Company's accounts receivable balances were with six customers. And as of December 31, 2011, the Company's accounts receivable balances were with two customers.

The Company currently purchases small machined parts, custom cartridge assemblies and electronic components from suppliers located in the United States. Although the Company currently obtains many of these components from single source suppliers, the Company could seek to have the parts, customer cartridges and electronic components manufactured elsewhere. As a result, management believes it could obtain alternative suppliers in most cases without incurring significant production delays. The Company acquires its components on a purchase order basis and does not have long-term contracts with suppliers.

Income Taxes

Deferred tax assets and liabilities are recorded based on the difference between the financial statement and the tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The Company calculates a provision for income taxes using the asset and liability method, under which deferred tax assets and liabilities are recognized by identifying the temporary differences arising from the different treatment of items for tax and accounting purposes. In determining the future tax consequences of events that have been recognized in the financial statements or tax returns, judgment and interpretation of statutes are required.

In assessing the realizability of deferred tax assets, management assesses the likelihood that deferred tax assets will be recovered from future taxable income, and to the extent that recovery is not likely or there is insufficient operating history, a valuation allowance is established. The Company adjusts the valuation allowance in the period management determines it is more likely than not that net deferred tax assets will or will not be realized. As of December 31, 2012 and 2011, the Company has provided a valuation allowance for all net deferred tax assets due to the modest income in 2012 and operating loss in 2011.

As of December 31, 2012 and 2011, the Company did not recognize any assets or liabilities relative to uncertain tax positions. Interest or penalties, if any, will be recognized in income tax expense. Since there are no significant unrecognized tax benefits as a result of tax positions taken, there are no accrued penalties or interest. Tax positions are positions taken in a previously filed tax return or positions expected to be taken in a future tax return that are reflected in measuring current or deferred income tax assets and liabilities reported in the financial statements. Tax positions include, but are not limited to, the following:

- an allocation or shift of income between taxing jurisdictions;
- the characterization of income or a decision to exclude reportable taxable income in a tax return; or
- a decision to classify a transaction, entity or other position in a tax return as tax exempt.

The Company reflects tax benefits only if it is more likely than not that the Company will be able to sustain the tax return position, based on its technical merits. If a tax benefit meets this criterion, it is measured and recognized based on the largest amount of benefit that is cumulatively greater than 50% likely to be realized.

The Company is potentially subject to tax audits for its United States federal and Arizona state income tax returns for tax years ended 2010 to 2012 and 2009 to 2012, respectively; however, earlier years may be subject to audit under certain circumstances. Tax audits by their very nature are often complex and can require several years to complete.

Impairment of Long-lived Assets

Long lived assets, such as equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Fair value is determined based on discounted cash flows or appraised values, depending on the nature of the asset. Assets to be disposed of, if any, would be separately presented in the balance sheet and reported at the lower of their carrying amounts or fair value less costs to sell, and are no longer depreciated. At December 31, 2012 and 2011, the Company concluded that there has been no impairment to the carrying value of its long-lived assets. As such, no impairment has been recorded.

Stock Based Compensation

The Company calculates the fair value of stock-based awards using the Black-Scholes-Merton option pricing valuation model, which incorporates various assumptions including volatility, expected term and risk-free interest rates. The assumptions used for the years ended December 31, 2012 and 2011, and the resulting estimates of weighted-average fair value per share of options granted during those periods, are as follows:

	2012	2011
Volatility	100% to 122%	94% to 119%
Risk-free interest rate	2% to 3%	2% to 3%
Dividend rate	-	-
Expected term	7 years	7 years
Weighted average fair value of options granted	$ 0.06	$ 0.07

The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar awards, giving consideration to the contractual terms, vesting schedules and expectations of future employee behavior. Expected stock price volatility is based on historical volatility of the Company's stock. The risk-free interest rate is based on the implied yield available on United States Treasury zero-coupon issues with an equivalent remaining term. The Company has not paid dividends in the past and does not plan to pay any dividends in the near future. The estimated fair value of stock-based compensation awards and other options is amortized to expense on a straight line basis over the relevant vesting period. As share-based compensation expense recognized is based on awards ultimately expected to vest, it is reduced for estimated forfeitures. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The Company's forfeiture rate was calculated based on its historical experience of awards which ultimately vested.

Net income/(loss) per common share

The net income or net loss per common share is computed by dividing net income or net loss by the weighted average of common shares outstanding. Diluted loss per share reflects the potential dilution that would occur if outstanding stock options were exercised utilizing the treasury stock method. Dilutive shares consisted of the following as of December 31, 2012, and 2011:

	2012	2011
Net income/(loss)………………...………………..………………………………	$ 113,396	$ (692,761)
Weighted average of common and common equivalent shares outstanding………….	158,285,045	158,285,045
Incremental shares from the assumed exercise of dilutive stock options……………	3,352,757	-
Dilutive potential common and common equivalent shares……………………………	161,637,802	158,285,045
Net income/(loss) per common and common equivalent shares:		
-Basic……………………………………………………………………………	$ 0.00	$ (0.00)
-Diluted…………………………………………………………………………	$ 0.00	$ (0.00)

As a result of the net loss for the year ended December 31, 2011, 8,724,340 shares of potentially dilutive options were considered anti-dilutive and excluded from the calculation as their effect would have been to reduce the net loss per share. As a result of being considered anti-dilutive, 79,672 potentially dilutive options were not included in the 2012 incremental shares above.

New Accounting Pronouncements

With the exception of those discussed below, no recent accounting pronouncements or changes in accounting pronouncements during the year ended December 31, 2012 are of significance or potential significance to us.

In May 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update No. 2011-04 (ASU No. 2011-04) "Fair Value Measurement". Requirements of ASU No. 2011-04 amends Topic 820 in two ways. Specifically, some of the amendments clarify how to apply the existing fair value measurement and disclosure requirements, while some of the amendments change a particular principle or requirement for measuring fair value or disclosing information about fair value measurements. ASU No. 2011-04 does not extend the use of fair value accounting, but rather provides guidance on how it should be applied where its use is already required, or permitted by other standards within GAAP. ASU No. 2011-04 supersedes much of the guidance in ASC Topic 820, but also clarifies existing guidance and changes certain wording in order to align ASC Topic 820 with international standards. The effective date for ASU 2011-04 is for interim and annual periods beginning after December 15, 2011, and should be applied prospectively. The Company's adoption of this policy did not have a material effect on the Company's financial statements.

In June 2011, the FASB issued guidance to require presentation of the total of comprehensive income, the components of net income and the components of other comprehensive income ("OCI") either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This guidance eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. Regardless of which format is chosen, the amendments establish a requirement for entities to present on the face of the financial statements reclassification adjustments for items that are reclassified from OCI to net income in the statement(s) where the components of net income and the components of OCI are presented. This guidance was effective for the Company on January 1, 2012; however, during December 2011 the FASB issued ASU No. 2011-12, which defers those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments. The Company's adoption of this policy is not expected to have a material effect on the Company's financial statements.

2. Inventory

Inventory consisted of the following as of December 31:

	2012	2011
Raw materials	$ 312,907	$ 159,066
Work-in-progress	-	293,122
Finished goods	57,112	352,360
Total inventory	$ 370,019	$ 804,548

3. Property and Equipment

Property and equipment consisted of the following as of December 31:

	2012	2011
Computer equipment	$ 344,714	$ 778,900
Furniture and office equipment	532,135	501,522
Leasehold improvements	254,488	184,778
Total property and equipment in use	1,131,337	1,465,200
Less: Accumulated depreciation	(540,970)	(764,565)
Property and equipment in use, net	590,367	700,635
Construction-in-progress	22,013	98,554
Property and equipment, net	$ 612,380	$ 799,189

As of December 31, 2012 and 2011 construction-in-progress includes leasehold improvements that were in-progress at year end. Depreciation expense was $227,492 and $202,686 for the years ended December 31, 2012 and 2011, respectively.

4. Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities consisted of the following at December 31:

	2012	2011
Standard one-year manufacturer's warranty	$ 40,000	$ 40,000
State and local taxes	62,069	62,069
Insurance premiums payable	1,012	14,368
Other	15,000	15,000
Total accrued expenses and other current liabilities	$ 118,081	$ 131,437

5. Related Party Transactions

The Company reimburses its executive officers for business expenses charged to personal credit cards. The Company makes monthly payments directly to the card issuer for these business expenses incurred on behalf of the Company. As of December 31, 2012 and 2011 the balance payable by the Company for the use of these personal credit cards totaled $0 and $35,048, respectively.

6. Commitments and Contingencies

Operating Lease Obligations

The Company's operating lease obligations primarily relate to a facility lease for the Company's corporate office space located at 7970 South Kyrene Road, Tempe, Arizona 85284, which expires in December, 2015, unless renewed. Future minimum lease payments under non-cancelable operating leases are as follows (years ended December 31):

2013	194,802
2014	271,649
2015	316,923
Total	$ 783,374

The Company has recognized a liability of $131,358 and $114,023 as of December 31, 2012 and 2011, respectively; relative to the increasing future minimum lease payments in the above table. Rent expense was $210,500 and $194,700 for the years ended December 31, 2012 and 2011, respectively.

General or Threatened Litigation

From time to time, the Company is notified of threatened litigation or that a claim is being made against it. The Company's policy is to not disclose the specifics of any claim or threatened lawsuit until such complaint is actually served on the Company. After consultation with appropriate legal counsel, if it is determined that the Company is not at fault, the Company will defend itself accordingly. Although we do not expect the outcome in any pending individual case to be material, the outcome of any litigation is inherently uncertain and there can be no assurance that any expense, liability or damages that may ultimately result from the resolution of these matters will be covered by our insurance or will not be in excess of amounts provided by insurance coverage and will not have a material adverse effect on our business, operating results or financial condition. As of December 31, 2012 and 2011, respectively, the Company has no accrual for general or threatened litigation and the Company believes its exposure to be de minimis in nature.

Employment Agreements

On April 2, 2012, the Company entered into three-year Employment Agreements with its Chief Executive Officer and Chief Operating Officer that call for base annual salaries of $195,000 and $175,000, respectively, subject to cost of living adjustments, and contain automatic one-year extension provisions. Capitalized terms in this note are defined in the Employment Agreements. If the Company's Chief Executive Officer or Chief Operating Officer are terminated by the Company for any reason other than for Cause, or if the Executive voluntarily terminates his own employment for Good Reason but not including a Change in Control, then the Company shall, subject to the terms of the Employment Agreements, be obligated to pay the Executive an amount equal to the product of (i) the greater of (a) the Executive's annual base salary in effect on the day preceding the date of such termination or (b) the Executive's annual base salary during the twelve full calendar months preceding the date of such termination, times (ii) three. This payment shall be payable in 18 equal monthly payments commencing on the first day of the month following the month in which the termination occurs. If a Change of Control of the Company occurs while the Executive is an employee of the Company and within 36 months from the date of such Change in Control the Company terminates the Executive's employment for any reason (except for the death or Disability of the Executive or for Cause) or the Executive terminates his employment for any reason, then the Company shall, subject to certain limitations, pay the Executive any earned and accrued but unpaid base salary through the date of termination plus an amount of severance pay equal to the product of (i) the greater of (a) the Executive's annual base salary in effect on the day preceding the date on which the Change of Control occurred or (b) the Executive's annual base salary during the twelve full calendar months preceding the date on which the Change of Control occurred, times (ii) four.

7. Income Taxes

The Company accounts for its deferred tax assets and liabilities, including excess tax benefits of share-based payments, based on the tax ordering of deductions to be used on its tax returns. The tax effects of temporary differences that give rise to significant portions of deferred tax assets and deferred tax liabilities at December 31 are as follows:

	2012	2011
Deferred tax assets:		
Net operating loss carry forwards	$ 3,847,000	$ 3,446,000
Deferred revenue	469,000	795,000
Non-qualified stock option expense	337,000	289,000
Reserves, accruals and other	129,000	117,000
Accumulated depreciation and amortization	2,210,000	2,387,000
Net deferred tax assets	6,992,000	7,034,000
Less: Valuation allowance	(6,992,000)	(7,034,000)
Net deferred tax assets	$ -	$ -

Management has elected to provide a deferred tax asset valuation allowance equal to the potential benefit of the deferred tax assets.

Internal Revenue Code Section 382 limits the ability to utilize net operating losses if a 50% change in ownership occurs over a three year period. Such limitation of the net operating losses may have occurred but we have not analyzed it at this time as the deferred tax asset is fully reserved. We believe we have approximately $9.6 million of federal and state net operating loss carry-forwards that are available to offset future taxable income that expire in various years from 2021 to 2032.

Significant components of the (provision) benefit for income tax for the years ended December 31:

	2012	2011
Current	$ -	$ -
Deferred	42,000	273,000
Change in valuation allowance	(42,000)	(273,000)
Provision (benefit) for income taxes	$ -	$ -

The Company is subject to federal and state taxes. A reconciliation of the Company's effective income tax rate to the federal statutory rate for the years ended December 31, is as follows:

	2012	2011
Federal income tax benefit at the statutory rate	$ 39,000	$ 236,000
State income taxes, net of federal benefit	7,000	41,000
Permanent differences	(4,000)	(4,000)
Change in valuation allowance	(42,000)	(273,000)
Provision (benefit) for income taxes	$ -	$ -

8. Line of Credit

The Company has a line of credit agreement with a financial institution with maximum availability of $750,000. The line of credit is secured by the Company's eligible accounts receivable and inventory and bears interest at varying rates, which at December 31, 2012 and 2011 was prime plus 1.5%, with a floor of 5.0%. Interest expense was approximately $17,350 and $3,200 for the years ended December 31, 2012 and 2011, respectively. The effective rate of interest for the year was 5.0%. The line of credit, which was amended and renewed in August 2012, primarily to include borrowing against received domestic purchase orders, matures in August 2013, and requires monthly payments of interest only. The line of credit is co-signed by the Company's Chief Executive Officer and his spouse as guarantors. As of December 31, 2012 and 2011, there were no amounts outstanding under the line of credit.

9. Term Loan Payable

As of December 31, 2012 the Company has a term loan payable to Arizona Bank & Trust. Monthly payments are $7,501 consisting of principal and interest, and the loan matures in August, 2015. Interest is 5.0% per annum based on a year of 360 days. The term loan is secured by the Company's eligible accounts receivable and inventory and is guaranteed by a related party.

As of December 31, 2012, a schedule of future minimum principal payments due on the term loan is as follows:

Year ending December 31,		
2013	$	80,499
2014		84,679
2015		58,957
Total	$	224,135

At December 31, 2012 the Company was not in compliance with certain financial covenants required by the business loan agreement, specifically current ratio and debt to equity limits. The Company has obtained a waiver from the term loan holder for the year ended December 31, 2012.

10. Stockholders' Deficit

Authorized Capital

The Company has authorized the issuance of two classes of stock designated as "common stock" and "preferred stock," each having a par value of $0.005 per share. The Company is authorized to issue 500,000,000 shares of common stock and 2,000,000 shares of preferred stock.

Treasury Stock

The Company did not repurchase any stock in 2012. In October 2011 the Company repurchased 43,200 restricted common shares from certain shareholders at an average price of $0.069 per share for a total purchase price $2,981, which is reflected as treasury stock on the accompanying balance sheet.

Stock Options

The Company periodically issues non-qualified incentive stock options to key employees, officers and directors under a plan approved by the Board of Directors in 2009. Terms of option grants are at the discretion of the Board of Directors. The Board of Directors has also approved a quarterly grant of 50,000 stock options to each of the Company's three directors, with an additional 100,000 stock options for the Chief Executive Officer and an additional 50,000 stock options for the Secretary of the Company. Effective April 1, 2012, the Board of Directors changed the quarterly grant to a total of 100,000 stock options per quarter to the CEO, 75,000 stock options per quarter to the COO/Secretary, and 50,000 stock options per quarter to any board member not an employee of the Company. The following table summarizes stock options as of December 31:

	2012		2011	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Options outstanding, beginning of year	8,724,340	$ 0.05	8,183,228	$ 0.05
Granted	5,475,000	0.06	2,125,000	0.08
Exercised	-	-	-	-
Expired / terminated	(600,000)	0.08	(1,583,888)	0.04
Options outstanding, end of year	13,599,340	0.05	8,724,340	0.05
Options exercisable, end of year	10,099,340	0.05	7,824,340	0.05
Weighted average fair value of options granted during the year		$ 0.05		$ 0.07

The following table summarizes the Company's non-vested stock options as of December 31:

	2012		2011	
	Number of Options	Weighted Average Grant Date Fair Value	Number of Options	Weighted Average Grant Date Fair Value
Non-vested options outstanding, beginning of year	900,000	$ 0.07	700,000	$ 0.06
Granted	3,150,000	0.05	700,000	0.07
Exercised	-	-	-	-
Expired / terminated	(550,000)	0.07	(500,000)	0.05
Non-vested options outstanding end of year	3,500,000	$ 0.05	900,000	$ 0.07

The following table summarizes information about stock options outstanding and exercisable as of December 31, 2012:

	Options Outstanding			Options Exercisable	
Range of Exercise Price	**Number of Options Outstanding**	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Life (Years)**	**Number of Options Exercisable**	**Weighted Average Exercise Price**
$0.03 - $0.04	5,274,340	0.04	3.2	5,274,340	0.04
$0.05 - $0.07	5,250,000	0.06	5.6	2,666,667	0.06
$0.07 - $0.09	3,075,000	0.08	5.3	2,158,333	0.08
$0.03 - $0.09	13,599,340	0.05	4.8	10,099,340	0.05

The aggregate intrinsic value of options outstanding and options exercisable were both $52,469 as of December 31, 2012. The aggregate intrinsic value of options outstanding and options exercisable were $253,324 and $249,224 as of December 31, 2011, respectively. The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying options and the fair value of our common stock, for those stock options that have an exercise price lower than the fair value of our common stock. Options with an exercise price above the fair value of our common stock are considered to have no intrinsic value. The total fair value of shares vested during the years ended December 31, 2012 and 2011 is $120,133 and $67,500, respectively. As of December 31, 2012, total unrecognized stock-based compensation expense related to non-vested stock options is $173,981, which is expected to be recognized in the next five years.

11. Subsequent Events

The Company has evaluated subsequent events through the date the accompanying financial statements were issued, which was March 28, 2012. No events have occurred which require further disclosure.