Halo Technology Holdings, Inc.
Form 10KSB
October 13, 2006

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

FORM 10-KSB

(Mark One)

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934,**
For The Fiscal Year Ended June 30, 2006

o **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: 000-33197

HALO TECHNOLOGY HOLDINGS, INC.
(Name of small business issuer in its charter)

NEVADA	**88-0467845**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
200 Railroad Avenue, 3rd Floor, Greenwich, Connecticut	**06830**
(Address of principal executive offices)	**(Zip Code)**

(203) 422-2950
(Issuer s telephone number)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT: None
SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:
Common Stock, Par Value $0.00001 Per Share
(Title of Class)

Check whether the issuer: (1) has 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 þ NO o

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. o

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

Issuer s revenues for its most recent fiscal year, ended June 30, 2006, were $25,208,995.

The aggregate market value of the common voting stock held by non-affiliates of the registrant as of October 12, 2006 was $11,860,465 based on the closing bid price of $.62 per share as reported on the Over-the-Counter Bulletin Board (OTC Bulletin Board) operated by the National Association of Securities Dealers, Inc.

The number of shares outstanding of the registrant s common stock, $0.00001 par value, as of October 12, 2006, was 30,160,378.

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Portions of the Proxy Statement for the Annual Meeting of Stockholders to be held on or about December 1, 2006 (the 2006 Proxy Statement) are incorporated by reference into Part III, Items 9 through 12 and 14, of this annual report on Form 10-KSB. The 2006 Proxy Statement, except for the parts therein which have been specifically incorporated by reference, shall not be deemed filed as part of this annual report on Form 10-KSB.

Transitional Small Business Disclosure Format (Check one): Yes o; No þ.

PART I

ITEM 1. DESCRIPTION OF BUSINESS.

Forward-Looking Information

Certain statements in this Annual Report on Form 10-KSB of the Company may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (the Reform Act). These forward-looking statements are made only as of the date hereof, and we undertake no obligation to update or revise the forward-looking statements, whether as a result of new information, future events or otherwise. The safe harbors for forward-looking statements provided by the Reform Act are unavailable to issuers of penny stock . Our shares may be considered a penny stock and, as a result, the safe harbors may not be available to us. Such forward-looking statements include those relating to future opportunities, the outlook of customers, the reception of new products and technologies, and the success of new initiatives. In addition, such forward-looking statements involve known and unknown risks, uncertainties, and other factors which may cause the actual results, performance or achievements of the Company to be materially different from any future results expressed or implied by such forward-looking statements. Such factors include: (i) demand for the Company s products; (ii) the actions of current and potential new competitors; (iii) changes in technology; (iv) the nature and amount of the Company s revenues and expenses; and (v) overall economic conditions and other risks detailed from time to time in the Company s periodic earnings releases and reports filed with the SEC, as well as the risks and uncertainties discussed in this Annual Report on Form 10-KSB.

Historical Background

Halo Technology Holdings, Inc. (the Company) was incorporated in the State of Nevada on June 26, 2000 under the name Abbott Mines, Ltd. to engage in the acquisition and exploration of mining properties. The Company obtained an interest in one mining property with mining claims on land located near Vancouver in British Columbia, Canada. To finance its exploration activities, the Company completed a public offering of its common stock, par value $.00001 per share, on March 14, 2001 and listed its common stock on the OTC Bulletin Board on July 3, 2001. The Company conducted its exploration program on the mining property and the results did not warrant further mining activity. Halo then attempted to locate other properties for exploration but was unable to do so.

The Acquisition of WARP Solutions, Inc.

On May 24, 2002, the Company and WARP Solutions, Inc. (WARP Solutions) closed a share exchange transaction (the Share Exchange) pursuant to a Share Exchange Agreement (the Exchange Agreement) dated as of May 16, 2002, by and among the Company, Carlo Civelli, Mike Muzylowski, WARP Solutions, Karl Douglas, John Gnip and related Sellers. Following the closing of the Share Exchange, WARP Solutions became a subsidiary of the Company and the operations of WARP Solutions became the sole operations of the Company.

Subsequent to the closing of the Share Exchange, the Company ceased all mineral exploration activities and the sole operations of the Company were the operations of its subsidiary, WARP Solutions.

The Upstream Merger and Name Change

On August 19, 2002, the Board of Directors of the Company authorized and approved the upstream merger of WARP Technology Holdings, Inc., a wholly owned subsidiary of the Company which had no operations, with and into the Company pursuant to Chapter 92A of the Nevada Revised Statutes (the Upstream Merger). The Upstream Merger became effective on August 21, 2002, when the Company filed Articles of Merger with the Nevada Secretary of State. In connection with the Upstream Merger, and as authorized by Section 92A.180 of the Nevada Revised Statutes, the Company changed its name from Abbott Mines Ltd. to WARP Technology Holdings, Inc.

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In February, 2006, Halo s board of directors approved resolutions to change the Company s name from Warp Technology Holdings, Inc. to Halo Technology Holdings, Inc. by amending our Articles of Incorporation. We received the consent of holders of a majority of the outstanding votes entitled to be cast approving the amendment. Accordingly, effective April 2, 2006, our name changed to Halo Technology Holdings, Inc.

The Acquisition of Spider Software, Inc.

On January 10, 2003, the Company, through its wholly-owned subsidiary 6043577 Canada Inc., acquired one hundred percent (100%) of the issued and outstanding capital stock of Spider Software, Inc. (Spider), a privately held Canadian corporation, through a share exchange transaction pursuant to a Share Exchange Agreement (the Spider Exchange Agreement) dated as of December 13, 2002. Pursuant to the Spider Exchange Agreement the Spider shareholders were issued 1,500,000 shares of the preferred stock of 6043577 Canada Inc., and the Company forgave outstanding Spider promissory notes of approximately $262,000, all in exchange for one hundred percent (100%) of the issued and outstanding capital stock of Spider. The Company owns 100% of the voting common stock of 6043577 Canada Inc. The preferred stock of 6043577 Canada Inc. has no voting rights or other preferences but is convertible on a 100 for 1 basis into the common stock of the Company. As a result, following the closing, Spider became a wholly-owned subsidiary of 6043577 Canada Inc. and thereby an indirect, wholly-owned subsidiary of the Company.

Acquisition of Gupta Technologies, LLC

On January 31, 2005, the Company completed the acquisition of Gupta Technologies, LLC and its wholly-owned subsidiaries Gupta Technologies GmbH, a German company, Gupta Technologies Ltd., a U.K. company, and Gupta Technologies S.A. de C.V., a Mexican company (collectively referred to herein as Gupta). The acquisition of Gupta (the Gupta Acquisition) was made pursuant to a Membership Interest Purchase Agreement (as amended, the Gupta Agreement) between the Company and Gupta Holdings, LLC (the Gupta Seller).

Under the Gupta Agreement, the total purchase price was $21,000,000, excluding transaction costs, of which the Company delivered $15,750,000 in cash on or before the closing. The remainder of the purchase price was paid in equity and debt securities issued or provided by the Company with the terms described herein. As a result, following the closing, Gupta became a wholly-owned subsidiary of the Company.

On September 13, 2006, the Company entered into a Purchase and Exchange Agreement with Unify Corporation whereby the Company agreed to sell Gupta to Unify in exchange for (i) Unify s risk management software and solution business as conducted by Unify through its Acuitrek, Inc. subsidiary (Acuitrek) and its Insurance Risk Management division, including, without limitation, the Acuitrek business and the NavRisk product (the NavRisk Business), (ii) Unify s ViaMode software product and related intellectual property rights (the ViaMode Product), (iii) 5,000,000 shares of Unify common stock, (iv) warrants to acquire 750,000 shares of Unify stock, (v) $5,000,000 in cash, of which Halo has received $500,000 as a deposit (the Deposit), and (vi) the amount by which the Gupta Net Working Capital exceeds the NavRisk Net Working Capital (as such terms are defined in the Unify Purchase Agreement, the Working Capital Adjustment). The sale of Gupta is expected to close in the second quarter of fiscal 2007.

Acquisition of Kenosia Corporation

On July 6, 2005, the Company completed the acquisition of Kenosia Corporation (Kenosia) pursuant to a Stock Purchase Agreement (The Kenosia Agreement) with Bristol Technology, Inc. (Bristol) and Kenosia. Under the Kenosia Agreement (the Kenosia Agreement) the Company purchased all of the stock of Kenosia from Bristol for a purchase price of $1,800,000 (net of a working capital adjustment). Kenosia is now a wholly-owned subsidiary of the Company, but as it was acquired after the end of our fiscal year, its results are not included in the financial results reported herein.

Acquisition of Five Enterprise Software Companies

On October 26, 2005, Halo completed the acquisition of Tesseract and four other companies; DAVID Corporation, Process Software, ProfitKey International, and Foresight Software, Inc. (collectively Process and Affiliates). These transactions were related party transactions.

Tesseract, headquartered in San Francisco, is a total HR solutions provider offering an integrated Web-enabled HRMS suite. Tesseract s Web-based solution suite allows HR users, employees and external service providers to communicate securely and electronically in real time. The integrated nature of the system allows for easy access to

data and a

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higher level of accuracy for internal reporting, assessment and external data interface. Tesseract s customer base includes corporations operating in a diverse range of industries, including financial services, transportation, utilities, insurance, manufacturing, petroleum, retail, and pharmaceuticals.

DAVID Corporation is a pioneer in Risk Management Information Systems. DAVID Corporation offers client/server-based products to companies that provide their own workers compensation and liability insurance. Many of DAVID Corporation s clients have been using its products for 10 years or longer.

Process Software develops infrastructure software solutions for mission-critical environments, including industry-leading TCP/IP stacks, an Internet messaging product suite, and an anti-spam software subscription service to large enterprises worldwide. With a loyal customer base of over 5,000 organizations, including Global 2000 and Fortune 1000 companies, Process Software has earned a strong reputation for meeting the stringent reliability and performance requirements of enterprise networks.

ProfitKey International develops and markets integrated manufacturing software and information control systems for make-to-order and make-to-stock manufacturers. ProfitKey s offering includes a suite of e-business solutions that includes customer, supplier and sales portals. ProfitKey s highly integrated system emphasizes online scheduling, capacity management, and cost management.

Foresight Software, Inc., a client/server Enterprise Resource Planning and Customer Relationship Management software company, was acquired as part of the acquisition of these five enterprise software companies. Foresight Software, Inc. was sold to a third-party on May 23, 2006 and is no longer a subsidiary of Halo.

The purchase price for the acquisition of DAVID Corporation, Process Software, ProfitKey International, and Foresight Software was an aggregate of $12,000,000, which Halo paid in cash. Under the merger agreement for the acquisition of Tesseract (the Tesseract Merger Agreement), the merger consideration consisted of (i) $4,500,000 in cash which was paid at closing, (ii) 7,045,454 shares of Series D Preferred Stock of Halo, and (iii) $1,750,000 originally due no later than March 31, 2006 and evidenced by a promissory note to Platinum Equity, LLC (the Platinum Note). Additionally, Halo was required to pay a working capital adjustment of $1,000,000. Since this amount was not paid by November 30, 2005, Platinum Equity, LLC (Platinum), the seller of Tesseract, has the option to convert the working capital adjustment into up to 1,818,182 shares of Series D Preferred Stock. To date, the Platinum has not elected to do so. Furthermore, since the working capital adjustment was not paid by November 30, 2005, Halo must pay Platinum a monthly transaction advisory fee of $50,000 per month, commencing December 1, 2005. As of June 30, 2006, Halo has accrued and expensed approximately $350,000 for such fees.

On March 31, 2006, the Company and Platinum entered into an Amendment and Consent (the Amendment and Consent) to the Platinum Note. Pursuant to the Amendment and Consent, the maturity of the Platinum Note was modified such that the aggregate principal amount of the Platinum Note and all accrued interest thereon shall be due and payable as follows: (i) $1,000,000 on March 31, 2006; and (ii) the remaining $750,000 in principal, plus all accrued but unpaid interest shall be paid on the earliest of (w) the second business day following the closing of the acquisition of Unify by the Company, (x) the second business day following termination of the merger agreement pursuant to which Unify is to be acquired by the Company, (y) the second business day after the Company closes an equity financing of at least $2.0 million subsequent to the date of the Amendment and Consent or (z) July 31, 2006. In accordance with the Amendment and Consent, $1,000,000 was paid to Platinum on March 31, 2006. Since the entire amount of the Platinum Note was not paid on or before March 31, 2006, Platinum retained 909,091 shares of Series D Preferred Stock of the Company, which had been previously issued to Platinum as part of the consideration under the Tesseract Merger Agreement. These shares would have been canceled if the Platinum Note had been paid in full by that date. Subsequently, the parties have engaged in discussions to further modify the terms of the amounts owed to Platinum. Platinum has indicated it will waive any current breaches of these obligations, but the parties have not yet entered into any definitive agreement. However, in the event Platinum does not agree to modify such terms, the Company would be in breach of such agreements.

The Tesseract Merger Agreement further provides that the rights, preferences and privileges of the Series D Preferred Stock will adjust to equal the rights, preferences and privileges of the next round of financing if such financing is a Qualified Equity Offering . Under the Tesseract Merger Agreement, a Qualified Equity Offering is defined as an equity financing (i) greater than $5,000,000, (ii) not consummated with any affiliate of Halo, and

(iii) the securities issued in such equity financing are equal or senior in liquidation and dividend preference to the Series D Preferred Stock. If Halo s next round of equity financing is not a Qualified Equity Offering, the shares of the Series D Preferred Stock will convert at the option of Platinum into the terms of the offering, or maintain the terms of the Series D Preferred Stock. In addition, the Series D Stock may be converted into common stock at the election of the holder.

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On April 3, 2006, the Company filed a Registration Statement on Form SB-2, File No. 333-132962, registering for resale the shares of common stock of the Company issuable upon conversion of the Series D Preferred Stock issued to Platinum in connection with the Tesseract Merger and as payment of dividends on such stock. This Registration Statement is currently pending before the Securities and Exchange Commission and is not yet effective. The Company will not receive any proceeds from the resale of the shares nor will the Company control the timing, manner and size of each sale pursuant to this Registration Statement. If this Registration Statement becomes effective, the holder of the Series D Preferred Stock will be permitted to convert its shares of Series D Preferred Stock to common stock and to resell such shares of common stock, subject to securities law restrictions as a result of Platinum being an affiliate of Halo. Since the average daily trading volume of Halo s common stock is relatively low (approximately 11,000 shares per day during the fiscal year ended June 30, 2006), attempts by the holder of the Series D Preferred Stock to resell any substantial portion of its shares could result in their being more shares offered for sale than buyers wishing to purchase shares of Halo common stock. This could limit the ability of shareholders to sell their shares in the manner or at the price that might be attainable if Halo s common stock were more actively traded or if the Series D Preferred Stock was not able to be resold pursuant to the Registration Statement on Form SB-2, File No. 333-132962.

Acquisition of Empagio

Halo entered into a merger agreement dated December 19, 2005, to acquire Empagio. On January 13, 2006, the closing occurred under the merger agreement and Empagio is now a wholly-owned subsidiary of Halo. The merger consideration consisted of 1,438,455 shares of common stock. Based on the closing price of Halo s Common Stock on the day of the closing, the total purchase price was $1,869,992, subject to adjustment.

Empagio is a human resources management software company. Its signature product is its SymphonyHR hosted software solution which automates HR procedures and reduces paperwork, ranging from payroll to benefits administration. Halo intends to integrate Empagio with additional HR solutions already within its portfolio to create a premier human resources management solutions provider. Empagio s operations have been consolidated with the operations of Tesseract and the consolidated entity operates under the name Empagio.

Acquisition of ECI

On January 30, 2006, Halo entered into a merger agreement with ECI (the ECI Merger Agreement). On March 1, 2006, the closing occurred under the ECI Merger Agreement, and ECI became a wholly owned subsidiary of Halo. The total merger consideration for all of the equity interests in ECI was $578,571 in cash and cash equivalents and 330,688 shares of Halo s common stock (with a value of $558,863 at the closing price of Halo s common stock), subject to adjustment based on the Net Working Capital (as defined in the ECI Merger Agreement) on the closing date. The acquisition of ECI s clients will enhance Empagio s human resources software offerings. ECI s operations will be consolidated with the operations of Empagio.

Foresight Sale

On May 23, 2006, the Company and Foresight Acquisition Company, LLC (Buyer) entered into a Merger Agreement pursuant to which Buyer acquired 100% of the outstanding common stock of Foresight Software, Inc., a wholly-owned subsidiary of Halo in exchange for a cash payment to Halo. The Company received $266,402 for this sale, of which $114,500 was applied to the principal of the outstanding Fortress debt. The Company recorded a gain of $12,072 on this sale.

Business of the Company

Halo is a holding company whose subsidiaries operate enterprise software and information technology businesses. The following pages describe the business of Halo s existing subsidiaries, Gupta Technologies, LLC, Warp Solutions, Kenosia Corporation, Tesseract Corporation, DAVID Corporation, Process Software, ProfitKey International, Empagio and ECI. In addition to holding its existing subsidiaries, Halo s strategy is to pursue acquisitions of businesses, which either complement Halo s existing businesses or expand the industries in which Halo operates.

Empagio Business

Empagio provides human resource outsourcing (HRO) to enable a faster, more predictable transformation of the human resources (HR) function, from mostly tactical to a greater level of strategic execution.

Empagio s solutions range from an on-demand HR management platform to full HRO. The Empagio platform integrates HR, benefits and payroll administration and human capital management, including: talent management, performance management, organization development and learning management with business analytics and executive dashboards. Empagio s outsourcing services include full administrative processing and customer support via U.S.-based Tier I and Tier II service centers, along with additional stand-alone services such as payroll tax filing. Empagio serves more than 45 clients nationwide, comprising more than two million employee lives. Empagio s clients include companies such as Home Depot, PNC Bank, Delta Airlines, Deere and Co., and the State of Alaska. While Empagio serves many large clients and is dedicated to continuing to meet their HR needs, Empagio s main focus for future growth is the mid-market, or companies with 1,000 to 20,000 employees.

Gupta Business

Gupta develops, markets and supports software products that enable software programmers to create enterprise class applications, operating on either the Microsoft Windows or Linux operating systems that are used in large and small businesses and governmental entities around the world. Applications developed using Gupta products are used in mission-critical processes in thousands of businesses worldwide. Everyday, people rely on Gupta products when filling a prescription at their local pharmacy, banking online, shipping a package, riding a train, or shopping at a convenience store. Businesses rely on Gupta products to run their manufacturing operations, track their finances and organize their data.

Gupta s flagship products, Team Developer and SQLBase, are specifically designed to meet the demands for enterprise performance and functionality combined with low total cost of ownership. SQLBase is a relational database that is easily embedded in applications. Data is stored in tables; each table contains data about a real world object such as customer, vendor, employee, invoice, etc. The term relational means that SQLBase through the use of primary keys (unique ID numbers) maintains the relationships between these various object allowing business to quickly find out all invoices for a particular customer or purchase orders for a particular vendor. SQLBase is easily embeddable because a software vendor may include the SQLBase installation process in their application and when the customer installs the application, the customer is not aware of the database being installed, just that the application is able to store and retrieve data as desired. SQLBase uses a statistical optimizer, which means it keeps track of the number of customers, or invoices in a table and will execute the best query to retrieve the data. SQLBase manages the tables, indexes on its own, and does not require the customer to perform on-going maintenance, therefore, is a low Ì or zero database administration required. Team Developer offers an object-oriented, GL toolset. Team Developer offers a very structured, easy to use outline format to write your application code. The structure, or indentations, make it easy to understand what application code is executed and its relationship with all the other code in the program. Team Developer is considered a 4-GL (fourth generation language) because its language is very business like and a programmer can focus more on what they want to accomplish Ì rather than the tedious and time consuming how to do a given task. Under the covers, Team Developer executes many lines of code to connect to the database, retrieve the data, format it and display it.

While Gupta products can be used independently with other tools and databases, the majority of Gupta s customers use them in conjunction with each other to develop business applications. A typical customer uses Team Developer to create a software application for a business solution, with SQLBase as the embedded database, and deploys that application within their organization (a corporate user), or sells the application as a proprietary product (ISVs and VARs). Gupta sells its products using a traditional software licensing model. Developers buy Team Developer licenses by the seat. SQLBase licenses are sold as either a single workstation version or a multi-user server version on a per seat basis. Gupta additionally offers maintenance and support contracts that allow customers to receive product upgrades and telephone support on an annual basis.

Gupta in its present form originated in February 2001 when Platinum, a private equity firm in Los Angeles, California, acquired certain assets and liabilities from Centura Software Corporation (Centura). These assets and liabilities related principally to the SQLBase and Team Developer product lines and included all rights to the intellectual property, the working capital, fixed assets, contracts, and operating subsidiaries that supported these products. Gupta also hired certain employees from Centura to support the development, sales, technical support, and administration of the acquired assets. Originally founded in 1983 as Plum Computers, Inc., the entity became Gupta

Technologies, Inc. in 1984, then Gupta Corporation in 1992, then Centura Software Corporation in 1996. Gupta is a limited liability company formed under the laws of the State of Delaware. In January 2005, Gupta was acquired by the Company from Gupta Holdings, LLC, a wholly owned subsidiary of Platinum. Gupta is based in Redwood Shores, California with offices in Munich, London, and Paris. It has over 1,000 customers in over 50 countries. On September 13, 2006, pursuant to a Purchase and Exchange Agreement with Unify Corporation, the Company agreed to sell Gupta to Unify. The sale is expected to close in the second quarter of fiscal 2007.

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Process Business

Process Software develops infrastructure software solutions for mission-critical environments, including industry-leading TCP/IP stacks (suites of data communication protocols), an Internet messaging product suite, and an anti-spam software subscription service to large enterprises worldwide. With a loyal customer base of over 5,000 organizations, including Global 2000 and Fortune 1000 companies, Process Software has earned a strong reputation for meeting the stringent reliability and performance requirements of enterprise networks.

DAVID Business

DAVID is a pioneer in Risk Management Information Systems. DAVID offers client/server-based products to companies that provide their own workers compensation and liability insurance. Many of DAVID s clients have been using its products for 10 years or longer.

Kenosia Business

Kenosia is a software company whose products include its DataAlchemy product line. DataAlchemy is a sales and marketing analytics platform that is utilized by global companies to drive retail sales and profits through timely and effective analysis of transactional data. Kenosia s installed customers span a wide range of industries, including consumer packaged goods, entertainment, pharmaceutical, automotive, spirits, wine and beer, brokers and retailers.

ProfitKey Business

ProfitKey International develops and markets integrated manufacturing software and information control systems for make-to-order and make-to-stock manufacturers. ProfitKey s offering includes a suite of e-business solutions that includes customer, supplier and sales portals. ProfitKey s highly integrated system emphasizes online scheduling, capacity management, and cost management.

Warp Solutions Business

Warp Solutions, Inc. a Delaware corporation, Warp Solutions, Ltd., a U.K. corporation, 6043577 Canada, Inc., a Canadian corporation, and Spider Software, Inc., a Canadian corporation, collectively, Warp Solutions. Warp Solutions produces a series of application acceleration products that improve the speed and efficiency of transactions and information requests that are processed over the Internet and intranet network systems. These products and technologies are designed to accelerate network applications, reduce network congestion, and reduce the cost of expensive server deployments for enterprises engaged in high volume network activities.

The primary product offered is the SpiderSoftware product, which is a software solution designed to enable caching of pure dynamic content at the web server layer. This product is installed on the web server of an enterprise to allow network administrators to select certain sections of its content to remain dynamic, a feature known as partial page caching.

The benefits of the SpiderSoftware solution are increased speed, performance, scalability, availability and efficiency of a network infrastructure s informational and transactional data flow. The primary advantages of the SpiderSoftware solution include highly granular (in other words, easily modified) cache control, support for both static caching (caching of non-changing data) and dynamic caching (caching of changing data), partial page caching, cross platform web administration tool, real-time cache efficiency performance monitoring, automatic image optimization, and support for multiple operating systems including Windows NT, Linux, Solaris, and Unix.

Sales and Marketing

Halo currently uses both indirect and direct sales models, based on geography. In Europe, Halo uses an indirect sales channel relying on VARs and distributors to sell its products to end users. Halo s sales and marketing team in Europe works directly with its VAR partners to help them market and sell Halo s products by engaging in joint efforts to meet with their customers, attend their roadshows, provide technical support and training and attending major technology trade events. In North America, Halo relies on direct sales force to sell its products. Halo is currently working on developing an indirect channel in North America. Halo is targeting VARs and ISVs, similar to ones Halo is successfully working with in Europe, to partner with in selling Halo s products. Throughout Latin America and AsiaPacific, Halo uses an indirect sales model similar to Europe. It is Halo s intent to increase its marketing activities worldwide in fiscal 2006 to increase Halo brand awareness, attract new partners and customers and generate increased revenues.

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Halo consistently re-evaluates its marketing programs. The Company anticipates that during fiscal 2007 it will invest in sales tools, website presence, public relations, advertising, events, direct marketing, customer loyalty programs and market research to support brand awareness, attract new customers and attract new partners. The Company does not anticipate materially increasing its marketing expenses in fiscal 2007 over the prior fiscal year.

Software Product Development

It is Halo s intent to continue developing enhanced functionality in Halo s existing products. Halo s future success will depend upon its ability to continue to enhance its current products and to develop and introduce new products on a timely basis that keep pace with technological developments and new industry standards and satisfy increasingly sophisticated customer requirements. Rapid technological change, frequent new product introductions and enhancements, uncertain product life cycles, changes in customer demands and evolving industry standards characterize the market for Halo s products. The introduction of products embodying new technologies and the emergence of new industry standards can render existing products obsolete and unmarketable. In order to effectively compete in its market Halo must be able to develop and market, on a timely and cost-effective basis, new products or new product enhancements that respond to technological change, evolving industry standards or customer requirements, avoid difficulties that could delay or prevent the successful development, introduction or marketing of these products and work to achieve market acceptance for its new products and product enhancements.

Intellectual Property and Proprietary Rights

We regard certain aspects of Halo s operations, products and documentation as proprietary. We relyon a combination of patent, copyright, trademark and trade secret laws and other measures to protect our proprietary rights. We also rely on contractual restrictions in Halo s agreements with customers, employees and others to protect our intellectual property rights. However, in certain foreign countries, effective copyright and trade secret protection may be unavailable or the laws of these other jurisdictions may not protect our proprietary technology rights to the same extent as the laws of the United States. Failure to obtain and/or maintain appropriate patent, copyright or trade secret protection either in the United States or in certain foreign countries, for any reason, may have a material adverse effect on Halo s business, operating results and financial condition. Halo licenses software and technology from third parties, including some competitors, and incorporates them into its own software products, some of which are critical to the operation of Halo s software.

The third party technology providers include CodeWeavers, Inc., Trolltech Inc., Graphics Server Technologies, L.P., Data Techniques, Inc. and Rogue Wave Software, Inc. The Company licenses software from these providers under terms customary for similar agreements. The agreements with these third parties provide for the Company s license of software during the term of the agreement in exchange for the payment of certain fees. The agreements with Data Techniques, Inc. and Rogue Wave Software, Inc. are shrinkwrap software license agreements for use of their ImageMan and Rogue Wave Stingray software products, respectively. These shrinkwrap agreements each grant a license for use on one computer module for each package purchased. The Rogue Software, Inc. agreement can be terminated by the software provider upon a breach of Halo s obligations under the agreement; otherwise, the licenses granted are perpetual.

The agreement with CodeWeavers, Inc. is dated September 20, 2004 and enables Gupta Technologies, LLC, a subsidiary of Halo, (Gupta Technologies) to obtain services from representatives of CodeWeavers, Inc. in connection with various software issues, including running Gupta Technologies software on the Linux Operating System. In exchange for the services, Gupta Technologies is to pay CodeWeavers, Inc. $100 per hour for certain consultants and $125 per hour for time spent working on agreed upon projects by Alexandre Julliard. CodeWeavers, Inc. may terminate the agreement upon breach without correction within 10 days by Gupta Technologies.

The agreement with Trolltech Inc. was entered into by Gupta Technologies, a subsidiary of Halo, and is dated December 15, 2004. The agreement grants Gupta Technologies with a nonexclusive, royalty-free license to use Trolltech s software for purposes of developing, testing and deploying Gupta Technologies Team Developer family of software. The license has a two year term and may be terminated by Trolltech immediately upon a breach by Gupta Technologies, if Gupta Technologies fails to pay fees for licensed software or infringes on Trolltech s software. Fees paid to Trolltech under the agreement include a $50,000 fee paid upon signing of the agreement and a $75,000 fee that was paid upon the first anniversary of the agreement.

The agreement with Graphics Server Technologies, L.P. was entered into by Gupta Technologies, a subsidiary of Halo, and is dated as of January 1, 2004. The agreement grants Gupta Technologies a nonexclusive, nontransferable

worldwide license to use Graphics Server SDK software product object code to prepare and provide technical support for Gupta Technologies Team Developer family of software. Gupta Technologies is to pay a $15,000 annual maintenance fee in exchange for the rights granted under the agreement. The agreement has a two-year term which may be extended for one or more additional two year terms by mutual agreement of the parties. Either party may terminate the agreement upon a material breach by the other that is not cured within 60 days of notice of such breach.

The source code for Halo s software products is protected both as a trade secret and as a copyrighted work. Some of Halo s customers are beneficiaries of a source code escrow account arrangement which enables the customer to obtain a contingent future limited right to use Halo s source code solely for the customer s internal use. If Halo s source code is accessed, the likelihood of misappropriation or other misuse of Halo s intellectual property may increase.

Halo may be subjected to claims of intellectual property infringement by third parties as the number of products and competitors in Halo s industry segment continues to grow and the functionality of products in different industry segments increasingly overlaps. Additionally, the fact that some of Halo s software components have been licensed from the open source community may expose Halo to increased risk of infringement claims by third parties.

We believe that Halo s copyrights, trademarks and other proprietary rights do not infringe upon the proprietary rights of third parties. However, there can be no assurance that third parties will not assert infringement claims against Halo in the future with respect to current or future products or that any such assertion will not require Halo to enter into royalty arrangements or result in litigation.

Competition

Our markets for products and services are highly competitive, and we expect competition to persist and intensify. We face competition from both established and emerging software companies that offer similar products targeted at businesses within markets served by our operating subsidiaries. Some of these companies have greater resources than we do, and we compete with these companies primarily on:

- product functionality, technology, integration, performance and price;
- industry-specific products and industry-expert service;
- ease of use and installation;
- cost benefits;
- sales and marketing efforts;
- support efforts; and
- new products.

Historically, many enterprise software vendors have targeted potential customers in the markets served by our operating subsidiaries:

- *Gupta* -Gupta s primary competitors are Oracle, Microsoft, Sybase, Borland, and MySQL.
- *Warp Solutions* - Warp Solution s primary competitor is Cisco.
- *Kenosia (including RevCast)*- Kenosia s primary competitors are Interactive Edge, Vision Chain, Bentonville Software, Decisions Made Easy, Proclarity and Verisync.
- *DAVID* - DAVID s primary competitors are Valley Oak Systems, GENSOURCE, Insurworx, Tropics,

  CSC RiskMaster and ATS.
- *Process (including Tenebril)* - Process s primary competitor is HP.

Empagio (including the former Tesseract and ECI) - Empagio s primary competitors are Ultimate Software, Hewitt, Accenture, ADP and Ceridian.

ProfitKey - ProfitKey s primary competitors are Epicor, Global Shop, Made 2 Manage and Intuitive.

We believe that the number of enterprise software vendors will continue to decline as the market consolidates around larger vendors who offer complete end-to-end solutions to customers at reasonable prices. Consolidation may occur through established companies developing their own products, through acquisitions, or through cooperative relationships between companies. Future consolidation could lead to increased price competition and other forms of competition.

Most of Halo s and Halo s subsidiaries competitors have longer operating histories, significantly greater financial, technical, marketing and other resources, significantly greater name recognition and a larger installed base of customers. In

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addition, some competitors have demonstrated willingness to, or may willingly in the future, incur substantial losses as a result of deeply discounted product offerings or aggressive marketing campaigns. As a result, Halo s and Halo s subsidiaries competitors may be able to respond more quickly to new or emerging technologies and changes in customer requirements, or to devote greater resources to the development, promotion and sale of competitive products, than we can. There is also a substantial risk that changes in licensing models or announcements of competing products by large, established competitors Microsoft, Oracle, HP, or others could result in the cancellation of customer orders in anticipation of the introduction of such new licensing models or products. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address customer needs which may limit Halo s ability to sell its products through particular partners. Accordingly, new competitors or alliances among, or consolidations of, current and new competitors may emerge and rapidly gain significant market share in Halo s current or anticipated markets. We also expect that competition will increase as a result of software industry consolidation. Increased competition is likely to result in price reductions, fewer customer orders, reduced margins and loss of market share, any of which could materially adversely affect Halo s business. We cannot be certain Halo will be able to compete successfully against current and future competitors or that the competitive pressures Halo faces will not materially adversely affect Halo s business, operating results and financial condition.

Raw Materials

Halo does not use any raw materials in its business.

Dependence on Major Customers

In fiscal years ended June 30, 2006 and 2005, Halo had one distributor, ADN Distribution GMBH (ADN), that accounted for approximately 10% and 22%, respectively, of Halo s revenues. In addition, in fiscal 2005, Halo had one customer, United Parcel Service General Services Co. (UPS), that accounted for 15% of its revenues. In fiscal 2006, no single customer accounted for more than 10% of the Company s revenues.

Gupta entered into a distribution agreement with ADN dated as of January 1, 2004, pursuant to which ADN was granted a nonexclusive and nontransferable right to market and distribute, through third party resellers, Gupta s commercially available software and other Gupta services. The scope of the rights granted in the agreement is the continent of Europe. Under this agreement, ADN was responsible for an initial payment of 2,015 Euros and is invoiced by Gupta Technologies, LLC for products and services purchase thereafter for distribution.

Gupta entered into an OEM Software License Agreement with UPS dated September 29, 1994 and last amended on December 31, 2004 thereby extending its term until December 31, 2006. Pursuant to this amended software license agreement, UPS agreed to pay Gupta $775,000 in exchange for a nontransferable, nonexclusive right to use, package and distribute and sublicense certain of Gupta s software programs that have been in the possession of UPS. Pursuant to the agreement, the payment made to Gupta does not include additional payments which may be made for technical support during the term of the agreement.

Research and Development

During the fiscal year 2006, Halo spent approximately $6,145,000 on research and development of its products. During the fiscal year 2005, Halo spent approximately $1,589,000 on research and the development of its products. The pricing of Halo s products reflects, among other things, the cost of their development as well as the cost of the component parts and applicable license fees.

Personnel

As of June 30, 2006, Halo employed 234 people, including 50 in sales and marketing, 99 in research and development, 40 in technical support and 45 in administration, all of whom are full-time employees. None of Halo s employees are covered by a labor union or collective bargaining agreement. Halo s success depends in large part on its ability to attract, motivate and retain highly skilled employees on a timely basis, particularly executive management, sales and marketing personnel, software engineers and other senior personnel. While Halo s efforts and that of its subsidiaries to attract and retain highly skilled employees could be harmed by its past or any future workforce reductions, Halo management believes that it can attract and retain the highly trained technical personnel who are essential to its product development, marketing, service and support teams.

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Risk Factors

From time to time, information provided by us or statements made by our employees may contain forward-looking information involving risks and uncertainties. In particular, statements contained in this report or incorporated by reference into this report that concern future operating results or other statements using words such as anticipate, believe, could, estimate, intend, may, plan, project, should or will constitute forward-looking statem under the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Our actual results of operations and financial condition have varied in the past and may in the future vary significantly from those stated in any forward-looking statements. Factors that may cause such differences include, without limitation, the risks, uncertainties and other information discussed below. Each of these factors, and others, are discussed from time to time in our filings with the Securities and Exchange Commission. We do not assume any obligation to update any forward-looking statement we make.

In addition to other information in this Annual Report on Form 10-KSB (including all exhibits hereto), the following risk factors should be carefully considered in evaluating the Company and its business, as such factors currently have a significant impact, or may have significant impact in the future, on the Company s business, results of operations, financial condition and the value of its outstanding securities. Additional risks and uncertainties not currently known to us or that we do not currently deem material may also become important factors that may harm our business.

Risks Related to Halo s Business

We have a limited operating history which may make it difficult to predict future results of operations.

Halo has a limited operating history. Such limited operating history makes it more difficult to predict whether or not we will be successful in the future. Our future financial and operational success is subject to the risks, uncertainties, expenses, delays and difficulties associated with managing a new business, many of which may be beyond our control. In addition, Halo competes in a relatively new market known as the information technology market. Because this market rapidly evolves, companies competing in it may face many uncertainties. Our success will depend on many factors, including those described in this Risk Factors section.

We have a history of losses and negative working capital and may need additional financing in the near future in order to continue operations.

We have experienced operating losses for each of the years during which we have operated. Halo has incurred recurring operating losses since its inception. As of June 30, 2006, Halo had an accumulated deficit of approximately $94.6 million and a working capital deficit of $23.2 million. At June 30, 2006, the Company had insufficient capital to fund all of its obligations. These conditions raise substantial doubt about the Company s ability to continue as a going concern. The financial statements do not include any adjustments to reflect the possible future effect of the recoverability and classification of assets or the amounts and classifications of liabilities that may result from the outcome of this uncertainty. The Company s continuation as a going concern is dependant upon receiving additional financing. The Company is currently seeking additional financing. There can be no assurance that the Company will be successful in its efforts to raise sufficient capital. Therefore, there can be no assurance that the Company will have sufficient capital to support its working capital needs through its 2007 fiscal year.

If we achieve profitability, we cannot give any assurance that we would be able to sustain or increase profitability on a quarterly or annual basis in the future. Furthermore, Halo intends to pursue opportunities to acquire other businesses, and may need to raise capital in order to pursue such acquisitions. Similarly, in the future, we may not generate sufficient revenue from operations to pay our operating expenses. If we fail to generate sufficient cash from operations to pay these expenses, our management will need to identify other sources of funds. We may not be able to borrow money or issue more shares of common stock or preferred stock to meet our cash needs. Even if we can complete such transactions, they may not be on terms that are favorable or reasonable from our perspective. As a result, you may lose your entire investment.

We may not be able to borrow funds, which in turn could impair our ability to carry out our business plan.

There currently are no legal limitations on our ability to borrow funds to increase the amount of capital available to us to carry out our business plan. However, our limited resources and limited operating history may make it difficult to borrow additional funds. The amount and nature of any such borrowings would depend on numerous

considerations, including our capital requirements, our perceived ability to meet debt service on any such borrowings and the then prevailing conditions in the financial markets, as well as general economic conditions. There can be no assurance that debt financing, if required or sought, would be available on terms deemed to be commercially acceptable by us and in our best interest.

If we fail to meet our obligations under our debt agreements our secured lender could foreclose on our assets.

On August 2, 2005, Halo entered into a credit agreement (as amended, the Fortress Credit Agreement), between Halo, the Subsidiaries of Halo listed in Schedule 1 thereto, Fortress Credit Corp. as original lender (together with any additional lenders, the Fortress Lenders), and Fortress Credit Corp. as agent (the Fortress Agent) pursuant to which Halo may borrow up to $50 million. Halo initially borrowed $10 million, the proceeds of which were used to pay off prior senior secured notes and a portion of Halo s subordinated indebtedness. On October 26, 2005, in connection with the acquisitions of five enterprise software companies, Halo entered into Amendment Agreement with Fortress amending the Fortress Credit Agreement. Under the Amendment, the Fortress Lenders made an additional loan of $15,000,000 under the credit facility. There can be no assurance that Halo will be able to borrow further amounts under the Fortress Credit Agreement. Future borrowings are subject to the satisfaction of various conditions precedent, including lender approval of the use of further borrowings.

The Fortress Credit Agreement contains numerous financial and operating covenants. There can be no assurance that Halo will be able to comply with these covenants, and failure to meet such covenants or the failure of the lenders to agree to amend or waive compliance with covenants that Halo does not meet would result in a default under the Fortress Credit Agreement. Moreover, Halo s subordinated debt incorporates the covenants and default provisions of the Fortress Credit Agreement. Any material default that is not amended or waived under any of these agreements will result in a default under most or all of Halo s financing arrangements. The Credit Agreement contains certain financial covenants usual and customary for facilities and transactions of this type. The Company is currently in compliance with these financial covenants. The Company anticipates that due to recent transactions, certain of the covenants under the Credit Agreement may have to be modified in order for the Company to continue to comply for future periods. The Company has engaged in discussions with the Fortress Agent, and anticipates negotiating appropriate modifications to the covenants to reflect these changes in the Company s business as they occur. In the event the Company completes further acquisitions, the Company and the other parties to the Credit Agreement will be required to agree upon modifications to the financial covenants to reflect the changes to the Company s consolidated assets, liabilities, and expected results of operations in amounts to be mutually agreed to by the parties. There can be no assurance that any such modifications will be agreed upon. In addition, the Credit Agreement provides that in the event of certain changes of control, including (i) a reduction in the equity ownership in the Company of Ron Bienvenu or his immediate family members below 90% of such equity interests on the date of the Credit Agreement, or (ii) Ron Bienvenu ceases to perform his current management functions and is not replaced within 90 days by a person satisfactory to Fortress, all amounts due may be declared immediately due and payable. The Credit Agreement contains specific events of default, including failure to make a payment, the breach of certain representations and warranties, and insolvency events. There is also a cross-default provision that provides that certain events of default under certain contracts between the Company or its subsidiaries and third parties will constitute an event of default under the Credit Agreement.

The Fortress Lenders have a security interest in all of Halo s and its subsidiaries assets, including the stock in the subsidiaries held by Halo. An unwaived default by Halo under the Fortress Credit Agreement could permit the lenders thereunder to foreclose on all of the assets of Halo, thereby causing Halo to cease doing business. Upon such an occurrence, stockholders would lose their entire investment in Halo.

A failure to adapt to rapidly changing markets and develop new technologies could harm our business.

The markets for our products are characterized by:

- rapidly changing technologies;
- evolving and competing industry standards;
- changing customer needs;
- frequent new product introductions and enhancements;
- increased integration with other functions; and

rapid product obsolescence.

To develop new products for our target markets, we must develop, gain access to and use leading technologies in a cost-effective and timely manner and continue to expand our technical and design expertise. In addition, we must maintain close working relationships with key customers and potential customers in order to develop new products that meet their changing needs. A failure to develop new technologies and adapt to changing technologies could affect our ability to remain competitive which could lead to a decline in our revenue and cash flow.

Halo may not be able to identify new product opportunities successfully, develop and bring to market new products, achieve design wins or respond effectively to new technological changes or product announcements by its competitors. In

addition, we may not be successful in developing or using new technologies or in developing new products or product enhancements that achieve market acceptance. Our pursuit of necessary technological advances may require substantial time and expense. Failure in any of these areas could harm our operating results by negatively impacting our revenue and cash flow.

Failure to timely develop new products which achieve market acceptance could interfere with Halo s customer relationships and adversely affect Halo s business, financial condition and results of operations.

Halo s subsidiaries are currently developing new products, as well as new applications of existing products. There can be no assurance that we will not experience difficulties that could delay or prevent the successful development, introduction or marketing of our products, or that our new or enhanced products will adequately meet the requirements of our current or prospective customers. Any failure by Halo or its subsidiaries to successfully design, develop, test and introduce such new products, or the failure of Halo s recently introduced products to achieve market acceptance, could prevent us from maintaining existing customer relationships, gaining new customers or expanding our markets and could have a material adverse effect on our business, financial condition and results of operations.

A failure by us to manage our growth and expansion could have a material adverse effect on our business.

Halo is currently anticipating a period of growth for certain of our operating subsidiaries as a result of its recent marketing and sales efforts. The resulting strain on our managerial, operational, financial and other resources could be significant. Success in managing this expansion and growth will depend, in part, upon the ability of senior management to manage effectively. Any failure to manage the anticipated growth and expansion could have a material adverse effect on our business.

We do not anticipate declaring any cash dividends in the foreseeable future which could reduce the liquidity of your investment.

We presently do not expect to pay cash dividends in the foreseeable future. The payment of cash dividends, if any, will be contingent upon our revenues and earnings, if any, capital requirements, and general financial condition. The payment of any cash dividends will be within the discretion of our board of directors. We presently intend to retain all earnings, if any, to implement our business plan. Accordingly, we do not anticipate the declaration of any cash dividends in the foreseeable future.

Our obligations to indemnify our officers and directors may divert funds from our business operations.

Our Articles of Incorporation provide for the indemnification of our officers and directors to the fullest extent permitted by the laws of the State of Nevada and the federal securities laws. It is possible that the indemnification obligations imposed under these provisions could result in a charge against our earnings and thereby affect the availability of funds for other uses.

Our common stock is subject to penny stock restrictions under federal securities laws which could reduce the liquidity of our common stock.

The Securities and Exchange Commission has adopted regulations, which generally define penny stock to be an equity security that has a market price less than $5.00 per share or an exercise price of less than $5.00 per share, subject to certain exemptions. On July 31, 2006, the last sale price for our common stock, as quoted on the OTC Bulletin Board, was $0.94 per share and therefore, our common stock is designated a penny stock. As a penny stock, our common stock is subject to Rule 15g-9 under the Exchange Act or the Penny Stock Rules. These rules include, but are not limited to, Rules 3a51-1, 15g-1, 15g-2, 15g-3, 15g-4, 15g-5, 15g-6 and 15g-7 under the Securities Exchange Act of 1934, as amended. These rules impose additional sales practice requirements on broker-dealers that sell such securities to persons other than established customers and accredited investors (generally, individuals with a net worth in excess of $1,000,000 or annual incomes exceeding $200,000, or $300,000 together with their spouses). For transactions covered by Rule 15g-9, a broker-dealer must make a special suitability determination for the purchaser and have received the purchaser s written consent to the transaction prior to sale. As a result, this rule may affect the ability of broker-dealers to sell our securities and may affect the ability of purchasers to sell any of our securities in the secondary market.

The rules may further affect the ability of owners of our shares to sell their securities in any market that may develop for them. There may be a limited market for penny stocks, due to the regulatory burdens on broker-dealers. The market among dealers may not be active. Investors in penny stock often are unable to sell stock back to the dealer

that sold them the

stock. The mark-ups or commissions charged by the broker-dealers may be greater than any profit a seller may make. Because of large dealer spreads, investors may be unable to sell the stock immediately back to the dealer at the same price the dealer sold the stock to the investor. In some cases, the stock may fall quickly in value. Investors may be unable to reap any profit from any sale of the stock, if they can sell it at all.

For any transaction involving a penny stock, unless exempt, the rules require delivery, prior to any transaction in a penny stock, of a disclosure schedule prepared by the Securities and Exchange Commission relating to the penny stock market. Disclosure is also required to be made about sales commissions payable to both the broker-dealer and the registered representative and current quotations for the securities. Finally, monthly statements are required to be sent disclosing recent price information for the penny stock held in the account and information on the limited market in penny stock. The penny stock restrictions will no longer apply to our common stock if we become listed on a national exchange. In any event, even if our common stock were exempt from the penny stock restrictions, we would remain subject to Section 15(b)(6) of the Exchange Act, which gives the Securities and Exchange Commission the authority to restrict any person from participating in a distribution of penny stock, if the Securities and Exchange Commission finds that such a restriction would be in the public interest.

Risk Factors Related to Halo s Acquisition Strategy

Failure to manage the risks associated with our growth and acquisition strategy could have a material adverse effect on Halo s operations and financial condition.

One of Halo s primary strategies is to pursue the acquisition of other companies or assets that either complement or expand its existing business. Halo completed the acquisition of Gupta in January 2005, the acquisition of Kenosia in July 2005, and the acquisition of Tesseract and four other software companies, DAVID, Process, ProfitKey and Foresight, in October 2005. In addition, Halo completed the acquisition of Empagio in January 2006 and ECI in March 2006. The acquisition of the NavRisk Business from Unify is expected to close in the second quarter of fiscal 2007. Halo has also had preliminary acquisition discussions with, or has evaluated the potential acquisition of, several other companies. However, Halo is unable to predict the likelihood or timing of a material acquisition being completed in the future.

Halo anticipates that one or more potential acquisition opportunities, including those that would be material, may become available in the near future. If and when appropriate acquisition opportunities become available, Halo intends to pursue them actively. There can be no assurance that Halo will be able to profitably manage the addition of Kenosia, Tesseract, DAVID, ProfitKey, Foresight, Process, Empagio, ECI, Tenebril and RevCast or that it will be able to identify, acquire or profitably manage additional companies or successfully integrate such additional companies into its operations without substantial costs, delays or other problems. In addition, there can be no assurance that any companies acquired will be profitable at the time of their acquisition or will achieve sales and profitability that justify the investment therein. Acquisitions may involve a number of special risks, including adverse effects on Halo s reported operating results, diversion of management s attention, dependence on retention and hiring of key personnel, and risks associated with unanticipated problems or legal liabilities, some or all of which could have a material adverse effect on Halo s operations and financial performance. The expansion of Halo s operations, whether through acquisitions or internal growth, may place substantial burdens on Halo s management resources and financial controls. There is no assurance that the increasing burdens on Halo s management resources and financial controls will not have an adverse effect on Halo s operations.

We may be required to recognize impairment charges which could negatively impact our earnings.

Goodwill and intangible assets account for approximately $51.7 million or 87% of Halo s assets as of June 30, 2006. We are required to perform impairment tests on our identifiable intangible assets with indefinite lives, including goodwill, annually or at any time when certain events occur, which could impact the value of our business. Our determination of whether impairment has occurred is based on a comparison of the assets fair market values with the assets carrying values. Significant and unanticipated changes could require a provision for impairment that could substantially affect our reported earnings in a period of such change.

Additionally, we are required to recognize an impairment loss when circumstances indicate that the carrying value of long-lived tangible and intangible assets with finite lives may not be recoverable. Management s policy in determining whether an impairment indicator exists, (a triggering event), comprises measurable operating

performance criteria as well as qualitative measures. If a determination is made that a long-lived asset s carrying value is not recoverable over its estimated useful life, the asset is written down to estimated fair value, if lower. The determination of fair value of long-lived assets is generally based on estimated expected discounted future cash flows, which is generally measured by discounting expected

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future cash flows identifiable with the long-lived asset at our weighted-average cost of capital. For the years ended June 30, 2006 and 2005, Halo had goodwill impairment charges of $5.2 million and $3.9 million, respectively.

Failure to finance future acquisitions could limit our ability to implement our business plan.

We seek to use shares of our common stock to finance a portion of the consideration for acquisitions. If our common stock does not maintain a sufficient market value or the owners of businesses we may seek to acquire are otherwise unwilling to accept shares of common stock as part of the consideration for the sale of their businesses, we may be required to use more of our cash resources in order to implement our acquisition strategy. If we have insufficient cash resources, our ability to pursue acquisitions could be limited unless we are able to obtain additional funds through debt or equity financing. Our ability to obtain debt financing may be constrained by existing or future loan covenants, the satisfaction of which may be dependent upon our ability to raise additional equity capital through either offerings for cash or the issuance of stock as consideration for acquisitions. We cannot assure you that our cash resources will be sufficient, or that other financing will be available on terms we find acceptable. If we are unable to obtain sufficient financing, we may be unable to implement fully our acquisition strategy.

Additional Risk Factors Related to the Business of Halo s Operating Subsidiaries

Financial results may vary significantly from quarter to quarter which could affect our ability to sustain our operations.

Halo s operating results have varied significantly from quarter to quarter at times in the past and may continue to vary significantly from quarter to quarter in the future due to a variety of factors. Many of these factors are outside of our control.

These factors include:

- fluctuations in demand for Halo s products, upgrades to Halo s products, or services;
- fluctuations in demand for Halo s products due to the potential deteriorating economic conditions of Halo s customer base;
- seasonality of purchases and the timing of product sales and shipments;
- unexpected delays in introducing new products and services or improvements to existing products and services;
- new product releases, licensing models or pricing policies by Halo s competitors;
- acquisitions or mergers involving Halo s competitors or customers;
- impact of changes to Halo s product distribution strategy and pricing policies;
- lack of order backlog;
- loss of a significant customer or distributor;
- changes in purchasing and/or payment practices by Halo s distributors or other customers;
- a reduction in the number of independent software vendors (ISVs), who embed Halo s products, or value-added resellers (or VARs), who sell and deploy Halo s products;
- changes in the mix of domestic and international sales;
- impact of changes to Halo s geographic investment levels and business models;

- gains or losses associated with discontinued operations; and

- changes in Halo s business plan or strategy.

Halo s revenue growth and profitability depend on the overall demand for Halo s products and services, which in turn depends on general economic and business conditions. The nature and extent of the effect of the current economic climate on Halo s ability to sell its products and services is uncertain. A softening of demand for Halo s products and services caused by weakening of the economy may result in decreased revenues or lower growth rates. There can be no assurance that we will be able to effectively promote revenue growth rates in all economic conditions.

Significant portions of Halo s expenses are not variable in the short term and cannot be quickly reduced to respond to decreases in revenues. Therefore, if Halo s revenues are below expectations, Halo s operating results are likely to be adversely and disproportionately affected. In addition, Halo may change its prices, modify its distribution strategy and policies, accelerate its investment in research and development, sales or marketing efforts in response to competitive pressures or pursue new market opportunities. Any one of these activities may further limit Halo s ability to adjust spending in response to revenue fluctuations.

Seasonality may contribute to fluctuations in Halo s quarterly operating results.

Halo s business has experienced seasonal customer buying patterns with relatively weaker demand in the quarters ending June 30 and September 30. We believe that this pattern may continue.

Halo currently operates without a backlog which can affect our periodic results.

Halo generally operates with virtually no order backlog because Halo s software products are shipped and revenue is recognized shortly after orders are received. This lack of backlog makes product revenues in any quarter substantially dependent on orders booked and shipped throughout that quarter.

Our efforts to develop and maintain brand awareness of Halo products may not be successful. A lack of brand awareness could adversely affect Halo s sales.

Brand awareness is important given competition in the markets where Halo operates. We are aware of other companies that use similar product names in order to promote their competing products and services, including but not limited to services to port Halo s customers applications to other database s and/or programming languages or development suites. We expect that it may be difficult or impossible to prevent third-party usage of Halo s or its operating subsidiaries names and our products names and variations of these names for competing goods and services. Competitors or others who use marks similar to Halo brand names may cause confusion among actual and potential customers, which could prevent Halo from achieving significant brand recognition. If we fail to promote and maintain the Halo brand or incur significant related expenses, Halo s business, operating results and financial condition could be materially adversely affected by a decline in sales and revenue.

Halo may face problems in connection with product line expansion which could affect its future operations and limit its growth opportunities.

In the future, Halo may acquire, license or develop additional products. Future product line expansion may require Halo to modify or expand its business. If Halo is unable to fully integrate new products with its existing operations, Halo may not receive the intended benefits of such product line expansion. We cannot be certain that the market acceptance or demand for these new products will meet our expectations. The failure to integrate new products with Halo s existing operations could materially affect our business by limiting our prospects for growth which could lead to stagnant or declining revenue.

A small number of distributors account for a significant percentage of Halo s billings. The loss of one or more of such distributors could significantly reduce Halo s revenue, cash flow and earnings.

The loss of a major distributor, changes in a distributor s payment practices, changes in the financial stability of a major distributor or any reduction in orders by such distributor, including reductions due to market or competitive conditions combined with the potential inability to replace the distributor on a timely basis, or any modifications to our pricing or distribution channel strategy could materially adversely affect Halo s business, operating results and financial condition. Many of Halo s ISVs, VARs and end users place their orders through distributors. A relatively small number of distributors (five) have accounted for a significant percentage (22% in the year ended June 30, 2006) of Halo s revenues. The five significant distributors are ADN Distribution, GmbH, Scientific Computers, NOCOM AB, Sphinx CST, and Xtura B.V. Halo, through its operating subsidiaries, has entered into distribution agreements with each of these five distributors for distribution of its products and services internationally. These distribution agreements are non-exclusive and cover territories throughout different regions of Europe. Pursuant to the terms of these agreements, the distributors may use resellers, must meet certain sales quotas or risk having the agreements terminated, and may represent themselves as authorized distributors. The loss of one or more significant distributors, unless it was offset by the attraction of sufficient new customers, could have a material adverse impact on the business of Halo by significantly revenue, cash flow and earnings. Halo expects it will continue to depend on a limited number of distributors for a significant portion of its revenues in future periods and the loss of a significant distributor could have a material adverse impact on Halo by significantly revenue, cash flow and earnings. Halo s distributors have not agreed to any minimum order requirements.

Halo depends on an indirect sales channel. A failure to grow its indirect sales or the loss of indirect channel partners could significantly reduce Halo s revenue, cash flow and earnings.

Halo s failure to grow its indirect sales channel or the loss of a significant number of members of its indirect channel partners would have a material adverse effect on Halo s business, financial condition and operating results.

Halo derives a

substantial portion of its revenues from indirect sales through a channel consisting of independent software vendors, value-added resellers, systems integrators, consultants and distributors.

Halo s sales channel could be adversely affected by a number of factors including:

- the emergence of a new platform resulting in the failure of independent software vendors to develop and the failure of value-added resellers to sell Halo s products based on Halo s supported platforms;
- pressures placed on the sales channel to sell competing products;
- Halo s failure to adequately support the sales channel;
- consolidation of certain of Halo s indirect channel partners;
- competing product lines offered by certain of Halo s indirect channel partners; and
- business model or licensing model changes of Halo s channel partners or their competitors.

We cannot be certain Halo will be able to continue to attract additional indirect channel partners or retain its current channel partners. In addition, we cannot be certain that Halo s competitors will not attempt to recruit certain of Halo s current or future channel partners. This may have an adverse effect on Halo s ability to attract and retain channel partners. The loss of indirect channel partners, or the inability to attract new channel partners, could lead to a loss of significant revenue, cash flow and earnings resulting in a material adverse effect on our business.

Halo may not be able to develop the strategic relationships necessary to succeed in its operations.

Halo s current collaborative relationships may not prove to be beneficial to us, and they may not be sustained. We may not be able to enter into successful new strategic relationships in the future, which could have a material adverse effect on Halo s business, operating results and financial condition due to increased development, marketing and distribution costs and expenses. From time to time, Halo has collaborated with other companies in areas such as product development, marketing, distribution and implementation. However, many of Halo s current and potential strategic relationships are with either actual or potential competitors. In addition, many of Halo s current relationships are informal or, if written, terminable with little or no notice.

The failure of Halo to maintain or obtain third-party software licenses could harm our business, operating results and financial condition due to loss of customer revenue.

Halo relies upon certain software that it licenses from third parties, including software integrated with Halo s internally developed software and used in Halo s products to perform key functions. These thirdparty software licenses may not continue to be available to Halo on commercially reasonable terms. In addition, some of Halo s software components have been licensed from the open source community. The loss of, or inability to maintain or obtain any of these software licenses, could result in shipment delays or reductions until Halo develops, identifies, licenses and integrates equivalent software. Any delay in product development or shipment could damage Halo s business, operating results and financial condition due to loss of customer and subsequent decline in revenue.

Halo may become subject to product or professional services liability claims which could divert a significant amount of our revenues from operations.

A product or professional services liability claim, whether or not successful, could damage Halo s reputation and business, operating results and financial condition. Halo s license and service agreements with its customers typically contain provisions designed to limit Halo s exposure to potential product or service liability claims. However, these contract provisions may not preclude all potential claims. Product or professional services liability claims could require us to spend significant time and money in litigation or to pay significant damages which could harm our business, operating results and financial condition.

Halo competes with Microsoft while simultaneously supporting Microsoft technologies. Our business maybe harmed if Microsoft s technology becomes more directly competitive with Halo.

Halo currently competes with Microsoft in the market for application development tools and data management products while simultaneously maintaining a working relationship with Microsoft. Microsoft has a longer operating

history, a larger installed base of customers and substantially greater financial, distribution, marketing and technical resources than Halo. As a result, Halo may not be able to compete effectively with Microsoft now or in the future, and Halo s business, operating results and financial condition may be materially adversely affected.

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We expect that Microsoft s commitment to and presence in the application development and data management products market will substantially increase competitive pressures. We believe that Microsoft will continue to incorporate SQL Server database technology into its operating system software and certain of its server software offerings, possibly at no additional cost to its users. We believe that Microsoft will also continue to enhance its SQL Server database technology and that Microsoft will continue to invest in various sales and marketing programs involving certain of Halo s channel partners. We believe Halo must maintain a working relationship with Microsoft to achieve success. Many of Halo s customers use Microsoft-based operating platforms. Thus it is critical to Halo s success that Halo s products be closely integrated with Microsoft technologies. Notwithstanding Halo s historical and current support of Microsoft platforms, Microsoft may in the future promote technologies and standards more directly competitive with or not compatible with Halo s technology which could lead to a decline in customer sales and resulting in a loss of revenue, cash flow and earnings, as well as limiting our future growth opportunities.

A failure to remain competitive in our industry could have a material adverse effect on our sales.

Halo, through its operating subsidiaries, encounters competition for its embedded database products primarily from large, public companies, including Microsoft, Oracle, Sybase, IBM, Progress, Pervasive Software, and Borland. In particular, Sybase s small memory footprint database software product, Adaptive Server Anywhere, and Microsoft s product, SQL Server, directly compete with Halo s products. There are also competitive pressures for application development tools from Microsoft Visual Studio, SYBASE PowerBuilder and Borland Delphi and Kylix. And, because there are relatively low barriers to entry in the software market, Halo may encounter additional competition from other established or emerging companies providing database products based on existing, new or open-source technologies. Open-source software, which is an emerging trend in the software marketplace, may impact Halo s business as interest, demand and use increases in the database segment and poses a challenge to Halo s business model, including recent efforts by proponents of open-source software to convince governments worldwide to mandate the use of open-source software in their purchase and deployments of software products. Firms adopting the open-source software model typically provide customers software produced by loosely associated groups of unpaid programmers and made available for license to end users at nominal cost, and earn revenue on complementary services and products, without having to bear the full costs of research and development for the open-source software. Because the present demand for open-source database software is largely concentrated in major corporations, Halo s embedded database business has not been adversely affected to date. However, it is likely that increased adoption of Linux will drive heightened interest in other more mature software categories such as database and certain business applications. To the extent competing open-source software products gain increasing market acceptance, sales of Halo s products may decline, Halo may have to reduce prices it charges for its products, and Halo s revenue and operating margins may decline. Mass adoption of open source databases in the SME market could have a material adverse impact on Halo s database business.

Application service providers (ASPs) may enter Halo s market and could cause a change in revenue models from licensing of client/server and Web-based applications to renting applications. Halo s competitors may be more successful than it is in adopting these revenue models and capturing related market share. In addition, Halo competes or may compete against database vendors that currently offer, or may develop, products with functionalities that compete with Halo s solutions. These products typically operate specifically with these competitors proprietary databases. Such competitors include IBM, Microsoft and Oracle. Competition also comes in the form of custom code, where potential customers have sufficient internal technical resources to develop solutions in-house without the aid of Halo s products or those of its competitors.

Most of Halo s competitors have longer operating histories, significantly greater financial, technical, marketing and other resources, significantly greater name recognition and a larger installed base of customers. In addition, some competitors have demonstrated willingness to, or may willingly in the future, incur substantial losses as a result of deeply discounted product offerings or aggressive marketing campaigns. As a result, Halo s competitors may be able to respond more quickly to new or emerging technologies and changes in customer requirements, or to devote greater resources to the development, promotion and sale of competitive products, than we can. There is also a substantial risk that changes in licensing models or announcements of competing products by competitors such as Microsoft, Oracle, Sybase, IBM, Progress, MySQL, or others could result in the cancellation of customer orders in anticipation of the

introduction of such new licensing models or products. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address customer needs which may limit Halo s ability to sell its products through particular partners. Accordingly, new competitors or alliances among, or consolidations of, current and new competitors may emerge and rapidly gain significant market share in Halo s current or anticipated markets. We also expect that competition will increase as a result of software industry consolidation. Increased competition is likely to result in price reductions, fewer customer orders, reduced margins and loss of market share, any of which could materially adversely affect Halo s business. We cannot be certain Halo will be able to compete successfully against current and future

competitors or that the competitive pressures Halo faces will not materially adversely affect Halo s business, operating results and financial condition.

Halo is susceptible to a shift in the market for client/server applications toward server based thin client or web-based applications.

Halo has derived substantially all of its historical application development tool and embedded database product revenues from the use of its products in client/server applications. Halo expects to rely on continued market demand for client/server applications indefinitely. However, we believe market demand may shift from client/server applications to server based solutions using Citrix or similar technology or, Web-based applications. If so, this shift could occur before Halo s product line has achieved market acceptance for use in Web-based applications. In addition, we cannot be certain that Halo s existing client/server developers will migrate to Web-based applications and continue to use Halo s products or that other developers of Web-based applications would select Halo s data management products. Further, this shift could result in a change in revenue models from licensing of client/server and Web-based applications to renting of applications from application service providers. A decrease in client/server application sales coupled with an inability to derive revenues from the Web-based application market could have a material adverse effect on Halo s business, operating results and financial condition.

Halo s dependence on international sales and operations subjects it to risks associated with foreign laws, staffing and currency.

We anticipate that for the foreseeable future Halo will derive a significant portion of its revenues from sources outside North America. In the fiscal years ended June 30, 2006 and 2005, Halo derived approximately 35% and 60%, respectively of its revenues outside North America. Halo s international operations, including its German operations, are generally subject to a number of risks. These risks include:

- foreign laws and business practices favoring local competition;
- dependence on local channel partners;
- compliance with multiple, conflicting and changing government laws and regulations;
- longer sales cycles;
- greater difficulty or delay in collecting payments from customers;
- difficulties in staffing and managing foreign operations;
- foreign currency exchange rate fluctuations and the associated effects on product demand and timing of payment;
- increased tax rates in certain foreign countries;
- difficulties with financial reporting in foreign countries;
- foreign protectionist laws and business practices that favor local competition;
- failure of local laws to provide the same degree of protection against infringement of our intellectual property;
- quality control of certain development, translation or localization activities; and
- political and economic instability.

We may not be successful in developing and implementing policies and strategies to address the foregoing factors in a timely and effective manner in each country where we do business. Consequently, the occurrence of one or more

of the foregoing factors could have a material adverse effect on our international operations or upon our financial condition and results of operations.

In addition, because a significant amount of our revenues are derived from sales in Germany, the factors adversely affecting Germany and its region could have an especially material impact on our operations. Halo may expand or modify its operations internationally. Despite Halo s efforts, it may not be able to expand or modify its operations internationally in a timely and cost-effective manner. Such an outcome would limit or eliminate any sales growth internationally, which in turn would materially adversely affect Halo s business, operating results and financial condition. Even if Halo successfully expands or modifies its international operations, Halo may be unable to maintain or increase international market demand for its products. We expect Halo s international operations will continue to place financial and administrative demands on us, including operational complexity associated with international facilities, administrative burdens associated with managing relationships with foreign partners, and treasury functions to manage foreign currency risks and collections.

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Fluctuations in the relative value of foreign currencies can reduce our revenues or increase our costs.

To date, the majority of Halo s transactions have been denominated in U.S. dollars. However, the majority of Halo s international operating expenses and substantially all of its international sales have been denominated in currencies other than the U.S. dollar. Therefore, Halo s operating results may be adversely affected by changes in the value of the U.S. dollar. Certain of Halo s international sales are denominated in U.S. dollars, especially in Europe. Any strengthening of the U.S. dollar against the currencies of countries where Halo sells products denominated in U.S. dollars will increase the relative cost of Halo s products and could negatively impact its sales in those countries. To the extent Halo s international operations expand or are modified, our exposure to exchange rate fluctuations may increase. Although these transactions have not resulted in material gains and losses to date, similar transactions could have a damaging effect on Halo s business, results of operations or financial condition in future periods.

ITEM 2. PROPERTIES.

The principal executive offices of Halo are located at 200 Railroad Avenue, 3rd Floor, Greenwich, Connecticut 06830. Halo amended its lease on May 1, 2006 for approximately 4,466 square feet of office space. The lease expires on August 31, 2010. Under the terms of the lease, the Company will pay an aggregate rent of $926,878. The property has a general purpose use for sales and administration, and Halo believes it will be sufficient for our needs for the foreseeable future.

Halo s wholly-owned subsidiary, Gupta, leases 6,319 square feet of office space at its headquarters in Redwood Shores, California, and 5,349 square feet of office space in Munich, Germany. Gupta additionally leases small sales offices in Paris and London.

The principal executive offices of Halo s Process subsidiary are located in Framingham, Massachusetts. Halo s subsidiary ProfitKey International leases 9,000 square feet of office space at its headquarters in Salem, New Hampshire. Halo s DAVID Corporation subsidiary leases 5,180 square feet of office space at its headquarters in San Francisco, California. Empagio leases 1,788 square feet of office space at its headquarters in Atlanta, Georgia, and 13,500 square feet of office space in San Francisco, California. Halo believes these premises, together with any premises acquired in connection pending acquisitions, will be sufficient for our needs for the foreseeable future.

ITEM 3. LEGAL PROCEEDINGS.

From time to time, Halo may be involved in litigation that arises in the normal course of its business operations. As of the date of this Annual Report, Halo is not a party to any litigation that it believes could reasonably be expected to have a material adverse effect on its business or results of operations.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

None.

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PART II

ITEM 5. MARKET FOR COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND SMALL BUSINESS ISSUER PURCHASES OF EQUITY SECURITIES.

The Company s common stock, par value $.00001 per share, is quoted on the OTC Bulletin Board operated by the National Association of Securities Dealers, Inc. under the symbol HALO .

The following table sets forth the range of high and low closing bid prices for the Company s common stock for the periods indicated as reported by the National Quotation Bureau, Inc. These prices represent quotations between dealers, do not include retail markups, markdowns or commissions, and do not necessarily represent actual transactions.

		Bid Price	
Fiscal Year	**Quarter Ended**	**Low**	**High**
2005	September 30, 2004	3.00	8.00
	December 31, 2004	1.50	5.00
	March 31, 2005	1.51	5.00
	June 30, 2005	1.60	4.00
2006	September 30, 2005	.92	2.85
	December 31, 2005	1.10	1.75
	March 31, 2006	1.20	1.80
	June 30, 2006	.80	1.30

As of October 12, 2006, the National Quotation Bureau, Inc. reported that the closing bid and ask prices on the Company s common stock were $.62 and $.80, respectively.

Holders

As of June 30, 2006, there were 26,723,247 shares of the Company s common stock outstanding. In addition, there were 7,045,454 shares of the Company s Series D Preferred Stock outstanding. The Series D Stock is currently convertible into 7,045,454 shares of the Company s common stock, subject to adjustments under the terms of the Series D Preferred Stock. Each holder of shares of Series D Preferred Stock is entitled to vote on all matters submitted to a vote of the stockholders of the Company and shall be entitled to that number of votes equal to the largest number of whole shares of common stock into which such holder s shares of Series D Preferred Stock could be converted.

At June 30, 2006, there were approximately 400 common stockholders of record, including shares held by brokerage clearing houses, depositories or otherwise in unregistered form. The beneficial owners of such shares are not known to us.

Dividends

We have not declared any cash dividends, nor do we intend to do so. We are not subject to any legal restrictions respecting the payment of dividends, except as provided under the rights and preferences of the Company s Series D Preferred Stock which restrict, the payment of any dividend with respect to the common stock without paying dividends on the Series D Stock, and which provide for a preference in the payment of the dividends on the Series D Preferred Stock requiring such dividends to be paid before any dividend or distribution is made to the common stockholders. Dividends on the Series D Preferred Stock accrue at the rate of 13% of the stated value of the preferred stock per annum, and are payable in cash or in shares of common stock. Dividends on each share of Series D Preferred Stock were paid initially on March 31, 2006 and are paid quarterly in arrears thereafter, in either cash or additional shares of common stock, at the election of the Company.

Our dividend policy will be based on our cash resources and needs and it is anticipated that all available cash will be needed for our operations in the foreseeable future.

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Securities Authorized for Issuance Under Equity Compensation Plans.

The following table sets forth as of June 30, 2006, certain information regarding the securities authorized for issuance under (i) the Warp Technology Holdings, Inc. 2002 Stock Incentive Plan (the 2002 Plan), and (ii) the Halo Technology Holdings 2005 Equity Incentive Plan (the 2005 Plan), which are the only equity compensation plans of the Company as of June 30, 2006.

Equity Compensation Plan Information

	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans
Equity compensation plans approved by security holders	3,643,500	$ 1.17	4,756,500
Equity compensation plans not approved by security holders	570,077	$ 5.38	206,534
Total	4,213,577	$ 1.74	4,963,034

In November 2002, the Company s Board of Directors approved and adopted the 2002 Plan as a means through which the Company and its subsidiaries may attract, retain and compensate employees and consultants. So that the appropriate incentive can be provided, the 2002 Plan provides for granting Incentive Stock Options, Nonqualified Stock Options, Restricted Stock Awards and Stock Bonuses, or a combination of the foregoing. A total of 776,611 Shares have been reserved for issuance pursuant to the 2002 Plan plus Shares that are subject to: (a) issuance upon exercise of an option but cease to be subject to such option for any reason other than exercise of such option; (b) an award granted under the 2002 Plan but forfeited or repurchased by the Company at the original issue price; and (c) an Award that otherwise terminates without Shares being issued. The 2002 Plan is administered by the Board of Directors. The Board of Directors may at any time terminate or amend the 2002 Plan in any respect, including without limitation amendment of any form of award agreement or instrument to be executed pursuant to the 2002 Plan; provided, however, that the Board of Directors will not, without the approval of the stockholders of the Company, amend the 2002 Plan in any manner that requires stockholder approval. Unless earlier terminated as provided under the 2002 Plan, the 2002 Plan will terminate November 2012. As of June 30, 2006, there were outstanding options to purchase 570,077 shares and there were 206,634 shares available for award under the 2002 Plan.

At the Annual Meeting of Stockholders of the Company held October 21, 2005, the stockholders of the Company approved the 2005 Plan which had been previously approved by the Board of Directors of the Company. The Compensation Committee of the Board of Directors of the Company will administer the 2005 Plan, including selecting the employees, consultants and directors to be granted Awards under the 2005 Plan and determining the type and size of each Award and the terms and conditions of each Award. The Company s employees, consultants and directors, or the employees, consultants and directors of the Company s related companies, may receive Awards under the 2005 Plan. The types of Awards that may be granted under the 2005 Plan are stock options (both incentive and non-qualified), stock appreciation rights, restricted stock, restricted stock units, performance stock, contract stock, bonus stock and dividend equivalent rights. Subject to adjustment for stock splits and similar events, the total number of shares of common stock that can be delivered under the 2005 Plan is 8,400,000 shares. No employee may receive options, stock appreciation rights, shares or dividend equivalent rights for more than four million shares during any calendar year. No incentive stock option will be granted under the 2005 Plan after September 13, 2015. The Board of Directors may at any time suspend, terminate or amend the 2005 Plan in any respect, including without limitation amendment of any form of award agreement or instrument to be executed pursuant to the 2005 Plan, and the

Compensation Committee may amend any outstanding awards in any respect; provided, however, that the Board of Directors or Compensation Committee will not, without the approval of the stockholders of the Company, amend the 2005 Plan in any manner that requires stockholder approval. As of June 30, 2006, there were outstanding options to purchase 3,643,500 shares and 4,756,500 shares available for award under the 2005 Plan.

Also as a result of the stockholder s approval of the 2005 Plan, the Compensation Committee of the Board of Directors determined to award cash bonus amounts, options and/or shares pursuant to the Fiscal 2006 Halo Senior Management Incentive Plan. No specific awards have yet been made under the Fiscal 2006 Halo Senior Management Incentive Plan. Any awards made will be made out of shares reserved under the 2002 Plan, the 2005 Plan or any other plans adopted in the future.

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Recent Sales of Unregistered Securities

None.

Section 15(g) of the Exchange Act

The Company s shares are covered by Section 15(g) of the Securities Exchange Act of 1934, as amended, and Rules 15g-1 through 15g-6 promulgated there under, which impose additional sales practice requirements on broker/dealers who sell our securities to persons other than established customers and accredited investors.

Rule 15g-2 declares unlawful any broker-dealer transactions in penny stocks unless the broker-dealer has first provided to the customer a standardized disclosure document.

Rule 15g-3 provides that it is unlawful for a broker-dealer to engage in a penny stock transaction unless the broker-dealer first discloses and subsequently confirms to the customer the current quotation prices or similar market information concerning the penny stock in question.

Rule 15g-4 prohibits broker-dealers from completing penny stock transactions for a customer unless the broker-dealer first discloses to the customer the amount of compensation or other remuneration received as a result of the penny stock transaction.

Rule 15g-5 requires that a broker dealer executing a penny stock transaction, other than one exempt under Rule 15g-1, disclose to its customer, at the time of or prior to the transaction, information about the sales persons compensation.

The Company s common stock may be subject to the foregoing rules. The application of the penny stock rules may affect our stockholder s ability to sell their shares because some broker/dealers may not be willing to make a market in our common stock because of the burdens imposed upon them by the penny stock rules.

ITEM 6. MANAGEMENT S DISCUSSION AND ANALYSIS OR PLAN OF OPERATIONS.

The following discussion and analysis provides information which the Company s management believes is relevant to an assessment and understanding of the Company s results of operations and financial condition. This discussion should be read together with the Company s financial statements and the notes to financial statements, which are included in this report.

Results of Operations

	Year Ended June 30,			
	2006		**2005**	
	(in 000 s)	% of Revenue	(in 000 s)	% of Revenue
Revenues	25,209	100%	5,124	100%
Cost of revenues	5,365	21%	846	17%
Gross margin	19,844	79%	4,278	83%
Product development	6,145	24%	1,589	31%
Sales, marketing and business development	7,508	30%	3,652	71%
General and administrative	15,128	60%	4,691	92%
Late filing penalty	(1,034)	-4%	1,034	20%
Goodwill impairment	5,200	21%	3,893	76%
Fair value gain (loss) on warrants	41,962	166%	(32,012)	-625%
Interest expense	9,303	37%	8,506	166%

Revenue

Revenue is derived from the licensing of software, maintenance contracts, training, and other consulting services. License revenue is derived from licensing of our software and third-party software products. Services revenue results from

consulting and education services, and maintaining, supporting and providing periodic unspecified upgrades for previously licensed products.

Total revenue increased by $20.1 million to $25.2 million for the year ended June 30, 2006 from $5.1 for the year ended June 30, 2005. This increase was primarily due to the acquisitions of Kenosia, $1.2 million, Empagio, $5.8 million, and Process and Affiliates, $6.7 million. There was an increase of $6.5 million in Gupta due to the shorter periods of operations recorded under Halo in fiscal 2005.

License revenue increased by $2.8 million to $5.8 million for the year ended June 30, 2006 from 3 million for the year ended June 30, 2005. This increase was primarily due to the acquisitions of Process and Affiliates, $1.4 million and an increase of $1.3 million in Gupta due to the shorter periods of operations recorded under Halo in fiscal 2005.

Services revenue increased $17.3 million to $19.4 million for the year ended June 30, 2006 from $2.1 million for the year ended June 30, 2005. This increase was primarily due to the acquisitions of Kenosia, $1.1 million, Empagio, $5.8 million, and Process and Affiliates, $5.3 million. There was an increase of $5.2 million in Gupta due to the shorter periods of operations recorded under Halo in fiscal 2005.

Because of the reduction of deferred revenue after an acquisition under generally accepted accounting principles, which has the effect of reducing the amount of revenue recognized in a given period from what would have been recognized had the acquisition not occurred, past reported periods should not be relied upon as predictive of future performance. Additionally, Halo s operating strategy is to continue to acquire technology companies. Each of such transactions will cause a change to our future financial results. Halo believes such transactions will have a positive effect on Halo s revenues and income (loss) before interest.

Cost of Revenue

Total cost of revenue increased by $4.5 million to $5.4 million for the year ended June 30, 2006 from $846,000 for the year ended June 30, 2005. This increase was primarily due to the acquisitions of Kenosia, $367,000, Empagio, $1.8 million, and Process and Affiliates, $1.7 million. There was an increase of $1 million in Gupta due to the shorter periods of operations recorded under Halo in fiscal 2005.

The principal components of cost of license fees are manufacturing costs, shipping costs, and royalties paid to third-party software vendors and amortization of acquired technologies. Cost of license revenue increased by $853,000 to $1.3 million for the year ended June 30, 2006 from $449,000 for the year ended June 30, 2005. This increase was primarily due to the acquisitions of Kenosia, $38,000, Empagio, $187,000 and Process and Affiliates, $459,000. This increase was partially offset by $85,000 decrease in amortization of acquired technologies due to a write-off of intangible assets related to the Warp Solutions business in June 2005. There was an increase of $535,000 in Gupta due to the shorter periods of operations recorded under Halo in fiscal 2005.

The principal components of cost of services are salaries paid to our customer support personnel and professional services personnel, amounts paid for contracted professional services personnel and third-party resellers, maintenance royalties paid to third-party software vendors and hardware costs. Cost of services revenue increased by $3.7 million to $4 million for the year ended June 30, 2006 from $396,000 for the year ended June 30, 2005. This increase was primarily a result of an increase in employee compensation directly related to additional headcounts added in conjunction with the acquisitions of Kenosia, $330,000, Empagio, $1.7 million, and Process and Affiliates, $1.2 million. There was an increase of $469,000 in Gupta due to the shorter periods of operations recorded under Halo in fiscal 2005.

Gross profit margins decreased to 79% for the year ended June 30, 2006, compared to 83% for the year ended June 30, 2005. The gross margin decrease was mainly due to the change in the product mix (increase in the proportion of maintenance and services revenue) the Company sells from the new subsidiaries.

Operating Expenses

Research and Development

Research and development expense consists primarily of salaries and other personnel-related expenses for engineering personnel, expensable hardware and software costs, overhead costs and costs of contractors. Research and development expenses increased by approximately $4.6 million to $6.1 million for the year ended June 30, 2006 from $1.6 million for the year ended June 30, 2005. This increase primarily resulted from the acquisitions of Kenosia, $323,000, Empagio, $819,000,

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and Process and Affiliates, $1.7 million. There was an increase of $1.7 million in Gupta due to the shorter periods of operations recorded under Halo in fiscal 2005.

Sales and Marketing

Selling and marketing expenses consist primarily of salaries, commissions, benefits, advertising, tradeshows, travel and overhead costs for Halo s sales and marketing personnel. Sales and marketing expenses increased by approximately $3.9 million to $7.5 million for the year ended June 30, 2006 from $3.7 for the year ended June 30, 2005. This increase was primarily attributable to the acquisitions of Kenosia, $166,000, Empagio, $406,000, and Process and Affiliates, $1 million. There was an increase of $2.7 million in Gupta due to the shorter periods of operations recorded under Halo in fiscal 2005.

General and Administrative

General and administrative costs include salaries and other direct employment expenses of our administrative and management employees, as well as legal, accounting and consulting fees and bad debt expense. General and administrative expenses increased by approximately $10.4 million to $15.1 million for the year ended June 30, 2006 from $4.7 million for the year ended June 30, 2005. This increase was primarily attributable to the acquisitions of Kenosia, $658,000, Empagio, $2.7 million, and Process and Affiliates, $3.2 million. There was an increase of $1.8 million in Gupta s operations due to the shorter periods of operations recorded under Halo in fiscal 2005. There was also an increase of approximately $2.2 million in corporate headcount to manage the increasing size and complexity of the Company s operations, as the Company has acquired new subsidiaries, as well as professional services fees associated with the acquisitions, securities laws, and tax compliance. However, this increase in corporate expenses was partially offset by a decrease in non-cash compensation of approximately $432,000.

Late filing penalty

As of June 30, 2005, the Company had accrued approximately $1 million for the penalties related to delays in certain events related to the Company s Series C Preferred Stock (all of which has been converted into common stock, as of June 30, 2006), and other securities sold January 31, 2005, the proceeds from which were used to fund the acquisition of Gupta. On January 31, 2005, the Company entered into certain Series C Subscription Agreements (collectively, the Series C Subscription Agreement), with the Investors named therein. Under the Series C Subscription Agreement, the Company issued Series C Notes, which, on March 31, 2005, converted into shares of Series C Preferred Stock, and warrants to acquire common stock. Since the Series C Notes were not converted by March 17, 2005, due to a delay in receiving approval required before effecting an amendment to the Company s Articles of Incorporation, the Company could have been considered to have been obligated to pay to the Investors a penalty in cash equal to ten percent (10%) of the principal amount of the Series C Notes. Accordingly, as of June 30, 2005, the Company accrued $647,500 for this potential penalty.

Furthermore, that certain Investors Agreement entered into by the Company and the Investors named therein on January 31, 2005 (the Series C Investors Agreement), the Company agreed to register the shares of common stock issuable (i) upon conversion of the Series C Stock, (ii) upon exercise of the warrants issued to the Series C stock holders, (iii) upon conversion of certain subordinated notes and certain warrants issued by the Company under the Subordinated Note and Warrant Purchase Agreement dated January 31, 2005, and (iv) the warrants issued under the Senior Note and Warrant Purchase Agreement dated January 31, 2005. The registration statement covering such shares, which was required to be filed under the Series C Investors Agreement, was filed after the due date under the agreement due to the delay in receiving required consents necessary for filing. As there was no assurance the Company would receive an acknowledgement that no penalty applied under the Series C Investors Agreement under these circumstances, or waiver of such penalties, the Company accrued $386,000 for the fiscal year ended June 30, 2005.

Subsequently, the Company received sufficient waivers and acknowledgements from the Investors that these penalties are not owed. Therefore, both of these accruals were reversed as of June 30, 2006.

Goodwill impairment

The Company recorded goodwill and intangible assets impairment of approximately $5.2 million and $4.0 million for the years ended June 30, 2006 and 2005. In fiscal year 2006, the Company determined that the net assets of Gupta was in excess of the amount of anticipated cash flow generated by the business. Based on a discounted cash flow

analysis, the Company determined that $5.2 million of goodwill has been impaired as of June 30, 2006. In fiscal year 2005, the entire value of $3.9 million of the intangible assets and goodwill related to the Spider acquisition was determined to be impaired. Spider s future cash flow is estimated to be minimal due to the Company s shift in strategy away from the business.

Fair Value Gain (Loss) on Warrants Revaluation

Certain warrants the Company issued as part of its financing activities have features that require them to be treated as a derivative in accordance with EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company s Own Stock. In addition to recognizing the value of the warrants by discounting the related debt and amortizing the discount to interest expense over the life of the debt, the value of the warrants are recognized as liabilities and revalued at the end of each period. The fair values of these warrants are determined based on the Black-Scholes model, Changes in fair values are charged to the Statements of Operations. Generally, if the Company s stock price increase, the fair value of the warrants increases, causing the liability to increase and resulting in loss, and vice versa. Fair value gain (loss) on warrants revaluation was approximately $41,962,000 and $(32,012,000) for the years ended June 30, 2006 and June 30, 2005, respectively. The gain in fiscal 2006 is a result of the stock price decrease while the loss in fiscal 2005 was mainly a result of the issuance of the warrants below their fair value. The gain (loss) relates to the change in the fair value of the warrants relating to the Series C Preferred Stock, Senior Notes, Subordinated Notes, Fortress, DCI Master LDC and the Convertible Notes, based on the Black-Scholes pricing model.

Interest Expense

Interest expense increased by $797,000 to $9.3 million for the year ended June 30, 2006 from $8.5 million for the year ended June 30, 2005. The increase was primarily due to Series D Preferred Stock paid as penalty of $1,091,000, and cash and accrued interest of $3.3 million. The increase was partially offset by the decrease in amortization of the fair value of the warrants of $2.7 million and the decrease in amortization of the deferred financing costs of $870,000.

Net Operating Loss Carryforwards

The Company has a U.S. Federal net operating loss carryforward of approximately $55,614,000 as of June 30, 2006, which may be used to reduce taxable income in future years through the year 2026. The deferred tax asset primarily resulting from net operating losses was approximately $22,136,000. Due to uncertainty surrounding the realization of the favorable tax attributes in future tax returns, the Company has placed a full valuation allowance against its net deferred tax asset. At such time as it is determined that it is more likely than not that the deferred tax asset is realizable, the valuation allowance will be reduced. Furthermore, the net operating loss carryforward may be subject to further limitation pursuant to Section 382 of the Internal Revenue Code.

Liquidity and Capital Resources

Halo has three primary cash needs. These are (1) operations, (2) acquisitions and (3) debt service and repayment. Halo has financed a significant component of its cash needs through the sale of equity securities and debt.

For the year ended June 30, 2006, cash provided by operating activities was approximately $133,000. Our net income $19.4 million was offset by gain on warrants revaluation of $42 million. In addition, components of cash used for operating activities included non-cash interest expense of $5.8 million, goodwill impairment of $5.2 million, depreciation and amortization expense of $2.9 million, and non-cash compensation expense of $1.1 million, increase in deferred revenue of $6.7 million, and increase in accounts payable and accrued expenses of $771,000. The Company also acquired additional cash through various credit and note agreements described below. Approximately $17.1 million was used to fund acquisitions, and approximately $10.6 million was used to repay the principal portion of the outstanding debt.

In fiscal 2006, Halo raised approximately $28.8 million, of which $25 million was from the issuance of senior notes and $3.8 million from issuance of convertible promissory notes.

On January 31, 2005, Halo issued $2,500,000 principal amount of subordinated convertible promissory notes (the Subordinated Notes). The Subordinated Notes bear interest at 10%, payable in common stock or cash, and mature January 31, 2007. The Subordinated Notes are convertible at any time into shares of Halo common stock at $1.00 per share, which conversion rate is subject to certain anti-dilution adjustments. The common stock issuable upon conversion of the Subordinated Notes has certain registration rights.

Halo entered into a $50,000,000 credit facility with Fortress Credit Opportunities I LP and Fortress Credit Corp. on August 2, 2005 (the Credit Agreement). Subject to the terms and conditions of the Credit Agreement, the lenders thereunder (the Lenders) agreed to make available to Halo a term loan facility in three Tranches, Tranches A, B and C, in an aggregate amount equal to $50,000,000 (the Loan). In connection with entering into the Credit Agreement, Halo

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borrowed $10,000,000 under Tranche A to repay its then-existing senior indebtedness, as well as certain existing subordinated indebtedness and to pay certain closing costs. On October 26, 2005, in connection with the closings of the acquisition of Tesseract, DAVID Corporation, Process Software, ProfitKey International and Foresight Software, Inc., Halo entered into Amendment Agreement No. 1 (Amendment Agreement) to the Credit Agreement under which the Lenders made an additional loan of $15,000,000 under Tranche B of the credit facility under the Credit Agreement. The rate of interest payable on the amounts borrowed under the Loan is a floating percentage rate per annum equal to the sum of the LIBOR for that period plus the Margin . For theses purposes, LIBOR means the rate offered in the London interbank market or U.S. Dollar deposits for the relevant period but no less than 2.65%. For these purposes, Margin means 9% per annum. Interest is due and payable monthly in arrears.

The Credit Agreement contains certain financial covenants usual and customary for facilities and transactions of this type. These financial covenants include Total Debt to EBITDA, Cash Interest Coverage Ratio, and Fixed Charge Covenant Ratio as defined. As of June 30, 2006, the Company is in compliance with these financial covenants. The Company anticipates that due to recent transactions, certain of the covenants under the Credit Agreement may have to be modified in the future in order for the Company to continue to comply for future periods. The Company has engaged in discussions with Fortress, and anticipates negotiating appropriate modifications to the covenants to reflect these changes in the Company s business as they occur. In the event the Company completes further acquisitions, the Company and the Lenders will be required to agree upon modifications to the financial covenants to reflect the changes to the Company s consolidated assets, liabilities, and expected results of operations in amounts to be mutually agreed to by the parties. If the Company were to fail to comply with the financial covenants under the Credit Agreement and the Lenders failed to agree to amend or waive compliance with the covenants that Halo did not meet, Halo would be in default under the Credit Agreement. Any default under the Credit Agreement would result in a default under most or all of Halo s other financing arrangements. The Lenders could foreclose on all of Halo s assets, including the stock in its subsidiaries, and could cause Halo to cease operating.

In addition, the Credit Agreement provides that in the event of certain changes of control, including (i) a reduction in the equity ownership in Halo of Ron Bienvenu or his immediate family members below 90% of such equity interests on the date of the Credit Agreement, or (ii) Ron Bienvenu ceases to perform his current management functions and is not replaced within 90 days by a person satisfactory to Fortress, all amounts due may be declared immediately due and payable.

The Credit Agreement contains specific events of default, including failure to make a payment, the breach of certain representations and warranties, and insolvency events. There is also a cross-default provision that provides that certain events of default under certain contracts between Halo or its subsidiaries and third parties will constitute an event of default under the Credit Agreement.

Halo s obligations under the Credit Agreement are guaranteed by the direct and indirect subsidiaries of Halo, and any new subsidiaries of Halo are obligated to become guarantors. Halo and its subsidiaries granted first priority security interests in their assets, and pledged the stock or equity interests in their respective subsidiaries, as collateral for the Loans. In addition, Halo has undertaken to complete certain matters, including the delivery of stock certificates in subsidiaries, and the completion of financing statements perfecting the security interests granted under the applicable state or foreign jurisdictions concerning the security interests and rights granted to the Lenders. Any new subsidiary of Halo will become subject to the same provisions.

On September 20, 2005, Halo issued a $500,000 principal amount promissory note (the September 2005 Note). The maturity on this note was December 19, 2005, unless it was converted prior to that date into equity. On January 11, 2006, the holder of this note converted the $500,000 principal (plus accrued interest) into the Series E Subscription Agreement described under Series E Notes and Series E Subscription Agreements below. Under the Series E Subscription Agreement, the holder of the September 2005 Note had the right, in the event that Halo completed or entered into agreements to sell equity securities on or before February 15, 2006, to convert the securities received under the Series E Subscription Agreement into such other equity securities as if the investor had invested the amount invested in such securities. The holder of the September 2005 Note exercised this right and received the same securities as were issued under the January 2006 Subscription Agreements. The terms of the January 2006 Subscription Agreements are described more fully below under January 2006 Subscription Agreements.

Also on September 20, 2005, the Company issued to the holder of the September 2005 Notes a Warrant to purchase 181,818 shares of common stock of the Company. The Warrant was issued in connection with the September 2005 Note described above. The exercise price for the Warrant shares is $1.375, subject to adjustment as provided in the Warrant. The Warrant is exercisable until September 20, 2010.

On October 14, 2005, one of Halo s directors, David Howitt, made a short-term loan to Halo for $150,000. On January 11, 2006, Mr. Howitt converted the principal (plus accrued interest) under this loan into the Series E Subscription Agreement described under Series E Notes and Series E Subscription Agreements below. Under the Series E Subscription Agreement, Mr. Howitt had the right, in the event that Halo completed or entered into agreements to sell equity securities on or before February 15, 2006, to convert the securities received under the Series E Subscription Agreement into such other equity securities as if he had invested the amount invested in such securities. Mr. Howitt has exercised this right and received the same securities as were issued under the January 2006 Subscription Agreements. The terms of the January 2006 Subscription Agreements are described more fully below under January 2006 Subscription Agreements.

On October 26, 2005, as part of the acquisition of Tesseract, Halo issued to Platinum Equity, LLC, a promissory note in the amount of $1,750,000 (the Platinum Note). The Platinum Note was issued in a related party transaction. The principal under the Platinum Note accrues interest at a rate of 9.0% per annum. The principal and accrued interest under the Platinum Note was originally due on March 31, 2006. Interest is payable in registered shares of common stock of Halo, provided that until such shares are registered, interest shall be paid in cash. The Platinum Note contains certain negative covenants including that Halo will not incur additional indebtedness, other than permitted indebtedness under the Platinum Note. Under the Platinum Note, the following constitute an event of default: (a) Halo shall fail to pay the principal and interest when due and payable: (b) Halo fails to pay any other amount under the Platinum Note when due and payable: (c) any representation or warranty of Halo was untrue or misleading in any material respect when made; (d) there shall have occurred an acceleration of the state maturity of any indebtedness for borrowed money of Halo or any Halo subsidiary of $50,000 or more in aggregate principal amount; (e) Halo shall sell, transfer, lease or otherwise dispose of all or any substantial portion of its assets in one transaction or a series of related transactions, participate in any share exchange, consummate any recapitalization, reclassification, reorganization or other business combination transaction or adopt a plan of liquidation or dissolution or agree to do any of the foregoing; (f) one or more judgments in an aggregate amount in excess of $50,000 shall have been rendered against Halo or any Halo subsidiary; (g) Halo breaches certain of its covenants set forth in the Platinum Note; or (h) an Insolvency Event (as defined in the Platinum Note) occurs with respect to Halo or a Halo subsidiary. Upon such an event of default, the holder may, at its option, declare all amounts owed under the Platinum Note to be due and payable.

Additionally, under the Tesseract Merger Agreement, Halo was required to pay Platinum a working capital adjustment of $1,000,000. Since this amount was not paid by November 30, 2005, Platinum has the option to convert the working capital adjustment into up to 1,818,182 shares of Series D Preferred Stock. To date, the Platinum has not elected to do so. Furthermore, since the working capital adjustment was not paid by November 30, 2005, Halo must pay Platinum a monthly transaction advisory fee of $50,000 per month, commencing December 1, 2005. As of June 30, 2006, Halo has accrued and expensed approximately $350,000 for such fees.

On March 31, 2006, the Company and Platinum entered into an Amendment and Consent (the Amendment and Consent) to the Platinum Note. Pursuant to the Amendment and Consent, the maturity of the Platinum Note was modified such that the aggregate principal amount of the Platinum Note and all accrued interest thereon shall be due and payable as follows: (i) $1,000,000 on March 31, 2006; and (ii) the remaining $750,000 in principal, plus all accrued but unpaid interest shall be paid on the earliest of (w) the second business day following the closing of the acquisition of Unify by the Company, (x) the second business day following termination of the merger agreement pursuant to which Unify is to be acquired by the Company, (y) the second business day after the Company closes an equity financing of at least $2.0 million subsequent to the date of the Amendment and Consent or (z) July 31, 2006. In accordance with the Amendment and Consent, $1,000,000 was paid to Platinum on March 31, 2006. Since the entire amount of the Platinum Note was not paid on or before March 31, 2006, Platinum retained 909,091 shares of Series D Preferred Stock of the Company, which had been previously issued to Platinum as part of the consideration under the Tesseract Merger Agreement. These shares would have been canceled if the Platinum Note had been paid in full by that date. Subsequently, the parties have engaged in discussions to further modify the terms of the amounts owed to Platinum. Platinum has indicated it will waive any current breaches of these obligations, but the parties have not yet entered into any definitive agreement. However, in the event Platinum does not agree to modify such terms, the

Company would be in breach of such agreements.

On October 21, 2005, Halo entered into certain convertible promissory notes to various accredited investors (the October 2005 Notes) in the aggregate principal amount of One Million Dollars ($1,000,000). Interest accrues under the October 2005 Notes at the rate of ten percent (10%) per annum. The principal amount of the October 2005 Notes, together with accrued interest, was due February 19, 2006, or 90 days after the date it was entered into, unless the October 2005 Notes were converted into debt or equity securities of Halo in Halo s next financing involving sales by Halo of a class of its preferred stock or convertible debt securities, or any other similar or equivalent financing transaction. Five hundred thousand dollars ($500,000) in principal amount (plus accrued interest) of the October 2005 Notes was repaid by Halo in early March.

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On January 11, 2006, the holder of the remaining $500,000 October 2005 Note converted the $500,000 principal (plus accrued interest) under this October 2005 Note into the Series E Subscription Agreement described under Series E Notes and Series E Subscription Agreements below. Under the Series E Subscription Agreement, the holder of this October 2005 Note had the right, in the event that Halo completed or entered into agreements to sell equity securities on or before February 15, 2006, to convert the securities received under the Series E Subscription Agreement into such other equity securities as if the investor had invested the amount invested in such securities. The holder of the October 2005 Note has exercised this right and receive the same securities as were issued under the January 2006 Subscription Agreements. The terms of the January 2006 Subscription Agreements are described more fully below under January 2006 Subscription Agreements.

Also on October 21, 2005, Halo issued warrants (the October 2005 Warrants) to purchase an aggregate of 363,636 shares of common stock, par value $0.00001 per share of Halo. The October 2005 Warrants were issued in connection with the October 2005 Notes described above. The exercise price for the October 2005 Warrants is $1.375, subject to adjustment as provided in the October 2005 Warrants. The October 2005 Warrants are exercisable until October 21, 2010. The October 2005 Warrants contain an automatic exercise provision in the event that the warrant has not been exercised but the Fair Market Value of the Warrant Shares (as defined in the October 2005 Warrants) is greater than the exercise price per share on the expiration date. The October 2005 Warrants also contain a cashless exercise provision. The October 2005 Warrants also contain a limitation on exercise which limits the number of shares of Halo common stock that may be acquired by the holder on exercise to that number of shares as will ensure that, following such exercise, the total number of shares of common stock then beneficially owned by such holder and its affiliates will not exceed 9.99% of the total number of issued and outstanding shares of Halo common stock. This provision is waivable by the holder on 60 days notice.

Series E Notes and Series E Subscription Agreements

On January 11, 2006, Halo entered into certain convertible promissory notes (the Series E Notes) in the aggregate principal amount of Seven Hundred Thousand Dollars ($700,000). Interest accrues under the Series E Notes at the rate of ten percent (10%) per annum. The Notes provide that they automatically convert into (i) such number of fully paid and non-assessable shares of Halo s Series E Preferred Stock (the Series E Stock) equal to the aggregate outstanding principal amount due under the Series E Notes plus the amount of all accrued but unpaid interest under the Series E Notes divided by $1.25, and (ii) warrants (the Series E Warrants) to purchase a number of shares of Halo s common stock equal to 40% of such number of shares of Series E Stock issued to the holder. Under the terms of the Series E Notes, the automatic conversion was to occur upon the effectiveness of the filing of the Certificate of Designations, Preferences and Rights (the Certificate of Designations) pertaining to Halo s Series E Stock, and, in the event that the Certificate of Designations was not filed 30 days after the Series E Notes were issued (February 10, 2006) then the holders of the Series E Notes may demand that Halo pay the principal amount of the Series E Notes, together with accrued interest. No demand for payment has been made.

Under the Series E Subscription Agreements described below, holders of the Series E Notes had the right, in the event that Halo completed or entered into agreements to sell equity securities on or before February 15, 2006, to convert the Series E Notes into such other equity securities as if the investor had invested the amount invested in such securities. The holders of the Series E Notes have exercised this right and received the same securities as were issued under the January 2006 Subscription Agreements. The terms of the January 2006 Subscription Agreements are described more fully below under *January 2006 Subscription Agreements.*

Series E Subscription Agreement

Also on January 11, 2006, Halo entered into certain Subscription Agreements (the Series E Subscription Agreements) for the sale of Series E Stock and Series E Warrants. In addition to the conversion of the principal and interest under the Series E Notes described above, investors under the Series E Subscription Agreements agreed to invest $150,000 in cash and committed to convert the $500,000 principal (plus accrued interest) under the September 2005 Note, and the $500,000 principal (plus accrued interest) under the outstanding October 2005 Note (each as described above). Accordingly, Halo has taken the position that these notes were amended by the Series E Subscription Agreement. Also under the Series E Subscription Agreement, an investor agreed to convert $67,500 in certain advisory fees due from Halo into Series E Stock and Warrants.

The material terms of the Subscription Agreements are as follows: Halo designates the closing date. The closing is anticipated to occur when the Series E Certificate of Designations becomes effective. The obligations of the investors under the Series E Subscription Agreement are revocable if the closing has not occurred within 30 days of the date of the agreement. No later than seventy five (75) days after the completion of the offering, Halo agreed to file with the SEC a registration statement covering the Halo common stock underlying the Series E Stock and the Series E Warrants, and any common stock that Halo may elect to issue in payment of the dividends due on the Series E Stock.

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Upon the completion of this offering, with a full round of investment of $10,000,000, the Series E investors will have the right for 15 months to invest, in the aggregate, an additional $10,000,000 in common stock of Halo, at $2.00 per share of common stock (as adjusted for stock splits, reverse splits, and stock dividends) or a 20% discount to the prior 30 day trading period, whichever is lower. Each such investor s right shall be his, her or its pro rata amount of the initial offering.

In the event that Halo completes or enters into agreements to sell equity securities on or before February 15, 2006, investors in Series E Stock may convert the securities received under the Series E Subscription Agreement into such other equity securities as if the investor had invested the amount invested in such securities. Halo will provide the Series E investors with five business days notice of such right. The investor will be required to execute and deliver all such transaction documents as required by Halo in order to convert such securities into such other securities.

Certain of the transactions in connection with the Series E Subscription Agreement were entered into by Mr. David Howitt, a director of Halo. Mr. Howitt invested $350,000 under the Series E Notes, and agreed to invest another $150,000 under the Series E Subscription Agreement. Mr. Howitt recused himself from the Halo board of directors decisions approving these transactions.

Investors under the Series E Subscription Agreements have exercised the right described above and received the same securities as were issued under the January 2006 Subscription Agreements. The terms of the January 2006 Subscription Agreements are described more fully below under *January 2006 Subscription Agreements.*

January 2006 Convertible Promissory Notes

On January 27 and on January 30, 2006, Halo entered into certain convertible promissory notes (the January 2006 Convertible Notes) in the aggregate principal amount of One Million Three Hundred Seventy-Five Thousand Dollars ($1,375,000). The principal amount of the January 2006 Convertible Notes, together with accrued interest, shall be due and payable on demand by the holder thereof on the maturity date which is no earlier than sixty (60) days after the date such January 2006 Convertible Notes were issued (the Original Maturity Date), unless the January 2006 Convertible Notes are converted into common stock and warrants as described below. In the event that the January 2006 Convertible Notes are not converted by their Original Maturity Date, interest will begin to accrue at the rate of ten percent (10%) per annum.

Each January 2006 Convertible Note shall convert into (i) such number of fully paid and nonassessable shares of Halo s common stock equal to the aggregate outstanding principal amount due under the January 2006 Convertible Note plus the amount of all accrued but unpaid interest on the January 2006 Convertible Note divided by $1.25, and (ii) warrants (the January 2006 Warrants) to purchase a number of shares of Halo s common stock equal to 75% of such number of shares of common stock. The January 2006 Convertible Notes shall so convert automatically (Mandatory Conversion) and with no action on the part of the holder on their Original Maturity Date to the extent that upon such conversion, the total number of shares of common stock then beneficially owned by such holder does not exceed 9.99% of the total number of issued and outstanding shares of Halo common stock. For such purposes, beneficial ownership shall be determined in accordance with Section 13(d) of the Exchange Act and the rules and regulations promulgated thereunder. In the event that a portion of the principal and interest under the January 2006 Convertible Notes has not been converted on the first Mandatory Conversion (and the holder has not demanded payment), there will be subsequent mandatory conversions until all of the principal and interest has been converted, provided that at each such Mandatory Conversion the total number of shares of common stock then beneficially owned by such lender does not exceed 9.99% of the total number of issued and outstanding shares of common stock. Prior to any such mandatory conversion the holder may at its option by writing to Halo, convert all or a portion of the principal and interest due under such holder s January 2006 Convertible Notes into common stock and January 2006 Warrants provided that at each such conversion the total number of shares of common stock then beneficially owned by such holder does not exceed 9.99% of the total number of issued and outstanding shares of Halo common stock. By written notice to Halo, each holder may waive the foregoing limitations on conversion but any such waiver will not be effective until the 61st day after such notice is delivered to Halo. On July 21, 2006, the January 2006 Convertible Notes and the January 2006 Warrants were converted into Halo common stock.

January 2006 Subscription Agreements

Also on January 27 and January 30, 2006, Halo entered into certain Subscription Agreements (the January 2006 Subscription Agreements) for the sale of the January 2006 Convertible Notes and the underlying common stock and January 2006 Warrants.

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The material terms of the January 2006 Subscription Agreements are as follows. Halo and the investors under the January 2006 Subscription Agreements made certain representations and warranties customary in private financings, including representations from the Investors that they are accredited investors as defined in Rule 501(a) of Regulation D (Regulation D) under the Securities Act.

The January 2006 Subscription Agreements further provide that Halo shall register the shares of common stock issuable upon conversion of the January 2006 Convertible Notes and upon conversion of the January 2006 Warrants (together, the Registrable Shares) via a suitable registration statement If a registration statement covering the Registrable Shares has not been declared effective after 180 days following the closing, the holders shall receive a number of shares of common stock equal to 1.5% of the number of shares received upon conversion of the January 2006 Convertible Notes for each 30 days thereafter during which the Registrable Shares have not been registered, subject to a maximum penalty of 9% of the number of shares received upon conversion of the January 2006 Convertible Notes.

The January 2006 Subscription Agreements allow the Investors to piggyback on the registration statements filed by Halo. Halo agreed that it will maintain the registration statement effective under the Securities Act until the earlier of (i) the date that all of the Registrable Shares have been sold pursuant to such registration statement, (ii) all Registrable Shares have been otherwise transferred to persons who may trade such shares without restriction under the Securities Act, or (iii) all Registrable Shares may be sold at any time, without volume or manner of sale limitations pursuant to Rule 144(k) under the Securities Act.

Upon the completion of the offering under the January 2006 Subscription Agreements, with a full round of investment of $10,000,000, the investors will have the right for 15 months after the final closing to invest, in the aggregate an additional $10,000,000 in common stock of Halo. The price of such followon investment will be $2.00 per share of common stock or a 20% discount to the prior 30 day trading period, whichever is lower; provided that the price per share shall not be less than $1.25. Each investor s portion of this follow-on right shall be such investor s pro rata amount of the January 2006 Convertible Notes issued pursuant to the January 2006 Subscription Agreements. Once Halo has issued a total of $5,000,000 of January 2006 Convertible Notes, the investors will be able to invest up to 50% of the amount which they may invest pursuant to this follow-on right; subsequent to the completion of the full round of $10,000,000 the investors may invest the remainder of the amount which they may invest pursuant to this follow-on right.

Notwithstanding anything to the contrary in the January 2006 Subscription Agreements, the number of shares of common stock that may be acquired by any investor upon any exercise of this follow-on right (or otherwise in respect hereof) shall be limited to the extent necessary to insure that, following such exercise (or other issuance), the total number of shares of common stock then beneficially owned by such investor and its Affiliates and any other persons whose beneficial ownership of common stock would be aggregated with such investor for purposes of Section 13(d) of the Exchange Act, does not exceed 9.99% of the total number of issued and outstanding shares of Halo common stock. By written notice to Halo, any investor may waive this provision, but any such waiver will not be effective until the 61st day after such notice is delivered to Halo.

In addition to the $1,375,000 in January 2006 Convertible Notes issued January 27 and January 30, 2006, pursuant to the January 2006 Subscription Agreements, the following investors have exercised their rights to accept the terms of the January 2006 Subscription Agreements in lieu of the Series E Subscription Agreements:

the holder of the $500,000 principal amount September 2005 Note;

the holder of the $500,000 principal amount October 2005 Note that is still outstanding;

the holders of the $700,000 principal amount of Series E Notes;

David Howitt, who made a $150,000 short term loan to Halo;

the investor who had agreed to convert $67,500 in certain advisory fees due from Halo into a Series E Subscription Agreement.

After the end of the fiscal year, all of these amounts have converted into common stock and warrants pursuant to the terms of the January 2006 Subscription Agreements. See, *Subsequent Events Issuance of Common Stock and Warrants* below.

Investing Activities and Current Debt

For the year ended June 30, 2006, the Company used approximately $17,422,000 for investing activities. During the same period, the Company paid approximately $507,000 in cash as part of consideration to acquire Kenosia, approximately

$16,345,000 in cash as part of consideration to purchase Tesseract, Process, DAVID, Profitkey, and Foresight from Platinum Equity, LLC, and approximately $573,000 in cash as part of consideration to purchase Executive Consultants, Inc. The purchase of Tesseract, Process, DAVID, Profitkey and Foresight were related party transactions.

As of June 30, 2006, the Company had debt that matures in the next 12 months in the amount of approximately $8,475,000. This consists of $1,750,000 payable to Platinum Equity, LLC (seller of Tesseract, Process, David, Profitkey, and Foresight), $2,206,126 as current portion of Fortress debt, $1,243,864 due to ISIS, and $3,275,000 notes payable to other investors. The $500,000 note payable to Bristol Technology, Inc. has been paid off in the quarter ended March 31, 2006. $1,000,000 was paid to Platinum Equity, LLC on March 31, 2006 to reduce the note to the current balance. Of the $3,275,000 in notes payable, $3,225,000 converted into equity securities after the end of the fiscal year. See *Subsequent Events Issuance of Common Stock and Warrants* below. In addition, the principal amounts due under the Credit Agreement with Fortress begin to amortize on August 2, 2006. The current portion of this loan under the Credit Agreement is $2,206,126 as of June 30, 2006.

Halo continues to evaluate strategic alternatives, including opportunities to strategically grow the business, enter into strategic relationships, make acquisitions or enter into business combinations. Halo can provide no assurance that any such strategic alternatives will come to fruition and may elect to terminate such evaluations at any time.

Termination Agreement with InfoNow

On June 26, 2006, Halo entered into a Termination Agreement with InfoNow Corporation (InfoNow) under which Halo and InfoNow mutually agreed to terminate the Agreement and Plan of Merger dated December 23, 2005 (the InfoNow Merger Agreement) among Halo, InfoNow, and WTH Merger Sub, Inc. (Merger Sub), a wholly-owned subsidiary of the Company. The InfoNow Merger Agreement was filed as Exhibit 10.110 to the Company s Current Report on Form 8-K filed by the Company on December 27, 2005. The InfoNow Termination Agreement provides for the mutual release of any claims in connection with the InfoNow Merger Agreement by Halo or InfoNow against the other party. In addition, Halo agreed to pay $200,000 to InfoNow.

As an inducement for Halo to enter into the InfoNow Merger Agreement and in consideration thereof, each of Michael W. Johnson, Jeffrey D. Peotter, Allan R. Spies and Duane Wentworth (collectively, the Stockholders) each a stockholder and director of InfoNow, had entered into a stockholder voting agreement (the InfoNow Stockholder Agreement). Pursuant to the terms of the InfoNow Stockholder Agreement, Halo was entitled to direct the voting of shares of InfoNow Common Stock held by the Stockholders. Pursuant to its terms, the InfoNow Stockholder Agreement terminated upon the termination of the InfoNow Merger Agreement. The Form of InfoNow Stockholder Agreement, dated as of December 23, 2005, by and among the Company and the Stockholders was included in Exhibit 10.110 to the Company s Current Report on Form 8-K filed by the Company on December 27, 2005.

A copy of the Termination Agreement was attached as Exhibit 10.124 to the Company s Current Report on Form 8-K filed by the Company on June 30, 2006 and is incorporated herein by reference. The foregoing description of the Termination Agreement is qualified in its entirety by reference to the full text of the Termination Agreement.

Subsequent Events

Issuance of Common Stock and Warrants

On July 21, 2006, Halo issued an aggregate of 2,732,392 shares of common stock in conversion of (1) an aggregate of $1,850,000 invested Halo (and $126,041.67 of interest on such amount) as described in the Halo s Current Report on Form 8-K filed January 18, 2006, and (2) an aggregate of $1,375,000 (and $64,444.44 of interest on such amount) invested in Halo as described in the Halo s Current Report on Form 8-K filed February 2, 2006. In addition, the investors received warrants to acquire an aggregate of 2,049,296 shares of common stock of the Company. The warrants have an exercise price of $1.25 per share, are exercisable over a five year term and subject to certain adjustments as set forth in the warrant. A copy of the form of the warrant is attached as Exhibit 10.126 to the Company s Current Report on Form 8-K filed July 27, 2006, and is incorporated herein by reference. In addition, 54,000 shares of common stock and warrants to acquire 40,500 shares of common stock were issued in payment of $67,500 in advisory fees.

Agreement and Plan of Merger with Tenebril, Inc.

On August 24, 2006 Halo entered into an Agreement and Plan of Merger (the Tenebril Agreement) with Tenebril Acquisition Sub, Inc., (Merger Sub) a wholly-owned subsidiary of the Company, Tenebril Inc., (Tenebril or the Target), and Sierra Ventures, as agent for the Target stockholders (the Stockholders Agent).

Under the terms of the Tenebril Agreement, Tenebril was merged with and into the Merger Sub (the Merger) with Tenebril surviving as a wholly-owned subsidiary of the Company. At the effective time of the Merger, the shares of Target Capital Stock issued and outstanding immediately prior to the effective time were converted into promissory notes issued by Halo (each, a Tenebril Note and collectively, the Tenebril Notes). The aggregate original principal amount of all Tenebril Notes issued by Halo was $3,000,000.

The Tenebril Notes are due February 15, 2007, and accrue interest at a rate equal to eight and one-quarter percent (8.25%) per annum. At the Company option, the Company may convert some or all of the amount due under the Tenebril Notes into shares of Common Stock of the Company. The number of shares issued upon conversion will be the total amount being converted divided by the Conversion Price then in effect. The Conversion Price is 85% of the Market Price as defined in the Tenebril Notes.

At the Closing, the Company also delivered to the Target Broker a promissory note (the Target Broker Promissory Note). The Target Broker Promissory Note was in the original principal amount of $110,000, plus applicable interest, and is due on February 15, 2007.

Under the Tenebril Agreement, Tenebril made certain customary representations and warranties to the Company concerning Tenebril and the Company made certain customary representations and warranties to Tenebril. The Tenebril Agreement contains indemnity terms which provide that each party shall indemnify the other party for breaches of representations and warranties and covenants made under the agreement, provided that neither party shall be required to pay any damages unless the aggregate amount of all damages exceeds certain limits and provided further that neither party shall be liable for damages in excess of certain limits.

Also on August 24, 2006, the Company entered into an Investors Agreement (the Tenebril Investors Agreement) with the Target Stockholders. This agreement provides for the registration of shares of the Company s Common Stock in the event the Company issues shares upon conversion of the Tenebril Notes. Under the Tenebril Investors Agreement, the Company shall, within thirty (30) days after the issuance of such shares (the Registrable Shares), prepare and file a registration statement on Form SB-2 or an equally suitable registration statement (the Registration Statement) for the purpose of registering all of the Registrable Shares for resale. Such Registration Statement also shall cover, to the extent allowable under the 1933 Act and the rules promulgated thereunder (including Rule 416), such indeterminate number of additional shares of Common Stock resulting from stock splits, stock dividends or similar transactions with respect to the Registrable Securities. The Company agreed to use its best efforts to cause such Registration Statement to be declared effective by the Securities and Exchange Commission (the SEC) at the earliest practicable date thereafter. The Company also agreed to use its best efforts to keep the Registration Statement effective (the Effectiveness Period) (subject to reasonable blackout provisions as may be required in order to comply with the securities laws) until the earlier of: (i) twenty four (24) months after the date that the Registration Statement is declared effective by the SEC; (ii) the date when all of the Registrable Shares covered by the Registration Statement are sold; or (iii) the date when Rule 144(k) is available with respect to all of the securities covered by such Registration Statement.

A copy of the Tenebril Agreement is attached as Exhibit 10.127 to the Company s Current Report on Form 8-K filed August 30, 2006, and is incorporated herein by reference. A copy of the form of Tenebril Notes is attached as Exhibit 10.128, to the Company s Current Report on Form 8-K filed August 30, 2006 and is incorporated herein by reference and a copy of the Tenebril Investors Agreement is attached as Exhibit 10.129 to the Company s Current Report on Form 8-K filed August 30, 2006, and is incorporated herein by reference. The foregoing description of the Tenebril Agreement, the Tenebril Notes and the Tenebril Investors Agreement is qualified in its entirety by reference to the full text of the agreements.

Amendment to Current Report on Form 8-K Regarding Third Quarter Earnings

In the Company s fiscal 2006 third quarter earnings release, dated May 15, 2006, and furnished to the SEC as a Current Report on Form 8-K on May 15, 2006, the Company reported that it had achieved positive cash flow from

operations and that it was generating positive operating cash flow (on a pro forma EBITDA basis). In making this statement, the Company included in its calculation of EBITDA (earnings before interest, taxes, depreciation and amortization) historical deferred revenues from acquired companies (as recorded on the historical financial statements of the

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acquired companies prior to acquisition) without giving effect to the deferred revenue fair value reduction required by GAAP and purchase accounting when concluding that its cash flow on a pro forma EBITDA basis was positive for the quarter ended March 31, 2006. Without the inclusion of this historical deferred revenues from acquired companies or if the Company had given effect to the deferred revenue fair value reduction , the Company would not have reported positive cash flow from operations on an EBITDA basis for the quarter ended March 31, 2006. After discussions with the Company s independent auditors and staff at the Securities and Exchange Commission, the Company has agreed not to use the measure pro forma EBITDA basis. The Company has amended its Quarterly Report on Form 10-QSB for the fiscal quarter ended March 31, 2006 to remove pro forma information with respect to Deferred Revenues included in the Management s Discussion and Analysis of Financial Condition and Results of Operations under the heading Non-GAAP Financial Measures.

Restatements of Periodic Reports

In the course of responding to comments received from the SEC in connection with the Company s registration statement on Form S-4 filed April 5, 2006, and amended on June 1, 2006, the Company identified errors resulting from the improper treatment of certain warrants to acquire common stock of the Company. The Company had treated the warrants as equity, but the warrants should have been treated as liabilities.

Accordingly, on September 1, 2006, the Company s Board of Directors determined that investors should not rely on the Company s (a) consolidated financial statements for the period ended June 30, 2005 and the report thereon of the Company s independent registered public accountants, included in the Company s Annual Report on Form 10-KSB filed with the SEC on September 28. 2005, (b) condensed consolidated financial statements for the period ended September 30, 2005, included in the Company s Quarterly Report on Form 10-QSB filed with the SEC on November 14, 2005, (c) condensed consolidated financial statements for the period ended December 31, 2005, included in the Company s Quarterly Report on Form 10-QSB filed with the SEC on February 15, 2006, and (d) condensed consolidated financial statements for the period ended March 31, 2006, included in the Company s Quarterly Report on Form 10-QSB filed with the SEC on May 15, 2006. The Board of Directors subsequently determined that investors should not rely on the Company s condensed consolidated financial statements for the period ended March 31, 2005, included in the Company s Quarterly Report on Form 10-QSB filed with the SEC on May 20, 2005.

As a result of these determinations, the Company has amended its Annual Report for the year ended June 30, 2005 and its Quarterly Reports for the interim periods ended March 31, 2006, December 31, 2005, September 30, 2005, and March 31, 2005. The amended Annual Report and the amended Quarterly Reports were filed with the SEC on October 11, 2006. The Company s Board of Directors have discussed these matters with the Company s independent registered public accounting firm.

The effects of these restatements on the Consolidated Statements of Operations for the twelve months ended June 30, 2005 and the three months ended March 31, 2006 are as follows:

	12 months Ended June 30, 2005		
	As Previously Reported	**Restatement Adjustments**	**Adjusted Financials**
Revenue	$ 5,123,922	$	$ 5,123,922
Net (loss)	(15,372,939)	(35,885,911)	(51,258,850)
Beneficial conversion and preferred dividends	(7,510,590)	(13,993,088)	(21,503,678)
Loss attributable to common stockholders	$ (22,883,529)	$ (49,878,999)	$ (72,762,528)
Loss per share basic	$ (11.97)		$ (38.06)
Loss per share diluted	$ (11.97)		$ (38.06)
Weighted-average number of common shares basic	1,912,033		1,912,033

Weighted-average number of common shares diluted	1,912,033	1,912,033

	9 months Ended March 31, 2006		
	As Previously Reported	Restatement Adjustments	Adjusted Financials
Revenue	$ 16,786,583	$	$ 16,786,583
Net income (loss)	(12,692,855)	34,052,427	21,359,572
Beneficial conversion and preferred dividends	(1,069,162)		(1,069,162)
Income (loss) attributable to common stockholders	$ (13,762,017)	$ 34,052,427	$ 20,290,410
Income (loss) per share basic	$ (2.97)		$ 4.38
Income (loss) per share diluted	$ (2.97)		$ 0.77
Weighted-average number of common shares basic	4,637,578		4,637,578
Weighted-average number of common shares diluted	4,637,578		27,860,277

Purchase and Exchange Agreement with Unify

On September 13, 2006, Halo and Unify Corporation (Unify) entered into a Purchase and Exchange Agreement (the Unify Purchase Agreement). Under the Unify Purchase Agreement, Halo agreed to sell its subsidiary, Gupta Technologies, LLC, to Unify in exchange for (i) Unify s risk management software and solution business as conducted by Unify through its Acuitrek, Inc. subsidiary (Acuitrek) and its Insurance Risk Management division, including, without limitation, the Acuitrek business and the NavRisk product (the NavRisk Business), (ii) Unify s ViaMode software product and related intellectual property rights (the ViaMode Product), (iii) 5,000,000 shares of Unify common stock, (iv) warrants to acquire 750,000 shares of Unify stock, (v) $5,000,000 in cash, of which Halo has received $500,000 as a deposit (the Deposit), and (vi) the amount by which the Gupta Net Working Capital exceeds the NavRisk Net Working Capital (as such terms are defined in the Unify Purchase Agreement, the Working Capital Adjustment).

The Unify Purchase Agreement includes customary representations and warranties concerning the parties to the agreement and the assets and liabilities of the businesses being exchanged. The Unify Purchase Agreement also includes covenants governing, among other things, the operations of these businesses in the ordinary course of business prior to the closing.

Consummation of the transactions is subject to several closing conditions, including, among others, that neither of the businesses being exchanged shall have suffered a material adverse change, and that Unify has received financing in an amount sufficient, together with any available funds from Unify s working capital, to enable Unify to pay the remaining portion of the Cash Purchase Price to Halo at the Closing. In addition, it is a condition to the Closing that Halo shall have received all consents required from its secured lenders.

The Unify Purchase Agreement contains indemnity terms which provide that each party shall indemnify the other party for breaches of representations and warranties and covenants made under the agreement, provided that neither party shall be required to pay any damages unless the aggregate amount of all damages exceeds certain limits contained in the Unify Purchase Agreement and provided further that neither party shall be liable for damages in excess of certain limits contained in the Unify Purchase Agreement.

The Unify Purchase Agreement may be terminated if the transactions do not close on or before December 29, 2006, for failure to meet closing conditions, and for other reasons set forth in the agreement. In the event of termination, the Deposit may be converted into equity securities of Halo (shares and warrants, if applicable), retained by Halo, or refunded by Halo depending on the reason for termination.

A copy of the Unify Purchase Agreement is attached as Exhibit 10.130 to the Company s Current Report on Form 8-K filed September 19, 2006, and is incorporated herein by reference. The foregoing description of the Unify Purchase Agreement is qualified in its entirety by reference to the full text of the Unify Purchase Agreement. Other exhibits to the Unify Purchase Agreement, which have not been filed with this Current Report on Form 8-K, will be furnished to

the Securities and Exchange Commission upon request.

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Termination Agreement with Unify

On September 13, 2006, Halo and Unify entered into a Termination Agreement (the Unify Termination Agreement) terminating the Merger Agreement entered into by Halo and Unify on March 14, 2006. A copy of the Merger Agreement was filed as Exhibit 10.118 to Halo s Current Report on Form 8-K filed March 20, 2006, a copy of Amendment No. 1 to the Merger Agreement was filed as Exhibit 10.123 to Halo s Current Report on Form 8-K filed May 24, 2006, and a copy of Amendment No. 2 to the Merger Agreement was filed as Exhibit 10.125 to Halo s Current Report on Form 8-K filed July 11, 2006. The Unify Termination Agreement further provides for the mutual release of any claims in connection with the Merger Agreement by Halo or Unify against the other party.

In connection with the Merger Agreement, two shareholders of Unify had executed stockholder agreements (together, the Stockholder Agreement) with Halo, requiring these stockholders to vote their Unify shares in favor of the Merger. Pursuant to the terms of the Stockholder Agreement, Halo was entitled to direct the voting of shares of Unify Common Stock held by the Stockholders. Pursuant to its terms, the Stockholder Agreement terminated upon the termination of the Merger Agreement. A copy of the form of Stockholder Agreement was filed as Exhibit 10.119 to Halo s Current Report on Form 8-K filed March 20, 2006.

A copy of the Purchase Agreement was attached as Exhibit 10.131 to the Company s Current Report on Form 8-K filed September 19, 2006, and is incorporated herein by reference. The foregoing description of the Unify Termination Agreement is qualified in its entirety by reference to the full text of the Unify Termination Agreement.

Equity Purchase Agreement with RevCast, Inc.

On September 15, 2006, Halo entered into an Equity Purchase Agreement (the RevCast Purchase Agreement) with the stockholders (the RevCast Stockholders) of RevCast, Inc., (RevCast) and the members (the Enterprises Members) of RevCast Enterprises, LLC (Enterprises; and, together with RevCast, the Acquired Companies). The RevCast Stockholders and the Enterprises Members are collectively referred to as the Sellers.

Pursuant to the RevCast Purchase Agreement, Halo acquired all of the equity securities of the Acquired Companies (the Equity Interests) from the Sellers in exchange for the Purchase Price. The Purchase Price for the Equity Interests was 350,000 shares of the Halo s common stock, as well as the Royalty Payments, if and when due under the RevCast Purchase Agreement. The Royalty Payments are defined in the RevCast Purchase Agreement as twenty percent (20%) of revenues generated by the assets of the Acquired Companies. The Royalty Payments will be paid in cash quarterly. The maximum Royalty Payment will be $400,000.

The RevCast Purchase Agreement includes customary representations and warranties concerning the parties to the agreement and the Acquired Companies assets and liabilities. The RevCast Purchase Agreement also contains indemnity terms which provide that the Sellers shall indemnify Halo, and Halo shall indemnify the Sellers, for breaches of representations and warranties and covenants made under the agreement, provided that neither party shall be required to pay any damages unless the aggregate amount of all damages exceeds certain limits contained in the RevCast Purchase Agreement, and, provided further, that neither party shall be liable for damages in excess of certain limits contained in the RevCast Purchase Agreement.

A copy of the RevCast Purchase Agreement was attached as Exhibit 10.132 to the Company s Current Report on Form 8-K filed September 21, 2006, and is incorporated herein by reference. The foregoing description of the RevCast Purchase Agreement is qualified in its entirety by reference to the full text of the RevCast Purchase Agreement.

Subordinated Debt Financing

On October 12, 2006, the Company entered into that certain Subscription Agreement (the Subscription Agreement) for the sale of the certain convertible promissory notes (each a Note and collectively, the Notes) and warrants (the Warrants) to acquire common stock in the Company. In connection with these transactions, the Company and the investors entered into certain subordination agreements concerning the priority of the Company s debt, and certain ancillary agreements, which are all described below.

The Company sold Notes in the aggregate principal amount of One Million Five Hundred Thousand Dollars ($1,500,000) under the Subscription Agreement. The Company received $1,500,000 in cash from the Investor. and 1,000,000 shares of its common stock in exchange for the issuance of these Notes. The Notes are convertible into common stock at any time at the option of the holder. The maturity date of the Notes is three years after the date of

issuance. In the event that the Notes are not converted by the maturity dates of the Notes, any principal outstanding will then be due and payable. Interest on outstanding principal amounts accrues at the rate of ten percent (10%) per annum and is payable in shares of the Company s common stock. The Company may prepay the amount due under the Notes at any time, provided that the Company make a proportional prepayment on any other Notes sold under the Subscription Agreement. If the holder of the Notes elects to convert the Note into common stock, the holder will receive a number of shares equal to the amount of principal being converted, divided by the conversion price, which is $0.68, subject to change as provided in the Note. In addition, the Company issued Notes in the aggregate principal amount of One Million Two Hundred Fifty Thousand Dollars ($1,250,000) under the Subscription Agreement in exchange for 1,000,000 shares of the Company s common stock.

Pursuant to the Subscription Agreement the Company issued Warrants to purchase a number of shares of the Company s common stock equal to 50% of the number of shares which would be issued upon conversion of the Notes. Accordingly, the Company issued warrants to acquire 1,102,942 shares of common stock in connection with the issuance of Notes in the aggregate principal amount of $1,500,000. The warrants have a conversion price of $.80 per share (subject to certain anti-dilution adjustments as provided in the Warrant) and are exercisable for a period of 5 years. The Company did not issued warrants in connection with the issuance of the $1,250,000 Note.

The material terms of the Subscription Agreements are as follows. The Company and the investors (the Investors) under the Subscription Agreements made certain representations and warranties customary in private financings, including representations from the Investors that they are accredited investors as defined in Rule 501(a) of Regulation D (Regulation D) under the Securities Act of 1933, as amended.

The Company undertakes to register the shares of Common Stock issuable upon conversion of the Notes, and upon conversion of the Warrants (together, the Registrable Shares) via a suitable registration statement pursuant to the registration rights set forth in the Subscription Agreement. If a registration statement covering the Registrable Shares has not been declared effective no later than 120 days from the closing, the Investors will receive certain penalties either in cash or in additional shares of common stock as set forth in the Subscription Agreement. The Investors will also have rights to participate in up to $5,000,000 of any future equity or convertible debt offerings by the Company.

On October 12, 2006, the Company entered into that a letter agreement (the Vision Agreement) with Vision Opportunity Master Fund, Ltd. (Vision). In consideration for Vision s entering into the Subscription Agreement and acting as lead investor, in addition to the Notes and Warrants that issued pursuant to the Subscription Agreement, the Company also issued to Vision warrants to purchase a number of shares of the Company s common stock equal to 50% of the number of shares which would be issued upon conversion of the Notes purchased by Vision. Accordingly, the Company issued to Vision additional warrants (the Additional Warrants) to acquire 1,102,942 shares of common stock in connection with the issuance of Notes in the aggregate principal amount of $1,500,000.

Furthermore, the Company agreed that, for as long as Vision is a holder of at least 25% of the Notes or Warrants purchased under the Subscription Agreement (or the shares of Common Stock issuable upon the conversion or exercise thereof), Vision will have the right to nominate one director to the Company s board of directors. The Company shall recommend that its shareholders approve such nomination at any shareholders meeting for the election of directors or in connection with any written consent of shareholders of the election of directors.

Under the Vision Agreement, the Company agreed to reduce its parent company overhead by a minimum of 25% within six (6) months of the Closing and represented that it shall use at least $5 million of the estimated $6 million in proceeds from the sale of its Gupta subsidiary to reduce the amount of its indebtedness to Fortress Credit Corp.

On October 12, 2006 the Company entered into that certain Subordination Agreement (the Subordination Agreement) with the Investor under the Subscription Agreement and Fortress Credit Corp. (Fortress), Halo s senior creditor pursuant to which the Investor agreed that the Notes are expressly subordinate and junior in right of payment to all senior obligations owed by the Company to Fortress or another senior lender under Halo s existing senior credit facility with Fortress. Also under this Subordination Agreement, Fortress consented to the issuance of the Notes and the other transactions set forth in the Subscription Agreement.

On October 12, 2006 the Company entered into that certain Intercreditor and Subordination Agreement (the Intercreditor Agreement) with the Investor under the Subscription Agreement and Halo s existing subordinated debt lenders (the Existing Lenders), Crestview Capital Master, LLC (Crestview) and CAMOFI Master LDC (CAMOFI). Under the Intercreditor Agreement the Investor agreed that the Notes are expressly subordinate and junior in right of payment to all senior obligations owed by the Company to the Existing Lenders under Halo s existing subordinated

notes purchased by the Existing Lenders under that certain Subordinated Note and Warrant Purchase Agreement dated January 31, 2005.

On October 12, 2006 the Company, the Investor, the Existing Lenders, and Fortress entered into a letter agreement (the Fortress Letter Agreement) whereby the parties agreed not to amend or modify the Intercreditor Agreement without the prior written consent of Fortress.

On October 12, 2006 the Company, Crestview and CAMOFI entered into a Consent Agreement (the Consent) whereby Crestview and CAMOFI consented to the transactions contemplated by the Subscription Agreement in consideration of: (i) the Company adjusting the Conversion Price set forth in the Subordinated Notes held by Crestview and CAMOFI to be modified from $1.00 to $0.68, and (ii) the Warrant Price set forth in the existing warrants held by those entities to be modified from $1.25 to $0.68.

Amendment No. 2 to Fortress Credit Agreement

On October 12, 2006 Company entered into Amendment Agreement No. 2 (Amendment Agreement) between the Company and Fortress relating to the Credit Agreement dated August 2, 2005 between the Company, the Subsidiaries of the Company listed in Schedule 1 thereto (the Subsidiaries), Fortress Credit Corp., as original lender (together with any additional lenders, the Original Lenders), and the Agent. Pursuant to this Amendment Agreement, certain covenants were amended or replaced, as follows:

The Company will not permit the Total Debt to EBITDA Ratio to exceed (a) 3.4 to 1 during the period from the April 1, 2006 to, and including, June 30, 2006, (b) 4.0 to 1 during the period from July 1, 2006 to, and including, September 30, 2006, (c) 4.0 to 1 during the period from October 1, 2006 to, and including, December 31, 2006, (d) 1.5 to 1 during the period from January 1, 2007 to, and including, March 31, 2007, (e) 1.5 to 1 during the period from April 1, 2007 to, and including, June 30, 2007 and (f) 1.5 to 1 during the period from July 1, 2007 to, and including, September 30, 2007.

The Company will not permit its Cash Interest Coverage Ratio to fall below (a) 3.5 to 1 during the period from the April 1, 2006 to, and including, June 30, 2006, (b) 2.6 to 1 during the period from July 1, 2006 to, and including, September 30, 2006, (c) 2.0 to 1 during the period from October 1, 2006 to, and including, December 31, 2006, (d) 1.7 to 1 during the period from January 1, 2007 to, and including, March 31, 2007, (e) 2.2 to 1 during the period from April 1, 2007 to, and including, June 30, 2007 and (f) 3.0 to 1 during the period from July 1, 2007 to, and including, September 30, 2007.

The Company will not permit the Fixed Charge Covenant Ratio to fall below (a) 3.2 to 1 during the period from the April 1, 2006 to, and including, June 30, 2006, (b) 1.9 to 1 during the period from July 1, 2006 to, and including, September 30, 2006, (c) 1.3 to 1 during the period from October 1, 2006 to, and including, December 31, 2006 (d) 1.0 to 1 during the period from January 1, 2007 to, and including, March 31, 2007, (e) 1.0 to 1 during the period from April 1, 2007 to, and including, June 30, 2007 and (f) 1.0 to 1 during the period from July 1, 2007 to, and including, September 30, 2007.

The Company will not permit the aggregate amount of Capital Expenditures by the Group during any twelve month period to exceed US$300,000.

All defined terms have the meanings set forth in the Amendment Agreement.

Working Capital Requirements

Halo s future capital requirements will depend on many factors, including cash flow from operations, continued progress in research and development programs, competing technological and market developments, and Halo s ability to maintain its current customers and successfully market its products, as well as any future acquisitions it undertakes. Halo intends to meet its cash needs, as in the past, through cash generated from operations, the proceeds of privately placed equity issuances and debt. Even without further acquisitions, in order to meet its financial obligations including repayment of outstanding debt obligations, Halo will have to issue further equity and engage in further debt transactions. There can be no guarantee that Halo will be successful in such efforts. In the absence of such further financing, Halo will either be unable to

meet its debt obligations or with have to significantly restructure its operations, or a combination of these two actions. Such actions would significantly negatively affect the value of Halo s common stock.

Halo s working capital requirements as of June 30,2006 was a deficit of approximately $23.2 million, comprised primarily of accounts payable and accrued expenses, $8.1 million, deferred revenue, $13.4 million, and short-term debt, $7.6 million, which was partially offset by cash $853,000, accounts receivable, $4.1 million, and other prepaid expenses, $996,000. Halo s working capital as of June 30, 2005 was a deficit of approximately $5.3 million, comprised primarily of accounts payable and accrued expenses, $4.6 million, deferred revenue, $3.4 million, and current notes payable, $1.3 million, which was partially offset by cash, $1.5 million, accounts receivable, $2 million and other prepaid expenses, $0.4 million.

The material increase in our capital requirements for the fiscal year, ended June 30, 2006, over the prior year is primarily due to the increase in headcount and compensation costs resulting from the acquisition of eight companies since June 30, 2005, and the expansion of our management team to lead the Company s acquisition, integration and management of our operating subsidiaries. As of June 30, 2005, Halo employed 57 people. As of June 30, 2006, Halo employed 234 people. Our accounts payable and accrued expenses similarly increased, rising from $4.6 million on June 30, 2005 to $8.1 million as of June 30, 2006. Likewise, our debt service has increased, primarily due to loans under the Fortress credit facility, the proceeds of which were used to fund part of the purchase price for the five companies we acquired in October 2005.

The Company expects its spending on research and development in the current fiscal year to remain consistent with the level of such expenditures in the fiscal year ended June 30, 2006, subject to changes in operations due to acquisitions or sales of subsidiary companies.

The Company anticipates further material increases in its operating costs for the current fiscal year ending June 30, 2007. We expect substantially increasing operating expenses in connection with the growth of our operations, the development of our enterprise technologies, the expansion of our services operations and our acquisition activity. Our capital requirements during the year ending June 30, 2007 will depend on numerous factors including the amount of resources we devote to:

- Funding the continued development of our products;
- Sales and marketing efforts;
- improving and extending our services and the technologies used to deliver these services to our customers;
- pursuing other strategic acquisitions and alliances; and
- making possible investments in businesses, products and technologies.

Given our current cash position, and our expectations of cash flows from operations, we anticipate requiring additional working capital of approximately $4 to $6 million for the year ending June 30, 2007 of which we have received $1.5 million in a transaction completed October 12, 2006, see Subsequent Events Subordinated Debt Financing. We expect to pursue equity or debt financing in order to meet these capital needs. There can be no assurance that we will be successful in such efforts. In the absence of such further financing, Halo will either be unable to meet its debt obligations or will have to significantly restructure its operations, or a combination of these two actions. Such actions would significantly negatively affect the value of Halo s common stock.

Critical Accounting Policies

The discussion and analysis of the Company s financial condition and results of operations is based on the Company s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses and disclosure of contingent liabilities.

On an on-going basis, we evaluate our estimates, including those related to revenue recognition and accounting for intangible assets. We base our estimates on historical experience and on various other assumptions that we believe to

be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

We have identified the accounting policies below as the policies critical to the Company s business operations and the understanding of the Company s results of operations. We believe the following critical accounting policies and the related judgments and estimates affect the preparation of Gupta s consolidated financial statements:

Revenue Recognition

The Company recognizes revenue in accordance with the American Institute of Certified Public Accountants Statement of Position (SOP) 97-2, Software Revenue Recognition.

Revenues are derived from the licensing of software, maintenance contracts, training, and other consulting services.

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In arrangements that include rights to multiple software products and/or services, the Company allocates and defers revenue for the undelivered items, based on vendor-specific objective evidence of fair value, and recognizes the difference between the total arrangement fee and the amount deferred for the undelivered items as revenue. In arrangements in which the Company does not have vendor-specific objective evidence of fair value of maintenance, and maintenance is the only undelivered item, the Company recognizes the total arrangement fee ratably over the contractual maintenance term.

Software license revenues are recognized upon receipt of a purchase order and delivery of software, provided that the license fee is fixed or determinable; no significant production, modification, or customization of the software is required; and collection is considered probable by management. For licensing of Gupta s software through its indirect sales channel, revenue is recognized when the distributor sells the software to its end-users, including value-added resellers. For licensing of software to independent software vendors, revenue is recognized upon shipment to the independent software vendors.

Service revenue for maintenance contracts is deferred and recognized ratably over the term of the agreement. Revenue from training and other consulting services is recognized as the related services are performed.

Vendor specific objective evidence of fair value for undelivered elements of an arrangement is based upon the normal pricing and discounting practices for those products and services when sold separately and maintenance contracts is measured by the renewal rate offered to the customer.

Business Combinations and Deferred Revenue

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

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

We have acquired several software companies in fiscal 2006, and we plan to make more acquisitions in the future. Acquired deferred revenue is recognized at fair value to the extent it represents a legal obligation assumed by the Company in accordance with EITF 01-03, Accounting in a Business Combination for Deferred Revenue of an Acquiree. Under this guidance, the Company estimates fair values of acquired deferred revenue by adding an approximated normal profit margin to the estimated cost required to fulfill the obligation underlying the deferred revenue. As a result of this valuation, the deferred revenues of the acquired companies normally decrease substantially. In the enterprise software industry, this reduction averages between forty to sixty percent of the original balance. The reduction of the deferred revenue has a negative effect on the recognized revenue until the deferred revenue balance builds up to a normal level of the acquired business. The length of this effect depends on contracts underlying the deferred revenue. As the Company continues to acquire more businesses in the enterprise software industry, the effect of this deferred revenue valuation will have significant effect on the Company s results of operations.

Product Development Costs

Product development costs incurred in the process of developing product improvements and enhancements or new products are charged to expense as incurred. Statement of Financial Accounting Standards (SFAS) No. 86, Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed, requires capitalization of certain software development costs subsequent to the establishment of technological feasibility. Based on the Company s product development process, technological feasibility is established upon the completion of a working

model. Costs incurred by the Company between the completion of the working model and the point at which the product is ready for general release has been insignificant.

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Intangible assets and Goodwill

Intangible assets are primarily comprised of customer relationships, developed technology, trade names and contracts. Goodwill represents acquisition costs in excess of the net assets of businesses acquired. In accordance with SFAS 142, Goodwill and Other Intangible Assets goodwill is no longer amortized; instead goodwill is tested for impairment on an annual basis. We assess the impairment of identifiable intangibles and goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider to be important which could trigger an impairment review include the following:

Significant underperformance relative to expected historical or projected future operating results;

Significant changes in the manner of use of the acquired assets or the strategy for the overall business; and

Significant negative industry or economic trends.

When we determine that the carrying value of intangibles and other long-lived assets may not be recoverable based upon the existence of one or more of the above indicators of impairment and the carrying value of the asset cannot be recovered from projected undiscounted cash flows, we record an impairment charge. We measure any impairment based on a projected discounted cash flow method using a discount rate determined by management to be commensurate with the risk inherent in the current business model. Significant management judgment is required in determining whether an indicator of impairment exists and in projecting cash flows. Trade names are considered to have indefinite life. All other intangibles are being amortized over their estimated useful life of three to ten years.

We have recorded a significant amount of goodwill on our balance sheet. As of June 30, 2006, goodwill was approximately $28 million, representing approximately 47% of our total assets and approximately 52% of our long-lived assets subject to depreciation, amortization and impairment. In the future, goodwill may increase as a result of additional acquisitions we will make. Goodwill is recorded on the date of acquisition and is reviewed at least annually for impairment. Impairment may result from, among other things, deterioration in the performance of our business, adverse market conditions and a variety of other circumstances. Any future determination requiring the write-off of a significant portion of the goodwill recorded on our balance sheet could have an adverse effect on our financial condition and results of operations. As of years ended June 30, 2006 and 2005, the Company had goodwill impairment charges of $5.2 million and $3.9 million, respectively.

Stock-Based Compensation

Prior to January 1, 2006, the Company used the intrinsic value method to account for stock-based compensation in accordance with Accounting Principles Board Opinion No. 25 (APB 25), Accounting for Stock Issued to Employees, and had adopted the disclosure-only provisions of SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Ì Transition and Disclosure. Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123(R), Share-Based Payment (SFAS 123(R)). SFAS 123(R) requires entities to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards (with limited exceptions). As a result, compensation cost of the Company for the year ended June 30, 2006 includes compensation expense for unvested portion of all the stock options outstanding and all the stock options granted after the effective date. No restatement has been made to prior periods. We had applied APB 25 s intrinsic value method up to December 31, 2005, and presented pro forma income statements in the footnote to show the effect of FAS123(R) as if it had been implemented in the prior periods.

ITEM 7. FINANCIAL STATEMENTS.

The financial statements and related notes responsive to this Item 7, together with the report of the Independent Registered Public Accounting Firm, are included as an appendix to this report as indexed on page F-1.

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

ITEM 8A. CONTROLS AND PROCEDURES.

As of June 30, 2006, the Company carried out an evaluation, under the supervision and with the participation of the Company s management, including Rodney A. Bienvenu, Jr., the Company s principal executive officer, and Mark Finkel, the Company s principal financial officer, of the effectiveness of the Company s disclosure controls and procedures (as such term is defined in Rule 13a-15(e) and Rule 15(d)-15(e) of the Securities Exchange Act of 1934 (the Exchange Act)

pursuant to Rule 13a-15(d) and 15(e) of the Exchange Act. Based upon that evaluation, Messrs. Bienvenu and Finkel have each concluded that, as of June 30, 2006, the Company s disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files, furnishes or submits under the Exchange Act is recorded, processed, summarized and reported on a timely basis except as follows:

A material control weakness is a significant deficiency or a combination of significant deficiencies that results in more than a remote likelihood that a material misstatement in financial statements will not be prevented or detected on a timely basis by employees in the normal course of their work. As of June 30, 2006, the management has identified that one of the Company s subsidiaries, Process Software, LLC (Process), has a material control weakness in its revenue recognition process.

The Company recognizes revenue in accordance with the American Institute of Certified Public Accountants Statement of Position (SOP) 97-2, Software Revenue Recognition. Under SOP 97-2, service revenue for maintenance contracts is deferred and recognized ratably over the term of the agreement. Process sometimes started this ratable recognition earlier or later than the actual contract date while it recognized the revenue over a shorter or longer period on other occasions. These resulted in improper revenue recognition, either understating or overstating the revenue and earnings. Process also demonstrated inconsistency in recording accounts receivable. The Company usually invoices its customers either on receipt of a purchase order or on signing of a contract. The invoiced amount is recorded as accounts receivable as of the invoice date. Process sometimes recorded accounts receivable earlier or later than the actual invoice date, resulting in over or understatement of accounts receivable. Process lacked the discipline and training of the personnel who record its sales transactions. It also lacked the monitoring process to mitigate these weaknesses.

These material weaknesses impacted our ability to properly record and report the financial results during the fiscal year 2006. However, the Company s management is actively engaged in remediation efforts to address this material weaknesses identified in our internal control over financial reporting. The Company has transitioned sales invoicing responsibilities from non-accounting personnel to accounting personnel better trained to process such documents. The Company is also in the process of implementing a new accounting system, which the Company anticipates will enable the Company to monitor ongoing activities without increasing staff level.

The total net adjustments as a result of this weakness was less than $35,000 in the fiscal year ended June 30, 2006.

The Company s management believes that the Company will be able to improve our disclosure controls and procedures and remedy the identified material weaknesses. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, will be or have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may not occur and not be detected

The changes in our internal control over financial reporting described above were implemented subsequent to the year ended June 30, 2006. There were no changes in our internal control over financial reporting identified in management s evaluation during the fiscal year to which this report relates that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

In the course of responding to comments received from the SEC in connection with the Company s registration statement on Form S-4 filed April 5, 2006, and amended on June 1, 2006, the Company identified errors resulting from the improper treatment of certain warrants to acquire common stock of the Company in accordance with EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company s Own Stock.* . The Company had treated the warrants as equity, but the warrants should have been treated as liabilities.

Accordingly, on September 1, 2006, the Company s Board of Directors determined that investors should not rely on the Company s (a) consolidated financial statements for the period ended June 30, 2005 and the report thereon of the

Company s independent registered public accountants, included in the Company s Annual Report on Form 10-KSB filed with the SEC on September 28. 2005, (b) condensed consolidated financial statements for the period ended September 30, 2005, included in the Company s Quarterly Report on Form 10-QSB filed with the SEC on November 14, 2005, (c) condensed consolidated financial statements for the period ended December 31, 2005, included in the Company s Quarterly

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Report on Form 10-QSB filed with the SEC on February 15, 2006, and (d) condensed consolidated financial statements for the period ended March 31, 2006, included in the Company s Quarterly Report on Form 10-QSB filed with the SEC on May 15, 2006. The Board of Directors subsequently determined that investors should not rely on the Company s condensed consolidated financial statements for the period ended March 31, 2005, included in the Company s Quarterly Report on Form 10-QSB filed with the SEC on May 20, 2005.

As a result of these determinations, the Company has amended its Annual Report for the year ended June 30, 2005 and its Quarterly Reports for the interim periods ended March 31, 2006, December 31, 2005, September 30, 2005, and March 31, 2005. The amended Annual Report and the amended Quarterly Reports were filed with the SEC on October 11, 2006. The Company s Board of Directors have discussed these matters with the Company s independent registered public accounting firm.

In the Company s fiscal 2006 third quarter earnings release, dated May 15, 2006, and furnished to the SEC as a Current Report on Form 8-K on May 15, 2006, the Company reported that it had achieved positive cash flow from operations and that it was generating positive operating cash flow (on a pro forma EBITDA basis). In making this statement, the Company included in its calculation of EBITDA (earnings before interest, taxes, depreciation and amortization) historical deferred revenues from acquired companies (as recorded on the historical financial statements of the acquired companies prior to acquisition) without giving effect to the deferred revenue fair value reduction required by GAAP and purchase accounting when concluding that its cash flow on a pro forma EBITDA basis was positive for the quarter ended March 31, 2006. Without the inclusion of this historical deferred revenues from acquired companies or if the Company had given effect to the deferred revenue fair value reduction , the Company would not have reported positive cash flow from operations on an EBITDA basis for the quarter ended March 31, 2006. After discussions with the Company s independent auditors and staff at the Securities and Exchange Commission, the Company has agreed not to use the measure pro forma EBITDA basis. The Company has amended its Quarterly Report on Form 10-QSB for the fiscal quarter ended March 31, 2006 to remove pro forma information with respect to Deferred Revenues included in the Management s Discussion and Analysis of Financial Condition and Results of Operations under the heading Non-GAAP Financial Measures.

ITEM 8B. OTHER INFORMATION.

None.

PART III

ITEMS 9, 10, 11, 12, and 14.

The information required by Items 9, 10, 11, 12 and 14 of Part III of this Form 10-KSB is incorporated by reference from the information contained in the 2006 Proxy Statement to be filed on or about October 28, 2006.

ITEM 13. EXHIBITS

Exhibit No.	Description of Exhibit
3.1 (1)	Articles of Incorporation of WARP Technology Holdings, Inc.
3.2 (1)	Bylaws of WARP Technology Holdings, Inc.
3.3 (2)	Form of the Articles of Merger of Abbott Mines Limited and WARP Technology Holdings, Inc.
3.4 (6)	Form of Certificate of Amendment to Articles of Incorporation of WARP Technology Holdings, Inc. filed with the Secretary of State of the State of Nevada on September 12, 2003.
3.6 (7)	Form of Certificate Of Designations, Preferences And Rights Of Series A 8% Cumulative Convertible Preferred Stock Of Warp Technology Holdings, Inc. as filed with the Secretary of State of the State of Nevada on October 1, 2003.
3.7 (7)	Form of Certificate Of Designations, Preferences And Rights Of Series B 10% Cumulative Convertible Preferred Stock Of Warp Technology Holdings, Inc. as filed with the Secretary of State of the State of Nevada on October 1, 2003.
3.8 (10)	Certificate of Designations, Preferences, and Rights of Series B-2 Preferred Stock, as filed with the Secretary of State of the State of Nevada on August 4, 2004.
3.9 (12)	Certificate of Change Pursuant to Nevada Revised Statutes Sec. 78.209, effecting 100 for 1 reverse split effective November 18, 2004, as filed with the Secretary of State of the State of Nevada on November 8, 2004.
3.10 (16)	Certificate of Amendment to Articles of Incorporation of WARP Technology Holdings, Inc., as filed with the Secretary of State of the State of Nevada on March 31, 2005.
3.11 (17)	Certificate of Designations of Series C Stock of WARP Technology Holdings, Inc.
3.12 (26)	Certificate of Designation for Nevada Profit Corporation, designating Series D Preferred Stock, as filed with the Secretary of State of the State of Nevada, effective October 26, 2005.
3.13 (33)	Certificate of Amendment to Articles of Incorporation of Halo Technology Holdings, Inc., as filed with the Secretary of State of the State of Nevada, effective April 2, 2006.
4.1 (1)	Specimen Certificate Representing shares of Common Stock, $.00001 par value per share, of WARP Technology Holdings, Inc.
4.2 (13)	Form of Bridge Note issued October 13, 2004 by Warp Technology Holdings, Inc.
4.3 (14)	Form of Amended and Restated Subordinated Secured Promissory Note.

4.4 (14)	Form of Senior Secured Promissory Note.
4.5 (14)	Form of Initial Warrant and Additional Warrant
4.6 (14)	Form of Subordinated Secured Promissory Note
4.7 (14)	Form of Warrant
4.8 (14)	Form of Convertible Promissory Note
4.9 (19)	$1,000,000 Promissory Note, dated July 6, 2005, to Bristol Technology, Inc.
4.10 (20)	Form of Promissory Note
4.11 (20)	Warrant Certificate, Form of Fact of Warrant Certificate, Warrants to Purchase Common Stock of Warp

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Exhibit No.	Description of Exhibit
	Technology Holdings, Inc.
4.12 (24)	Form of Promissory Note first issued October 21, 2005.
4.13 (24)	Form of Warrant, first issued October 21, 2005, to purchase shares of Common Stock, par value $0.00001 per share, of the Company.
4.14 (30)	Form of Note first issued January 11, 2006
4.15 (31)	Form of Note first issued January 27, 2006.
4.16	Form of Note first issued October 12, 2006.
4.17	Form of Warrant first issued October 12, 2006.

Exhibit No.	Description of Exhibit
	shares of Common Stock of Warp Technology Holdings, Inc., par value $0.00001 per share.
10.24 (11)	Form of Incentive Stock Option Agreement for Ernest Mysogland to purchase an aggregate of 5,022,843 shares of Common Stock of Warp Technology Holdings, Inc., par value $0.00001 per share.
10.26 (11)	Form of Consulting Agreement between WARP Technology Holdings, Inc. and ISIS Capital Management, LLC which was executed by the parties thereto on August 4, 2004.
10.27 (11)	Form of Stock Option Agreement between WARP Technology Holdings, Inc. and ISIS Capital Management, LLC which was executed by the parties thereto on August 4, 2004.
10.30(13)	Letter agreement dated September 13, 2004 between WARP Technology Holdings, Inc. and Griffin Securities, Inc. for Griffin to act on a best efforts basis as a non-exclusive financial advisor and placement agent for the Client in connection with the structuring, issuance, and sale of debt and equity securities for financing purposes.
10.31(13)	Purchase Agreement Assignment and Assumption as of October 13, 2004, by and between ISIS Capital Management, LLC and WARP Technology Holdings, Inc.
10.32(13)	Financial Advisory/Investment Banking Agreement dated September 20, 2004 between WARP Technology Holdings, Inc. and Duncan Capital LLC
10.33(14)	Amendment No. 2 to Extension Agreement by and between Warp Technology Holdings, Inc. and Gupta Holdings, LLC.
10.34 (14)	Amendment No. 3 to Extension Agreement by and between Warp Technology Holdings, Inc. and Gupta Holdings, LLC
10.35 (14)	Amendment to Membership Interest Purchase Agreement made and entered into as of January 31, 2005, by and between Warp Technology Holdings, Inc. and Gupta Holdings, LLC
10.36 (14)	Form of Series C Subscription Agreement entered into January 31, 2005 by and between Warp Technology Holdings, Inc. and the Investors as identified therein.
10.37 (14)	Investors Agreement entered into the 31st day of January, 2005 by and among Warp Technology Holdings, Inc., and the persons listed on Exhibit A thereto.
10.38 (14)	Senior Note and Warrant Purchase Agreement, as of January 31, 2005, by and among Warp Technology Holdings, Inc. and the Purchasers identified therein.
10.39 (14)	Subordinated Note and Warrant Purchase Agreement, as of January 31, 2005, by and among Warp Technology Holdings, Inc. and the Purchasers identified therein.
10.40 (14)	Senior Security Agreement, dated as of January 31, 2005, between Warp Technology & Holdings, Inc. and Collateral Agent (as defined therein).

10.41 (14)	Senior Security Agreement, dated as of January 31, 2005, between Warp Solutions, Inc. and Collateral Agent (as defined therein).
10.42 (14)	Senior Security Agreement, dated as of January 31, 2005, between Gupta Technologies, LLC and Collateral Agent (as defined therein).
10.43 (14)	Senior Guaranty, dated as of January 31, 2005, between Warp Solutions, Inc. and Collateral Agent (as defined therein).
10.44 (14)	Senior Guaranty, dated as of January 31, 2005, between Gupta Technologies, LLC and Collateral Agent (as defined therein).
10.45 (14)	Subordinated Security Agreement, dated as of January 31, 2005, between Warp Technology Holdings, Inc. and Collateral Agent (as defined therein).
10.46 (14)	Subordinated Subsidiary Security Agreement, dated as of January 31, 2005, between Warp Solutions, Inc. and Collateral Agent (as defined therein).
10.47 (14)	Subordinated Subsidiary Security Agreement, dated as of January 31, 2005, between Gupta Technologies, LLC and Collateral Agent (as defined therein).

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Exhibit No.	Description of Exhibit
10.48 (14)	Subordinated Guaranty, dated as of January 31, 2005, between Warp Solutions, Inc. and Collateral Agent (as defined therein).
10.49 (14)	Subordinated Guaranty, dated as of January 31, 2005, between Gupta Technologies, LLC and Collateral Agent (as defined therein).
10.50 (14)	Intercreditor and Subordination Agreement dated as of January 31, 2005, by and among: the Subordinated Noteholders, the Senior Noteholders, Warp Technology Holdings, Inc., Warp Solutions, Inc., Gupta Technologies, LLC, and the Collateral Agent (as such terms are defined therein).
10.51 (14)	Collateral Agency Agreement made as of January 31, 2005 by and among the Collateral Agent (as defined therein) and the Noteholders (as defined therein).
10.52 (14)	Post Closing Agreement, dated as of January 31, 2005, by and among the Credit Parties and the Collateral Agent (as such terms are defined therein).
10.53 (15)	Separation Agreement, dated as of March 3, 2005, by and between Warp Technology Holdings, Inc. and Gus Bottazzi.
10.54 (18)	Letter Agreement dated October 31, 2003 by and between Gupta Technologies, LLC and Jeffrey L. Bailey.
10.55 (18)	Letter Agreement dated August 4, 2004 by and between Gupta Technologies, LLC and Jeffrey Bailey, as amended January 1, 2005.
10.56 (18)	Premium International Distribution Agreement dated January 1, 2004 by and between ADN Distribution, GmbH and Gupta Technologies, LLC.
10.57 (18)	Premium International Distribution Agreement dated March 1, 2005 by and between Scientific Computers and Gupta Technologies, LLC.
10.58 (18)	Premium International Distribution Agreement dated January 1, 2004 by and between NOCOM AB and Gupta Technologies, LLC, as amended January 1, 2005.
10.59 (18)	Premium International Distribution Agreement dated October 1, 2003 by and between Sphinx CST and Gupta Technologies, LLC, as amended October 1, 2004.
10.60 (18)	Premium International Distribution Agreement dated March 24, 2004 by and between Xtura B.V. and Gupta Technologies, LLC.
10.61 (18)	OEM Software License Agreement dated September 29, 1994 by and between United Parcel Service General Services Co. and Gupta Technologies, LLC, as amended September 8, 1995, September 30, 1999, December 21, 1999, March 23, 2001, and December 31, 2004.
10.62 (18)	Service Agreement dated March 27, 2002 by and between Offshore Digital Services Inc., DBA Sonata and Gupta Technologies, LLC, as amended March 28, 2003, July 21, 2003, and March 28, 2004.

10.63 (18)	Services Agreement dated September 20, 2004 by and between CodeWeavers, Inc. and Gupta Technologies, LLC.
10.64 (18)	OEM Product Agreement dated September 20, 2004 by and between CodeWeavers, Inc. and Gupta Technologies, LLC.
10.65 (18)	Qt Commercial License Agreement for Enterprise Edition dated as of December 15, 2004 by and between Trolltech Inc. and Gupta Technologies, LLC.
10.66 (18)	OEM License Agreement dated January 1, 2004 by and between Graphics Server Technologies, L.P. and Gupta Technologies, LLC.

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Exhibit No.	Description of Exhibit
10.67 (18)	Shrinkwrap software license agreement with Data Techniques, Inc. for the ImageMan software product.
10.68 (18)	Shrinkwrap software license agreement with Rogue Wave Software Inc. for the Rogue Wave Stingray software product.
10.69 (18)	Lease Agreement dated July 19, 2001 by and between Westport Joint Venture and Gupta Technologies, LLC, together with amendments thereto.
10.70 (18)	Stock Purchase Agreement by and among WARP Technology Holdings, Inc., Bristol Technology, Inc. and Kenosia Corporation, dated June 10, 2005.
10.71 (19)	Pledge and Security Agreement by and among Warp Technology Holdings, Inc., Kenosia Corporation, and Bristol Technology, Inc. dated July 6, 2005.
10.72 (20)	Credit Agreement dated August 2, 2005 between Warp Technology, Inc., the Subsidiaries of the Company, Fortress Credit Corp., as Original Lender and Agent
10.73 (20)	Agreement regarding issuance of warrant certificates dated as of August 2, 2005 between Warp Technology Holdings, Inc., and Fortress Credit Corp.
10.74 (20)	Security Agreement dated as of August 2, 2005 between Warp Technology Holdings, Inc. and Fortress Credit Corp.
10.75 (20)	Stock Pledge Agreement dated as of August 2, 2005 between Warp Technology Holdings, Inc. and Fortress Credit Corp.
10.76 (20)	Pledge Agreement dated as of August 2, 2005 between Warp Technology Holdings, Inc. and Fortress Credit Corp.
10.77 (20)	Intercreditor and Subordination Agreement dated as of August 2, 2005 between Warp Technology Holdings, Inc, the Subsidiaries of Warp Technology Holdings, Inc., the Financial Institutions, the Holders of Subordinated Notes and Fortress Credit Corp.
10.78 (20)	Deed dated August 1, 2005 between Gupta Technologies, LLC and Fortress Credit Corp.
10.79 (20)	Deed dated August 2, 1005 between Gupta Technologies Limited and Fortress Credit Corp.
10.80 (20)	Deed dated August 2, 2005 between Warp Solutions Limited and Fortress Credit Corp.
10.81 (20)	Deed dated August 2, 1005 between Gupta Technologies, LLC and Fortress Credit Corp.
10.82 (20)	Deed dated August 2, 2005 between Warp Solutions, Inc. and Fortress Credit Corp.
10.83 (20)	Security Trust Agreement dated August , 2005 between Fortress Credit Corp., Fortress Credit Opportunities I LP, Finance Parties and Security Grantors

10.84 (21)	Share Pledge Agreement dated August 2, 2005 between Gupta Technologies LLC, Fortress Credit Corp., Fortress Credit Opportunities I LP and Finance Parties
10.85 (21)	Commercial Lease dated as of August 29, 2005 by and between Railroad Avenue LLC and Warp Technology Holdings, Inc.
10.86 (22)	Purchase Agreement dated as of September 12, 2005 by and between Warp Technology Holdings, Inc., Platinum Equity, LLC, Energy TRACS Acquisition Corp. and Milgo Holdings, LLC.
10.87 (22)	Merger Agreement dated as of September 12, 2005 by and between Warp Technology Holdings, Inc., TAC/Halo, Inc., Tesseract Corporation and Platinum Equity, LLC
10.88 (23)	Promissory Note dated September 20, 2005 whereby Warp Technology Holdings, Inc. promises to pay to the order of DCI Master LDC in the principal amount of $500,000

Exhibit No.	Description of Exhibit
10.89 (23)	Warrant to purchase 181,818 shares of common stock, par value $0.00001 per share issued to DCI Master LDC
10.90 (25)	Halo Technology Holdings 2005 Equity Incentive Plan
10.91 (25)	Form of Employee Incentive Stock Option Agreement under Halo Technology Holdings 2005 Equity Incentive Plan
10.92 (25)	Form of Non-Qualified Stock Option Agreement under Halo Technology Holdings 2005 Equity Incentive Plan
10.93 (25)	Fiscal 2006 Halo Senior Management Incentive Plan
10.94 (26)	Amendment No. 1 to Merger Agreement, dated as of October 26, 2005 among Platinum Equity, LLC, Warp Technology Holdings, Inc., TAC/Halo, Inc., TAC/HALO, LLC and Tesseract Corporation.
10.95 (26)	Investor s Agreement, dated October 26, 2005 by and among Warp Technology Holdings, Inc. and Platinum Equity, LLC.
10.96 (26)	Promissory Note of Warp Technology Holdings, Inc. dated October 26, 2005 in the amount of $1,750,000.
10.97 (26)	Amendment Agreement No. 1 between Warp Technology Holdings, Inc., Fortress Credit Opportunities I LP and Fortress Credit Corp. dated October 26, 2005.
10.98 (26)	Intercreditor and Subordination Agreement between Warp Technology Holdings, Inc., the Subsidiaries of Warp Technology Holdings, Inc., the Financial Institutions listed in Part 2 of Schedule 1, the Holdings of Subordinated Notes listed in Part 3 of Schedule 1 and Fortress Credit Corp., dated October 26, 2005.
10.99 (26)	Pledge Agreement between Warp Technology Holdings, Inc. and Fortress Credit Corp. dated October 26, 2005 regarding Process Software, LLC.
10.100 (26)	Pledge Agreement between Warp Technology Holdings, Inc. and Fortress Credit Corp. dated October 26, 2005 regarding ProfitKey International, LLC.
10.101 (26)	Pledge Agreement between Warp Technology Holdings, Inc. and Fortress Credit Corp. dated October 26, 2005 regarding and TAC/Halo, LLC.
10.102 (26)	Stock Pledge Agreement between Warp Technology Holdings, Inc. and Fortress Credit Corp. dated October 26, 2005 regarding David Corporation.
10.103 (26)	Stock Pledge Agreement between Warp Technology Holdings, Inc. and Fortress Credit Corp. dated October 26, 2005 regarding Foresight Software, Inc.
10.104 (26)	Security Agreement between Process Software, LLC and Fortress Credit Corp. dated October 26, 2005.

10.105 (26)	Security Agreement between ProfitKey International, LLC and Fortress Credit Corp. dated October 26, 2005.
10.106 (26)	Security Agreement between TAC/Halo, LLC and Fortress Credit Corp. dated October 26, 2005
10.107 (26)	Security Agreement between Foresight Software, Inc. and Fortress Credit Corp. dated October 26, 2005.
10.108 (26)	Security Agreement between David Corporation and Fortress Credit Corp. dated October 26, 2005.
10.109 (27)	Merger Agreement, dated as of December 19, 2005, by and among Warp Technology Holdings, Inc., EI Acquisition, Inc., Empagio, Inc., and certain stockholders of Empagio.
10.111 (28)	Employment Agreement with Mark Finkel
10.112 (28)	Non-Competition Agreement with Mark Finkel
10.113 (28)	Confidentiality Agreement with Mark Finkel
10.114 (29)	Form of Agreement Regarding Warrants
10.115 (30)	Subscription Agreement entered into January 11, 2006
10.116 (31)	Subscription Agreement first entered into January 27, 2006
10.117 (32)	Merger Agreement, dated as of January 30, 2006, by and among Warp Technology Holdings, Inc., ECI Acquisition, Inc., Executive Consultants, Inc., and certain stockholders of Executive Consultants, Inc.

Exhibit No.	Description of Exhibit
10.120 (34)	Amendment and Consent, dated as of March 31, 2006 between Warp Technology Holdings, Inc. and Platinum Equity, LLC.
10.121 (35)	Lease with 200 Railroad LLC. Certain exhibits and schedules to the Lease are referred to in the text thereof and the Registrant agrees to furnish them supplementally to the Securities and Exchange Commission upon request.
10.122 (37)	Form of Consent Agreement entered into by certain Series C Preferred Stockholders and Halo Technology Holdings, Inc.
10.126 (38)	Form of Warrant issued July 21, 2006.
10.127 (39)	Agreement and Plan of Merger dated August 24, 2006 between Halo Technology Holdings, Inc., Tenebril Acquisition Sub, Inc., Tenebril Inc., and Sierra Ventures.
10.128 (39)	Form of Promissory Note Issued to Tenebril Stockholders
10.129(39)	Investors Agreement dated August 24, 2006 between Halo Technology Holdings, Inc. and the Investors named therein.
10.130 (40)	Purchase and Exchange Agreement between Halo and Unify Corporation dated September 13, 2006.
10.131 (40)	Termination Agreement among Halo, UCA Merger Sub, Inc., and Unify Corporation, dated September 13, 2006.
10.132 (41)	Equity Purchase Agreement among Halo, the RevCast Stockholders and the Enterprises Members dated September 15, 2006.
10.133 (42)	Subscription Agreement first entered into October 12, 2006.
10.134 (42)	Letter Agreement between the Company and Vision dated October 12, 2006.
10.135 (42)	Form of Subordination Agreement among the Company, Fortress and other lenders.
10.136 (42)	Form of Intercreditor and Subordination Agreement with Existing Subordinated Lenders.
10.137 (42)	Letter Agreement with Fortress.
10.138 (42)	Consent Agreement with Subordinated Lenders
10.139 (42)	Amendment No. 2 to Fortress Credit Agreement
21.1 (36)	Subsidiaries of Halo Technology Holdings, Inc.

(1)

Incorporated herein by reference to the exhibits to WARP Technology Holdings, Inc. s Registration Statement on Form SB-2 (File No. 333-46884).

(2) Incorporated herein by reference to the exhibits to WARP Technology Holdings, Inc. s Current Report on Form 8-K filed by the Company on September 3, 2002.

(3) Incorporated herein by reference to the exhibits to the Annual Report on Form 10-KSB filed by Warp Technology Holdings, Inc. on October 7, 2002.

(4) Incorporated herein by reference to the exhibits to Warp Technology Holdings, Inc. s Current Report on Form 8-K filed on January 27, 2003.

(5) Incorporated by reference to the

exhibits to the Quarterly Report on Form 10-QSB filed by Warp Technology Holdings, Inc. on February 14, 2003.

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(6) Incorporated by reference to the exhibits to WARP Technology Holdings, Inc. s Annual Report on Form 10-KSB filed by the Company on October 14, 2003.

(7) Incorporated by reference to the exhibits to 3.6 to WARP Technology Holdings, Inc. s Quarterly Report on Form 10-QSB filed by the Company on November 14, 2003.

(8) Incorporated by reference to the exhibits to the Quarterly Report on Form 10-QSB filed by the Company on February 12, 2004.

(9) Incorporated by reference to the exhibits to the Quarterly Report on Form 10-QSB filed by the Company on May 17, 2004.

(10) Incorporated herein by reference to the exhibits to

WARP Technology Holdings, Inc. s Current Report on Form 8-K filed on August 20, 2004.

(11) Incorporated herein by reference to the exhibits to WARP Technology Holdings, Inc. s Annual Report on Form 10-KSB, filed on October 13, 2004.

(12) Incorporated herein by reference to the exhibits to WARP Technology Holdings, Inc. s Current Report on Form 8-K filed on November 12, 2004.

(13) Incorporated herein by reference to the exhibits to WARP Technology Holdings, Inc. s Quarterly Report on Form 10-QSB, filed on November 15, 2004.

(14) Incorporated herein by

reference to the exhibits to WARP Technology Holdings, Inc. s Current Report on Form 8-K filed on February 4, 2005.

(15) Incorporated herein by reference to the exhibits to WARP Technology Holdings, Inc. s Current Report on Form 8-K filed on March 9, 2005.

(16) Incorporated herein by reference to the exhibits to WARP Technology Holdings, Inc. s Current Report on Form 8-K filed on April 1, 2005.

(17) Incorporated herein by reference to the exhibits to WARP Technology Holdings, Inc. s Current Report on Form 8-K filed on April 4, 2005.

(18) Incorporated herein by reference to the exhibits to

WARP Technology Holdings, Inc. s Registration Statement on Form S-2 (File Number 333-123864)

(19) Incorporated herein by reference to the exhibits to WARP Technology Holdings, Inc. s Current Report on Form 8-K filed on July 11, 2005.

(20) Incorporated herein by reference to the exhibits to WARP Technology Holdings, Inc. s Current Report on Form 8-K filed on August 16, 2005.

(21) Incorporated herein by reference to the exhibits to WARP Technology Holdings, Inc. s Current Report on Form 8-K filed on September 2, 2005.

(22) Incorporated herein by reference to the exhibits to

WARP Technology Holdings, Inc. s Current Report on Form 8-K filed on September 16, 2005.

(23) Incorporated herein by reference to Warp Technology Holdings, Inc. s Current Report on Form 8-K field on September 26, 2005.

(24) Incorporated herein by reference to the second of Warp Technology Holdings, Inc. s Current Reports on Form 8-K filed on October 27, 2005.

(25) Incorporated herein by reference to the third of Warp Technology Holdings, Inc. s Current Reports on Form 8-K filed on October 27, 2005.

(26) Incorporated herein by reference to Warp Technology Holdings, Inc. s

Current Report on Form 8-K filed on November 1, 2005.

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(27) Incorporated herein by reference to Warp Holdings, Inc. s Current Report on Form 8-K filed on December 23, 2005.

(28) Incorporated herein by reference to Warp Technology Holdings, Inc. s Current Report on Form 8-K filed on January 4, 2006.

(29) Incorporated herein by reference to Warp Technology Holdings, Inc. s Current Report on Form 8-K filed on January 6, 2006.

(30) Incorporated herein by reference to Warp Technology Holdings, Inc. s Current Report on Form 8-K filed on January 18, 2006.

(31) Incorporated herein by reference to Warp Technology

Holdings, Inc. s Current Report on Form 8-K filed on February 2, 2006.

(32) Incorporated herein by reference to Warp Technology Holdings, Inc. s Current Report on Form 8-K filed on February 3, 2006.

(33) Incorporated herein by reference to Warp Technology Holdings, Inc. s Current Report on Form 8-K filed on March 31, 2006.

(34) Incorporated herein by reference to Halo Technology Holdings, Inc. s Current Report on Form 8-K filed April 3, 2006.

(35) Incorporated herein by reference to Halo Technology Holding, Inc. s Current Report on Form 8-K filed May 5, 2006.

(36) Incorporated hererin by reference to the exhibits to the Quarterly Report on Form 10-QSB filed by Halo Technology Holdings, Inc. on May 15, 2006.

(37) Incorporated herein by reference to Halo Technology Holdings, Inc. s Current Report on Form 8-K filed on May 19, 2006.

(38) Incorporated herein by reference to Halo Technology Holdings, Inc. s Current Report on Form 8-K filed on July 27, 2006.

(39) Incorporated herein by reference to Halo Technology Holdings, Inc. s Current Report on Form 8-K filed on August 30, 2006.

(40) Incorporated herein by reference to

Halo Technology Holdings, Inc. s Current Report on Form 8-K filed on September 19, 2006.

(41) Incorporated herein by reference to Halo Technology Holdings, Inc. s Current Report on Form 8-K filed on September 21, 2006.

(42) Incorporated herein by reference to Halo Technology Holdings, Inc. s Current Report on Form 8-K filed on October 13, 2006.

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SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

October 13, 2006

HALO TECHNOLOGY HOLDINGS, INC.

By: /S/ **Rodney A. Bienvenu, Jr.**

Rodney A. Bienvenu, Jr.,
CEO, Chairman as Registrant s duly authorized officer

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

By: /S/ Rodney A. Bienvenu, Jr.

Rodney A. Bienvenu, Jr.,
Principal Executive Officer
Date: October 13, 2006

By: /S/ Mark Finkel

Mark Finkel
Principal Financial Officer
Date: October 13, 2006

By: /S/ Takeshi Taniguchi

Takeshi Taniguchi
Controller or Principal Accounting Officer
Date: October 13, 2006

By: /S/ John A. Boehmer

John A. Boehmer
Director
Date: October 13, 2006

By: /S/ David M. Howitt

David M. Howitt
Director
Date: October 13, 2006

By: /S/ John L. Kelly

John L. Kelly

Director
Date: October 13, 2006

By: /S/ Gordon O. Rapkin

Gordon O. Rapkin
Director
Date: October 13, 2006

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EXHIBIT INDEX

The following documents are filed herewith:

Exhibit No.	Description of Exhibit
21.1	Subsidiaries of the Company.
31.1	Certification of Periodic Report pursuant to Section 302 of the Sarbanes Oxley Act of 2002.
31.2	Certification of Periodic Report pursuant to Section 302 of the Sarbanes Oxley Act of 2002.
32.1	Certification pursuant to 18 U.S.C., Section 1350, as adopted pursuant to Section 906 of the Sarbanes Oxley Act of 2002.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of
Halo Technology Holdings, Inc.

We have audited the accompanying consolidated balance sheets of Halo Technology Holdings, Inc. and subsidiaries as of June 30, 2006 and 2005, and the related consolidated statements of operations, stockholders equity (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 has determined that it is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Halo Technology Holdings, Inc. and subsidiaries as of June 30, 2006 and 2005, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that Halo Technology Holding, Inc. and subsidiaries will continue as a going concern. As more fully described in Note 1 to the financial statements, the Company has incurred recurring operating losses and has a working capital deficiency at June 30, 2006. These conditions raise substantial doubt about the Company s ability to continue as a going concern. Management s plans in regard to these matters are also described in Note 1. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

Mahoney Cohen & Company, CPA, P.C.
New York, New York
September 22, 2006, except for Note 23(h) and Note 23(i) which is as of October 12, 2006

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Halo Technology Holdings, Inc.
Consolidated Balance Sheets
(Audited)

	Year Ended June 30, 2006	Year Ended June 30, 2005
Assets		
Current Assets:		
Cash and cash equivalents	$ 853,901	$ 1,548,013
Marketable securities	9,750	
Accounts receivable, net of allowance for doubtful of $124,063 and $30,845 respectively	4,086,772	2,024,699
Due from Platinum Equity, LLC	302,500	
Prepaid expenses and other current assets	693,255	409,496
Total current assets	5,946,178	3,982,208
Property and equipment, net	432,909	223,025
Deferred financing costs, net	1,492,096	476,876
Intangible assets, net of accumulated amortization of $3,551,075 and $756,064 respectively	23,544,108	15,678,736
Goodwill	28,138,396	7,055,264
Investment and other assets	149,851	884,379
Total assets	$ 59,703,538	$ 28,300,488
Liabilities and stockholders equity		
Current liabilities:		
Current portion of senior notes payable	$ 1,333,126	$
Note payable to Platinum Equity, LLC	1,750,000	
Notes payable	3,280,721	
Accounts payable	2,255,697	872,433
Accrued expenses	5,881,491	3,752,731
Deferred revenue	13,405,832	3,392,896
Due to ISIS	1,243,864	1,293,534
Total current liabilities	29,150,731	9,311,594
Subordinate notes payable	1,770,833	2,020,835
Senior notes payable	20,752,493	5,687,500
Other long term liabilities	1,000,009	43,275
Series C warrants liabilities	3,720,893	40,440,024
Senior and Sub warrants liabilities	1,333,942	14,889,600
Other warrants liabilities	2,566,319	

Total liabilities		60,295,220		72,392,828
Commitments and contingencies				
Mandatory redeemable Series D Preferred Stock: $.00001 par value; 8,863,636 shares authorized, 7,045,454 issued and outstanding (Liquidation value $7,750,000)		7,750,000		
Stockholders equity (deficit):				
Preferred stock (Canadian subsidiary)		2		2
Series C Preferred Stock: $.00001 par value; 16,000,000 shares authorized, 14,193,095 issued and outstanding (Liquidation value $14,193,095)				14,193,095
Shares of Common Stock to be issued for accrued dividends on Series C Preferred Stock				212,897
Shares of Common Stock to be issued for accrued interest on subordinated debt		41,667		
Common stock: $.00001 par value; 150,000,000 shares authorized, 26,723,247 and 3,110,800 shares issued and outstanding respectively		267		31
Additional paid-in-capital		86,265,258		55,036,831
Deferred compensation				(970,711)
Accumulated other comprehensive loss		(43,528)		(105,262)
Accumulated deficit		(94,605,348)		(112,459,223)
Total stockholders equity (deficit)		(8,341,682)		(44,092,340)
Total liabilities and stockholders equity (deficit)	$	59,703,538	$	28,300,488

See accompanying notes to consolidated financial statements.

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Halo Technology Holdings, Inc.
Consolidated Statements of Operations
(Audited)

	Year Ended June 30, 2006	Year Ended June 30, 2005
Revenue		
Licenses	$ 5,823,440	$ 2,986,752
Services	19,385,555	2,137,170
Total revenues	25,208,995	5,123,922
Cost of revenue		
Cost of licenses	1,301,761	449,073
Cost of services	4,062,777	396,490
Total cost of revenues	5,364,538	845,563
Gross Profit	19,844,457	4,278,359
Product development	6,145,413	1,589,099
Sales, marketing, and business development	7,507,661	3,652,117
General and administrative	15,127,506	4,690,743
Late filing penalty	(1,033,500)	1,033,500
Intangible impairment		62,917
Goodwill impairment	5,200,000	3,893,294
Loss before interest and fair value gain (loss) on warrants	(13,102,623)	(10,643,311)
Fair value gain (loss) on warrants revaluation	41,962,169	(32,011,536)
Interest expense	(9,302,539)	(8,506,058)
Income (loss) before income taxes	19,557,007	(51,160,905)
Income taxes	(181,655)	(97,945)
Net income (loss)	$ 19,375,352	$ (51,258,850)
Computation of gain (loss) applicable to common shareholders		
Net income (loss) before beneficial conversion and preferred dividends	$ 19,375,352	$ (51,258,850)
Beneficial conversion and preferred dividends	(1,521,477)	(21,503,678)
Income (loss) attributable to common stockholders	$ 17,853,875	$ (72,762,528)

Basis net income (loss) per share attributable to common stock	$	3.21	$	(38.06)
Diluted net income (loss) per share attributable to common stock	$	1.31	$	(38.06)
Weighted-average shares outstanding basic		5,566,364		1,912,033
Weighted-average shares outstanding diluted		14,887,182		1,912,033

See accompanying notes to consolidated financial statements.

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Halo Technology Holdings, Inc.
Consolidated Statements of Stockholders Equity
(Audited)

	Years Ended June 30,			
	2006		2005	
	Shares	Amounts	Shares	Amounts
Preferred stock (Canadian Subsidiary)				
Balance, beginning of year	1,710	$ 2	4,264	$ 4
Conversion to common stock			(2,554)	(2)
Balance, end of year	1,710	$ 2	1,710	$ 2
Series B Preferred Stock				
Balance, beginning of year		$	2,915	$ 2,915,100
Series B Preferred Stock issued			570	570,000
Conversion to common stock			(3,485)	(3,485,100)
Balance, end of year		$		$
Series B-2 Preferred Stock				
Balance, beginning of year		$		$
Series B-2 Preferred Stock issued			1,600	1,600
Conversion to common stock			(1,600)	(1,600)
Balance, end of year		$		$
Series C Preferred Stock				
Balance, beginning of year	14,193,095	$ 14,193,095		$
Conversion from Series C Notes and Bridge Notes			3,200,000	10,993,095
Series C Preferred Stock issued			10,993,095	3,200,000
Conversion to common stock	(14,193,095)	(14,193,095)		
Balance, end of year		$	14,193,095	$ 14,193,095

Shares of common stock to be issued				
Balance, beginning of year		$ 212,897		$ 392,939
Preferred stock dividends issued		(212,897)		(180,042)
Sub debt interest accrued		41,667		
Balance, end of year		$ 41,667		$ 212,897
Common stock				
Balance, beginning of year	3,110,800	$ 31	971,115	$ 10
Conversion of preferred stock	14,193,095	142	2,115,160	21
Preferred stock dividends issued	1,379,444	14		
Exercise of warrants	6,064,822	61		
Common stock issued	1,975,086	19	24,525	

Other domestic debt securities	—	—	4,867	(2,612)	4,867	(2,612)
	$26,375	$(225)	$37,178	$(9,916)	$63,553	$(10,141)

	At December 31, 2008					
	Less Than 12 Months		Greater Than 12 Months		Total	
(in thousands)	Amortized Cost	Unrealized Losses	Amortized Cost	Unrealized Losses	Amortized Cost	Unrealized Losses
U.S. government agency mortgage-backed securities	$3,611	$(46)	$—	$—	$3,611	$(46)
U.S. government agency collateralized mortgage obligations	1,476	(5)	—	—	1,476	(5)
Private-label collateralized mortgage obligations	51,107	(15,205)	3,078	(288)	54,185	(15,493)
Municipal securities	7,360	(121)	173	(2)	7,533	(123)
Other domestic debt securities	—	—	4,941	(2,032)	4,941	(2,032)
	$63,554	$(15,377)	$8,192	$(2,322)	$71,746	$(17,699)

The Company performed discounted cash flow analyses for our private-label collateralized mortgage obligations rated less than investment grade at September 30, 2009. These analyses used the current month, last three month and last twelve month historical prepayment speeds, the cumulative default rates and the loss severity rates to determine if there was an other-than-temporary impairment at September 30, 2009. One security with an amortized cost basis of $6.3 million and an unrealized loss of $1.9 million was deemed to be other-than-temporarily impaired at September 30, 2009. The Company recognized an other-than-temporary impairment loss of $565,000 on this security at June 30, 2009 and did not recognize any additional other-than-temporary impairment loss in the third quarter of 2009. As of December 31, 2008, the Company did not identify any securities that were other-than-temporarily impaired. Please see the "Securities" section of Management's Discussion and Analysis in this document for a detailed explanation of the impairment analysis process. The Company will continue to evaluate the securities portfolio for other-than-temporary impairment at each reporting date and can provide no assurance there will not be an other-than-temporary impairment

in future periods.

The following table presents the other-than-temporary impairment activity related to credit loss, which is recognized in earnings, and the other-than-temporary impairment activity related to all other factors, which are recognized in other comprehensive income.

	Three Months Ended September 30, 2009		
(in thousands)	Impairment Related to Credit Loss	Impairment Related to Other Factors	Total Impairment
Recognized as of beginning of period	$ 565	$ —	$ 565
Charges on securities for which OTTI was not previously recognized	—	—	—
Recognized as of end of period	$ 565	$ —	$ 565

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The amortized cost and estimated fair value of securities by contractual maturities are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	At September 30, 2009	
	Amortized Cost	Fair Value
	(in thousands)	
Due in one year or less	$15,379	$15,384
Due after one year through five years	69,484	69,783
Due after five years through ten years	46,950	47,772
Due after ten years	179,030	169,439
Total	$310,843	$302,378

The Company has a $8.4 million investment in Federal Home Loan Bank of San Francisco (FHLB) stock. The FHLB stock is carried at cost at September 30, 2009, as the stock can only be redeemed at par. The Company considered the long-term nature of the investment and our intent and ability to hold this investment for a period of time sufficient to recover our recorded investment and determined it was not impaired at September 30, 2009.

NOTE 5 – LOANS AND ALLOWANCE FOR LOAN LOSSES

The loan portfolio by type consists of the following:

(in thousands)	At September 30, 2009	At December 31, 2008
Commercial mortgage	$ 365,540	$ 302,016
Commercial loans and lines of credit	250,422	228,958
Multifamily mortgage	134,096	51,607
Construction and land development	94,721	133,054
Home mortgage	51,747	45,202
Home equity loans and lines of credit	38,638	22,568
Installment and credit card	5,687	5,016
Total loans	940,851	788,421
Allowance for loan losses	(12,137)	(8,048)
Loans, net	$ 928,714	$ 780,373
Loans held-for-sale	$ —	$ 31,401

Loans held-for-sale at December 31, 2008 represented performing multifamily residential loans originated from January 2008 to December 2008 at interest rates which approximated market rates. In the first quarter of 2009, the Company identified two prospective buyers for these loans and they undertook their purchase due diligence shortly after year-end. The Company accepted a bid from one of these buyers in March subject to completion of due diligence. This prospective buyer aggregates loans and re-sells them to the Federal National Mortgage Association (or FNMA). Subsequent to accepting the bid, FNMA changed its underwriting and documentation standards and, while the Company did work with the prospective buyer and our borrowers to meet these new standards, the Company

ultimately determined not to pursue the sale and returned these performing, multifamily mortgage loans to the regular loan portfolio. A market loss of $709,000 was recognized in noninterest expense for the second quarter of 2009 to write down these loans to the lower of cost or market value.

At September 30, 2009, loans with a balance of $516.1 million were pledged as security for Federal Home Loan Bank, or FHLB, advances. Loan balances include net deferred fees of $1.5 million and $1.8 million at September 30, 2009 and December 31, 2008, respectively.

Most of the Company’s lending activity is with customers located in the six Southern California counties where our branches are located. The Company has no significant credit exposure to any individual customer; however, the economic condition in Southern California could adversely affect customers. A significant portion of our loans are collateralized by real estate. Changes in the economic condition in Southern California could adversely affect the value of real estate.

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Changes in the allowance for loan losses were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
	(Dollars in thousands)			
Beginning balance	$11,955	$7,893	$8,048	$7,828
Provision for loan losses	4,117	300	10,296	950
Loans charged-off	(4,079)	(206)	(6,590)	(917)
Recoveries on loans charged-off	144	12	383	138
Ending balance	$12,137	$7,999	$12,137	$7,999
Allowance to gross loans	1.29 %	1.02 %	1.29 %	1.02 %

Past due loans and foreclosed assets consist of the following:

(dollars in thousands)	At September 30, 2009	At December 31, 2008
Accruing loans past due 30 - 89 days	$ 7,314	$ 2,644
Accruing loans past due 90 days or more	$ 2,970	$ 429
Nonaccrual loans	$ 39,330	$ 8,475
Foreclosed assets	$ 6,120	$ 327

There were $39.3 million and $8.5 million of nonaccrual loans at September 30, 2009 and December 31, 2008, respectively. Had these loans performed according to their original terms, additional interest income of approximately $676,000 and $162,000 would have been recognized in the three months ended September 30, 2009 and September 30, 2008, respectively. Had these loans performed according to their original terms, additional interest income of approximately $1,317,000 and $400,000 would have been recognized in the nine months ended September 30, 2009 and September 30, 2008, respectively.

The Company considers a loan to be impaired when, based on current information and events, the Company does not expect to be able to collect all amounts due according to the loan contract, including scheduled interest payments. Due to the size and nature of the loan portfolio, impaired loans are determined by periodic evaluation on an individual loan basis. The average balance of impaired loans was $32.7 million for the nine months ended September 30, 2009 and $10.6 million for the nine months ended September 30, 2008. Impaired loans were $41.4 million at September 30, 2009 and $34.5 million at December 31, 2008. Loan loss allowances for individually impaired loans are computed in accordance with FASB accounting standards related to accounting by creditors for impairment of a loan and are based on either the estimated collateral value less estimated selling costs (if the loan is a collateral-dependent loan), or the present value of expected future cash flows discounted at the loan's effective interest rate. Of the $41.4 million of impaired loans at September 30, 2009, $3.7 million had specific allowances of $0.6 million. Of the $34.5 million of impaired loans at December 31, 2008, $2.0 million had specific allowances of $0.6 million.

NOTE 6 – GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill was $60.7 million at September 30, 2009 and $50.1 million at December 31, 2008. The $10.6 million increase in goodwill represents the goodwill recognized from the purchase of certain assets and the assumption of

certain deposit liabilities from the FDIC in its capacity as receiver of 1st Centennial Bank. No impairment loss was recognized for the periods ended September 30, 2009 and December 31, 2008.

Core deposit intangibles, net of accumulated amortization, were $9.0 million at September 30, 2009 and $5.2 million at December 31, 2008. The increase in core deposit intangibles is due to the $4.7 million core deposit intangible recognized from the assumption of certain deposit liabilities from the FDIC in its capacity as receiver of 1st Centennial Bank. Amortization expense for the three months ended September 30, 2009 and 2008 was $316,000 and $198,000, respectively. Amortization expense for the nine months ended September 30, 2009 and 2008 was $910,000 and $593,000, respectively.

Trade name intangible, net of accumulated amortization, was $3.0 million at September 30, 2009 and $3.3 million at December 31, 2008. Amortization expense for the three months ended September 30, 2009 and 2008 was $100,000 in each period. Amortization expense for the nine months ended September 30, 2009 and 2008 was $300,000 in each period.

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NOTE 7 – EARNINGS (LOSS) PER SHARE

Basic earnings (loss) per share, or EPS, excludes dilution and is computed by dividing income (loss) available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflect the potential dilution that could occur if common shares were issued pursuant to the exercise of common stock options under the Company's stock option plans and if common shares were issued from the conversion of the convertible preferred stock.

The following table illustrates the computations of basic and diluted EPS for the periods indicated:

	Three months ended September 30,				Nine months ended September 30,			
	2009		2008		2009		2008	
(in thousands, except per share data)	Diluted	Basic	Diluted	Basic	Diluted	Basic	Diluted	Basic
Net income (loss) as reported	$(136)	$(136)	$1,761	$1,761	$(1,797)	$(1,797)	$5,234	$5,234
Less preferred stock dividend declared	(313)	(313)	—	—	(819)	(819)	—	—
Income (loss) available to common shareholders	$(449)	$(449)	$1,761	$1,761	$(2,616)	$(2,616)	$5,234	$5,234
Weighted average common shares outstanding	11,631	11,631	11,466	11,466	11,598	11,598	11,478	11,478
Restricted stock	—	—	—	—	—	—	—	—
Convertible preferred stock	—	—	278	—	—	—	276	—
Net effect of dilutive securities	—	—	278	—	—	—	276	—
Weighted average common shares outstanding (1)	11,631	11,631	11,744	11,466	11,598	11,598	11,754	11,478
Earnings (loss) per common share	$(0.04)	$(0.04)	$0.15	$0.15	$(0.23)	$(0.23)	$0.45	$0.46

(1) In accordance with FASB accounting standards related to earnings per share, due to the net loss for the three and nine months ended September 30, 2009, the impact of securities convertible to common stock is not included as its effect would be anti-dilutive.

NOTE 8 – COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) is the change in equity during a period from transactions and other events and circumstances from non-owner sources. Total comprehensive income (loss) was as follows:

	Three months ended Sept. 30,		Nine months ended Sept. 30,	
(dollars in thousands)	2009	2008	2009	2008
Other comprehensive income (loss):				
Unrealized loss on interest rate swaps used in cash flow hedges	$ —	$ —	$ —	$ (226)
Unrealized gain (loss) on securities available-for-sale	5,271	(1,999)	9,830	(7,849)
Reclassification adjustment for gains included in net income (loss)	(1,639)	—	(4,310)	—
Other comprehensive income (loss), before tax	3,632	(1,999)	5,520	(8,075)
Income tax benefit (expense) related to items of other comprehensive income (loss)	(1,479)	678	(1,544)	3,023
Other comprehensive income (loss)	2,153	(1,321)	3,976	(5,052)
Net income (loss)	(136)	1,761	(1,797)	5,234
Comprehensive income	$ 2,017	$ 440	$ 2,179	$ 182

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NOTE 9 – FAIR VALUE MEASUREMENT

FASB accounting standards codification related to fair value measurements defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurement. This standard applies to all financial assets and liabilities that are being measured and reported at fair value on a recurring and non-recurring basis. Upon adoption of this accounting standard update, there was no cumulative effect adjustment to beginning retained earnings and no impact on the financial statements in the first quarter of 2008.

As defined in the FASB accounting standards codification, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The following table presents information about the Company's assets and liabilities measured at fair value on a recurring and non-recurring basis as of September 30, 2009 and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value. In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) for identical instruments that are highly liquid, observable and actively traded in over-the-counter markets. Fair values determined by Level 2 inputs utilize inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model-derived valuations whose inputs are observable and can be corroborated by market data. Level 3 inputs are unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

The Company uses fair value to measure certain assets and liabilities on a recurring basis when fair value is the primary measure for accounting. This is done primarily for available-for-sale securities and derivatives. Fair value is used on a nonrecurring basis to measure certain assets when applying lower of cost or market accounting or when adjusting carrying values, such as for loans held-for-sale, collateral dependent impaired loans, and foreclosed property. Fair value is also used when evaluating impairment on certain assets, including securities, goodwill, core deposit and other intangibles, for valuing assets and liabilities acquired in a business combination and for disclosures of financial instruments as required by FASB accounting standards codification related to fair value disclosure reporting.

The following tables present information on the assets measured and recorded at fair value on a recurring and nonrecurring basis at September 30, 2009.

		Financial Assets Measured at Fair Value on a Recurring Basis as of September 30, 2009, Using		
(in thousands)	Fair value at Sept. 30, 2009	Quoted prices in active markets for identical assets (Level 1)	Other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Available-for-sale securities	$ 302,378	$ —	$ 302,378	$ —

Total assets measured at fair value on a recurring basis	$ 302,378	$ —	$ 302,378	$ —

		Assets Measured at Fair Value on a Non-Recurring Basis as of September 30, 2009, Using		
(in thousands)	Fair value at Sept. 30, 2009	Quoted prices in active markets for identical assets (Level 1)	Other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Collateral dependent impaired loans	$ 3,745	$ —	$ —	$ 3,745
Foreclosed property	6,120	—	—	6,120
Total assets measured at fair value on a non-recurring basis	$ 9,865	$ —	$ —	$ 9,865

The following methods were used to estimate the fair value of each class of financial instrument above:

Securities – Fair values for securities are obtained from a third-party pricing service for identical or comparable assets. The market valuations include observable market inputs and are therefore considered Level 2 inputs for purposes of determining the fair value.

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Collateral dependent impaired loans – Impaired loans are measured and recorded at the lower of cost basis or the fair valueof the underlying collateral credit support on a nonrecurring basis. The impaired loans shown are collateral dependent and, accordingly, are measured based on the fair value of such collateral. The fair value of each loan's collateral is generally based on estimated market prices from an independently prepared appraisal, which is then adjusted for the cost related to liquidating such collateral; such valuation inputs result in a nonrecurring fair value measurement that is categorized as a Level 3 measurement.

Foreclosed assets – Foreclosed assets are measured and recorded at the lower of cost basis or fair value on a nonrecurring basis. The foreclosed assets shown are collateral dependent and, accordingly, are measured based on the fair value of such collateral. The fair value of each asset's collateral is generally based on estimated market prices from an independently prepared appraisal, which is then adjusted for the cost related to liquidating such collateral; such valuation inputs result in a nonrecurring fair value measurement that is categorized as a Level 3 measurement.

FASB accounting standards codification requires that the Company disclose estimated fair values for its financial instruments during annual and interim reporting periods. Fair value estimates, methods and assumptions, set forth below for our financial instruments, are made solely to comply with the requirements of the disclosures regarding fair value of financial instruments. The following describes the methods and assumptions used in estimating the fair values of financial instruments, excluding financial instruments already recorded at fair value as described above in our SFAS No. 157 disclosures.

Cash and cash equivalents – The carrying amounts of cash and federal funds sold approximate their fair value.

Loans – Loans are not measured at fair value on a recurring basis. Therefore, the following valuation discussion relates to estimating the fair value to be disclosed under fair value disclosure requirements. Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type and further segmented into fixed and adjustable rate interest terms and by credit risk categories. The fair values of loans is then estimated by discounting scheduled cash flows through the estimated maturity using estimated market prepayment speeds and estimated market discount rates that reflect the credit and interest rate risk inherent in the loans. Loans, other than those held-for-sale, are not normally purchased and sold by the Company, and there are no active trading markets for much of this portfolio.

Deposits – The fair values disclosed for demand deposits are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The carrying amounts of variable-rate money market accounts and fixed-term certificates of deposit (CDs) approximate their fair values at the reporting date. Fair values for fixed-rate CDs are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Federal Home Loan Bank advances and other borrowings – The fair value of the FHLB advances and other borrowings is estimated using a discounted cash flow analysis based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

Junior subordinated debentures – The fair value of the debentures is estimated using a discounted cash flow analysis based on current incremental borrowing rates for similar types of borrowing arrangements.

Off-balance sheet instruments – Off-balance sheet instruments include unfunded commitments to extend credit and standby letters of credit. The fair value of these instruments is not considered practicable to estimate because of the lack of quoted market prices and the inability to estimate fair value without incurring excessive costs.

The following table estimates fair values and the related carrying amounts of the Company’s financial instruments:

(in thousands)	At September 30, 2009 Carrying Amount	Estimated Fair Value
Financial assets:		
Cash, due from banks and federal funds sold	$104,148	$104,148
Securities available-for-sale	302,378	302,378
FHLB and other stock	9,829	9,829
Loans, net	928,714	864,725
Financial liabilities:		
Demand deposits, money market and savings	$702,528	$702,528
Time certificates of deposit	422,503	426,348
FHLB advances and other borrowings	149,000	155,216
Junior subordinated debentures	26,740	12,060

These fair value disclosures represent the Company’s best estimates based on relevant market information and information about the financial instruments. Fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of the various instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in the above methodologies and assumptions could significantly affect the estimates.

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

Cautionary Statement

This Quarterly Report on Form 10-Q contains certain forward-looking statements about us, which statements are intended to be covered by the safe harbor for "forward-looking statements" provided by the Private Securities Litigation Reform Act of 1995. All statements other than statements of historical fact are forward-looking statements. Such statements involve inherent risks and uncertainties, many of which are difficult to predict and are generally beyond our control. We caution readers that a number of important factors could cause actual results to differ materially from those expressed in, implied or projected by, such forward-looking statements. Risks and uncertainties include, but are not limited to:

- revenues are lower than expected;
- credit quality deterioration which could cause an increase in the provision for loan losses;
- competitive pressure among depository institutions increases significantly;
- changes in consumer spending, borrowings and savings habits;
- our ability to successfully integrate acquired entities or to achieve expected synergies and operating efficiencies within expected time-frames or at all;
- technological changes;
- the cost of additional capital is more than expected;
- a change in the interest rate environment reduces interest margins;
- asset/liability repricing risks and liquidity risks;
- general economic conditions, particularly those affecting real estate values, either nationally or in the market areas in which we do or anticipate doing business are less favorable than expected;
- a slowdown in construction activity;
- the effects of and changes in monetary and fiscal policies and laws, including the interest rate policies of the Federal Reserve Board;
- recent volatility in the credit or equity markets and its effect on the general economy;
- demand for the products or services of First California and the Bank, as well as their ability to attract and retain qualified people;
- the costs and effects of legal, accounting and regulatory developments; and
- regulatory approvals for acquisitions cannot be obtained on the terms expected or on the anticipated schedule.

If one or more of the factors affecting our forward-looking information and statements proves incorrect, then our actual results, performance or achievements could differ materially from those expressed in, or implied or projected by, the forward-looking information and statements contained in this document. Therefore, we caution you not to place undue reliance on our forward-looking information and statements. The forward-looking statements are made as of the date of this document and we do not intend, and assume no obligation, to update the forward-looking statements or to update the reasons why actual results could differ from those expressed in, or implied or projected by, the forward-looking statements. All forward-looking statements contained in this document, and all subsequent written and oral forward-looking statements attributable to us or any other person acting on our behalf, are expressly qualified by these cautionary statements. The following discussion and analysis should be read in conjunction with our quarterly unaudited interim consolidated financial statements, and notes thereto, contained in this report, which have been prepared in accordance with generally accepted accounting principles, and with our 2008 Form 10-K, which is incorporated herein by reference.

Overview

First California Financial Group, Inc., or First California, or the Company, is a bank holding company which serves the comprehensive banking needs of businesses and consumers in Los Angeles, Orange, Riverside, San Bernardino, San Diego and Ventura counties through our wholly-owned subsidiary, First California Bank, or the Bank. The Bank is a state chartered commercial bank which provides traditional business and consumer banking products ranging from construction finance, entertainment finance and commercial real estate lending via 17 full-service branch locations. The Company also has two unconsolidated statutory business trust subsidiaries, First California Capital Trust I and FCB Statutory Trust I, which raised capital through the issuance of trust preferred securities.

At September 30, 2009, we had consolidated total assets of $1.5 billion, gross loans of $940.9 million, deposits of $1.1 billion and shareholders' equity of $161.1 million. At December 31, 2008, we had consolidated total assets of $1.2 billion, gross loans of $788.4 million, deposits of $817.6 million and shareholders' equity of $158.9 million.

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For the third quarter of 2009, we had a net loss of $0.1 million, compared with net income of $1.8 million for the third quarter of 2008. Our net loss for the first nine months of 2009 was $1.8 million, compared to net income for the first nine months of 2008 of $5.2 million.

After a dividend payment of $312,500 on our Series B preferred shares, we incurred a loss per diluted common share of $0.04 for the 2009 third quarter. Our 2008 third quarter net income on a diluted per common share basis was $0.15. Our net loss for the first nine months of 2009, after Series B preferred share dividends of $819,000, was $0.23 per diluted common share. Our net income for the first nine months of 2008 on a diluted per common share basis was $0.45.

Critical accounting policies

We based our discussion and analysis of our consolidated results of operations and financial condition on our unaudited consolidated interim financial statements and our audited consolidated financial statements which have been prepared in accordance with generally accepted accounting principles. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets and liabilities, income and expense, and the related disclosures of contingent assets and liabilities at the date of these consolidated financial statements. We believe these estimates and assumptions to be reasonably accurate; however, actual results may differ from these estimates under different assumptions or circumstances. The following are our critical accounting policies and estimates.

Allowance for loan losses

We establish the allowance for loan losses through a provision charged to expense. We charge-off loan losses against the allowance when we believe that the collectability of the loan is unlikely. The allowance is an amount that we believe will be adequate to absorb probable losses on existing loans that may become uncollectible, based on evaluations of the collectability of loans and prior loan loss experience. The evaluation includes an assessment of the following factors: any external loan review and any regulatory examination, estimated probable loss exposure on each pool of loans, concentrations of credit, value of collateral, the level of delinquency and nonaccruals, trends in the portfolio volume, effects of any changes in the lending policies and procedures, changes in lending personnel, present economic conditions at the local, state and national level, the amount of undisbursed off-balance sheet commitments, and a migration analysis of historical losses and recoveries for the prior eight quarters. Various regulatory agencies, as a regular part of their examination process, periodically review our allowance for loan losses. Such agencies may require us to recognize additions to the allowance based on their judgment of information available to them at the time of their examination. The allowance for loan losses was $12.1 million at September 30, 2009 and was $8.0 million at December 31, 2008.

Deferred income taxes

We recognize deferred tax assets subject to our judgment that realization of the assets are more-likely-than-not. We establish a valuation allowance when we determine that realization of income tax benefits may not occur in future years. There were net deferred tax assets of $0.5 million at September 30, 2009 and net deferred tax assets of $2.6 million at December 31, 2008. There was no valuation allowance at either period end.

Derivative instruments and hedging

For derivative instruments designated in cash flow hedging relationships, we assess the effectiveness of the instruments in off-setting changes in the overall cash flows of designated hedged transactions on a quarterly basis. Beginning in the second quarter of 2008, we no longer had any derivative instruments designated in cash flow hedging

relationships on our consolidated balance sheet. For the first nine months of 2008, we also had an interest rate floor for which we did not designate a hedging relationship. Accordingly, we recognized all changes in fair value of the interest rate floor directly in current period earnings. We owned no derivative instruments in 2009.

Assessments of impairment

We assess goodwill for impairment on an annual basis, or at interim periods if an event occurs or circumstances change which may indicate a change in the implied fair value of the goodwill. Impairment exists when the carrying amount of goodwill exceeds its implied fair value. We perform our annual impairment assessment at the end of our fiscal year to determine the fair value of the Company and to determine appropriate market factors used in the fair value calculations. At December 31, 2008, the annual assessment resulted in the conclusion that goodwill was not impaired. At September 30, 2009, because of the net loss for the nine months ended September 30, 2009, we performed an interim assessment and concluded that goodwill was not impaired.

We perform regularly an impairment analysis on our securities portfolio in accordance with the FASB accounting standards codification guidance related to consideration of impairment related to certain debt and equity securities. If we do not intend to sell, and it is more likely than not that we are not required to sell, a debt security before recovery of its cost basis, other-than-temporary impairment should be separated into (a) the amount representing credit loss and (b) the amount related to other factors. The amount of the other-than-temporary impairment related to credit loss is recognized in earnings and other-than-temporary impairment related to other factors is recognized in other comprehensive income (loss). Other-than-temporary declines in fair value are assessed based on the duration the security has been in a continuous unrealized loss position, the severity of the decline in value, the rating of the security, the long-term financial outlook of the issuer, the expected future cash flows and our ability and intent on holding the securities until the fair values recover.

Based upon the results of our other-than-temporary impairment analysis as of June 30, 2009, we recorded an other-than-temporary impairment loss of $565,000 on one security. The Company did not record any additional other-than-temporary impairment loss in the third quarter of 2009. Please see the "Securities" section of Management's Discussion and Analysis in this document for a detailed explanation of our impairment analysis process. We will continue to evaluate our securities portfolio for other-than-temporary impairment at each reporting date and we can provide no assurance there will not be another other-than-temporary loss in future periods.

Recent Developments

FDIC-assisted 1st Centennial Bank Transaction

On January 23, 2009, the Bank assumed the insured, non-brokered deposits of 1st Centennial Bank, totaling approximately $270 million, from the FDIC. Under the terms of the purchase and assumption agreement with the FDIC, the Bank also purchased from the FDIC approximately $178 million in cash and cash equivalents, $89 million in securities and $101 million in loans related to 1st Centennial Bank. The assumption of deposits and purchase of assets from the FDIC was an all-cash transaction with an aggregate transaction value of $48.8 million. The Bank recorded $10.6 million in goodwill in connection with this transaction. We have since fully integrated all six of the former 1st Centennial Bank branches into the Bank's full-service branch network.

Emergency Economic Stabilization Act of 2008 (Troubled Asset Relief Program – Capital Purchase Program)

In response to the financial crisis affecting the banking system and financial markets and going concern threats to investment banks and other financial institutions, on October 3, 2008, the Emergency Economic Stabilization Act of 2008, or the EESA, became law. Through its authority under the EESA, the United States Treasury, or the Treasury, announced in October 2008 the Troubled Asset Relief Program - Capital Purchase Program, or the CPP, a program designed to bolster healthy institutions, like us, by making $250 billion of capital available to U.S. financial institutions in the form of preferred stock.

We participated in the CPP in December 2008 so that we could continue to lend and support our current and prospective clients, especially during this unstable economic environment. Since our participation in the CPP, we were able to increase the average balance of our commercial and consumer loans by $194.6 million, or 30 percent, from December 31, 2008 to September 30, 2009. Under the terms of our participation, we received $25 million in exchange for the issuance of preferred stock and a warrant to purchase common stock, and became subject to various requirements, including certain restrictions on paying dividends on our common stock and repurchasing our equity securities, unless the Treasury has consented. Additionally, in order to participate in the CPP, we were required to adopt certain standards for executive compensation and corporate governance. These standards generally apply to the Chief Executive Officer, Chief Financial Officer and the three next most highly compensated senior executive officers, and include (1) ensuring that incentive compensation of senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution; (2) required claw-back of any bonus or incentive compensation paid to a senior executive based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate; (3) limiting golden parachute payments to certain senior executives; and (4) agreement not to deduct for tax purposes executive compensation in excess of $500,000 for each senior executive. To date, we have complied with these requirements, but the Secretary of the Treasury is empowered under EESA to adopt other standards, with which we would be required to comply. Additionally, the bank regulatory agencies, Treasury and the Office of Special Inspector General, also created by the EESA, have issued guidance and requests to the financial institutions that participated in the CPP to document their plans and use of CPP funds and their plans for addressing the executive compensation requirements associated with the CPP. We will respond to such requests accordingly.

In February 2009, the U.S. Congress enacted the American Recovery and Reinvestment Act of 2009, or the ARRA, was enacted. Among other provisions, the ARRA amended the EESA and contains requirements imposed on financial institutions like us which have already participated in the CPP. These requirements expand the initial executive compensation restrictions under the CPP to include, among other things, application of the required claw-back provision to our top 25 most highly compensated employees, prohibition of certain bonuses to our top five most highly compensated employees, expanded limitations on golden parachute payments to top ten most highly compensated employees, implementation of a company-wide policy regarding excessive and luxury expenditures, and requirement of a shareholder advisory vote on our executive compensation.[1] Under the new ARRA requirements, we may redeem early the shares issued to the Treasury under the CPP without any penalty or requirement to raise new capital, as previously required under the original terms of the CPP. However, until the shares are redeemed and for so long as we continue to participate in the CPP, we will remain subject to these expanded requirements and any other requirements applicable to CPP participants that may be subsequently adopted.

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1 At our Annual Meeting of Stockholders held on May 27, 2009, all matters presented before the meeting were approved by the requisite vote, including a substantial majority of votes cast in favor of our executive compensation, as set forth in our ‘Say on Pay’ item.

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On June 10, 2009, Treasury issued an interim final rule implementing and providing guidance on the executive compensation and corporate governance provisions of EESA, as amended by ARRA. The regulations were published in the Federal Register on June 15, 2009 and set forth the following requirements:

- Evaluation of employee compensation plans and potential to encourage excessive risk or manipulation of earnings;
- Compensation committee discussion, evaluation and review of senior executive officer compensation plans and other employee compensation plans to ensure that they do not encourage unnecessary and excessive risk;
- Compensation committee discussion, evaluation and review of employee compensation plans to ensure that they do not encourage manipulation of reported earnings;
- Compensation committee certification and disclosure requirements regarding evaluation of employee compensation plans;
- “Claw-back” of bonuses based on materially inaccurate financial statements or performance metrics;
- Prohibition on golden parachute payments;
- Limitation on bonus payments, retention awards and incentive compensation;
- Disclosure regarding perquisites and compensation consultants;
- Prohibition on gross-ups;
- Luxury or excessive expenditures policy;
- Shareholder advisory resolution on executive compensation; and
- Annual compliance certification by principal executive officer and principal financial officer.

Additionally, the regulations provided for the establishment of the Office of the Special Master for TARP Executive Compensation with authority to review certain payments and compensation structures.

In general, neither the requirements of EESA, as amended by ARRA, nor Treasury’s regulations promulgated thereunder apply retroactively prior to June 15, 2009, the date the regulations were published in the Federal Register. The regulations confirm that the bonus payment limitation does not apply to amounts accrued or paid prior to June 15, 2009, and the golden parachute prohibition applies only to payments due to departures on or after June 15, 2009. Many of the requirements apply only during the period during which an obligation arising from financial assistance under the TARP remains outstanding, disregarding unexercised warrants but, for companies that have already received financial assistance, no earlier than June 15, 2009. For companies that become Troubled Asset Relief Program, or TARP, recipients following June 15, 2009, the requirements and restrictions generally become effective when the company receives TARP funds.

The EESA also increased FDIC deposit insurance on most accounts from $100,000 to $250,000. The increase in deposit insurance expires at the end of 2013 and deposit insurance premiums paid by the banking industry were unaffected by this increase. The FDIC utilizes a risk-based assessment system that imposes insurance premiums based upon a risk matrix that takes into account a bank’s capital level and supervisory rating. Effective February 2009, the FDIC adopted a rule to uniformly increase 2009 FDIC deposit assessment rates by 7 to 9 cents for every $100 of

domestic deposits. The FDIC also assessed a special assessment of 5 cents on each institution's assets minus Tier 1 capital as of June 30, 2009, to restore the deposit insurance fund reserves. Our special assessment amount was $668,000. The FDIC has recently adopted a rule requiring insured depository institutions to prepay their quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012, on December 30, 2009, along with each institution's risk-based deposit insurance assessment for the third quarter of 2009. FDIC insurance premiums are expected to increase significantly in 2009 compared to prior years. Annual FDIC insurance expense was $682,000 in 2008 and $164,000 in 2007. With the 5 basis point special assessment included, we estimate our 2009 FDIC insurance expense will be approximately $3.0 million.

In addition, the FDIC has implemented two temporary programs under the Temporary Liquidity Guaranty Program, or the TLGP, to provide deposit insurance for the full amount of most non-interest bearing transaction accounts through the end of 2009 and to guarantee certain unsecured debt of financial institutions and their holding companies through June 2012. The Bank is participating in the deposit insurance program. Under the deposit insurance program, through December 31, 2009, the FDIC guarantees all noninterest-bearing transaction accounts for the entire amount in the account. Coverage under this program is in addition to and separate from the coverage available under the FDIC's general deposit insurance rules. The FDIC charges "systemic risk special assessments" to depository institutions that participate in the TLGP.

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Results of operations – for the three and nine months ended September 30, 2009 and 2008

Our earnings are derived predominantly from net interest income, which is the difference between interest and fees earned on loans, securities and federal funds sold (these asset classes are commonly referred to as interest-earning assets) and the interest paid on deposits, borrowings and debentures (these liability classes are commonly referred to as interest-bearing funds). The net interest margin is net interest income divided by average interest-earning assets.

Our net interest income for the third quarter of 2009 was $11.4 million, up from $10.3 million for the same period a year ago. The net interest margin (tax equivalent) for the third quarter of 2009 was 3.50 percent compared with 4.18 percent for the same quarter last year. Our net interest income for the nine months ended September 30, 2009 increased to $34.0 million from $30.9 million for the nine months ended September 30, 2008. Our net interest margin (tax equivalent) for the first nine months of 2009 was 3.60 percent, compared to 4.17 percent for the same period last year. The increase in our net interest income reflects the increase in our interest-earning assets from the FDIC-assisted 1st Centennial Bank transaction and from the growth in our lending activities. The decrease in our net interest margin reflects the effect of higher levels of lower-yielding Federal funds sold and the decrease in rates earned on interest-earning assets, offset in part by the decrease in the rates paid for our interest-bearing funds.

The following table presents the distribution of our average assets, liabilities and shareholders' equity in combination with the total dollar amounts of interest income from average interest earning assets and the resultant yields, and the dollar amounts of interest expense and average interest bearing liabilities, expressed in both dollars and rates for the three and nine months ended September 30, 2009 and 2008. Loans include loans held-for-sale and loans on non-accrual status.

	Three months ended September 30,							
	2009				2008			
(dollars in thousands)	Average Balance	Interest Income/ Expense	Weighted Average Yield/Rate		Average Balance	Interest Income/ Expense	Weighted Average Yield/Rate	
Loans2	$935,848	$13,331	5.65	%	$778,104	$12,674	6.48	%
Securities	262,664	2,819	4.49	%	213,699	2,870	5.54	%
Federal funds sold and deposits with banks	108,165	78	0.29	%	850	4	1.87	%
Total earning assets	1,306,677	$16,228	4.97	%	992,653	$15,548	6.26	%
Non-earning assets	152,404				129,391			
Total average assets	$1,459,081				$1,122,044			
Interest bearing checking	$80,514	$65	0.32	%	$58,911	$105	0.71	%
Savings and money market	290,894	839	1.14	%	183,262	723	1.57	%
Certificates of deposit	441,737	2,034	1.83	%	316,341	2,132	2.68	%
Total interest bearing deposits	813,145	2,938	1.43	%	558,514	2,960	2.11	%
Borrowings	151,930	1,455	3.80	%	195,771	1,801	3.66	%
Junior subordinated debentures	26,733	439	6.57	%	26,683	439	6.58	%

Total borrowed funds	178,663	1,894	4.21	%	222,454	2,240	4.01	%
Total interest bearing funds	991,808	$4,832	1.93	%	780,968	$5,200	2.65	%
Noninterest checking	295,444				192,289			
Other liabilities	11,554				12,266			
Shareholders’ equity	160,275				136,521			
Total liabilities and shareholders’ equity	$1,459,081				$1,122,044			
Net interest income		$11,396				$10,348		
Net interest margin (tax equivalent) 1			3.50	%			4.18	%

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	Nine months ended September 30,					
	2009			2008		
(dollars in thousands)	Average Balance	Interest Income/ Expense	Weighted Average Yield/Rate	Average Balance	Interest Income/ Expense	Weighted Average Yield/Rate
Loans2	$913,256	$39,144	5.73 %	$778,337	$39,391	6.76 %
Securities	272,706	9,847	5.08 %	220,837	8,827	5.50 %
Federal funds sold and deposits with banks	90,467	368	0.54 %	909	18	2.65 %
Total earning assets	1,276,429	$49,359	5.21 %	1,000,083	$48,236	6.48 %
Non-earning assets	155,190			126,071		
Total average assets	$1,431,619			$1,126,154		
Interest bearing checking	$77,096	$168	0.29 %	$57,667	$342	0.79 %
Savings and money market	256,122	2,077	1.08 %	200,533	2,928	1.95 %
Certificates of deposit	460,044	7,274	2.11 %	296,235	7,105	3.20 %
Total interest bearing deposits	793,262	9,519	1.60 %	554,435	10,375	2.49 %
Borrowings	158,466	4,512	3.81 %	201,612	5,599	3.71 %
Junior subordinated debentures	26,720	1,365	6.81 %	26,670	1,316	6.58 %
Total borrowed funds	185,186	5,877	4.24 %	228,282	6,915	4.05 %
Total interest bearing funds	978,448	$15,396	2.10 %	782,717	$17,290	2.95 %
Noninterest checking	280,036			192,704		
Other liabilities	12,808			13,528		
Shareholders’ equity	160,327			137,205		
Total liabilities and shareholders’ equity	$1,431,619			$1,126,154		
Net interest income		$33,963			$30,946	
Net interest margin (tax equivalent) 1			3.60 %			4.17 %

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1 Includes tax equivalent adjustments primarily related to tax-exempt income on securities.

2 Interest on loans includes loan fees and costs, which totaled -$0.1 million and $0.3 million for the three months ended September 30, 2009 and 2008, respectively, and zero and $0.7 million for the nine months ended September 30, 2009 and 2008, respectively. The average loan balance includes loans held-for-sale and nonaccrual loans where nonaccrual interest is excluded.

Our net interest income changes with the level and mix of average interest-earning assets and average interest-bearing funds. We call the changes between periods in interest-earning assets and interest-bearing funds balance changes. We measure the effect on our net interest income from balance changes by multiplying the change in the average balance between the current period and the prior period by the prior period average rate.

Our net interest income also changes with the average rate earned or paid on interest-earning assets and interest-bearing funds. We call the changes between periods in average rates earned and paid rate changes. We measure the effect on our net interest income from rate changes by multiplying the change in average rates earned or paid between the current period and the prior period by the prior period average balance.

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We allocate the change in our net interest income attributable to both balance and rate on a pro rata basis to the change in average balance and the change in average rate.

	Three months ended September 30, 2009 to 2008 due to:		
(in thousands)	Rate	Volume	Total
Interest income			
Interest on loans	$(1,913)	$2,570	$657
Interest on securities	(709)	658	(51)
Interest on Federal funds sold and deposits with banks	(363)	437	74
Total interest income	(2,985)	3,665	680
Interest expense			
Interest on deposits	1,372	(1,349)	23
Interest on borrowings	(58)	403	345
Interest on junior subordinated debentures	1	(1)	—
Total interest expense	1,315	(947)	368
Net interest income	$(1,670)	$2,718	$1,048

	Nine months ended September 30, 2009 to 2008 due to:		
(in thousands)	Rate	Volume	Total
Interest income			
Interest on loans	$(7,075)	$6,828	$(247)
Interest on securities	(1,053)	2,073	1,020
Interest on Federal funds sold and deposits with banks	(1,355)	1,705	350
Total interest income	(9,483)	10,606	1,123
Interest expense			
Interest on deposits	5,325	(4,469)	856
Interest on borrowings	(111)	1,198	1,087
Interest on junior subordinated debentures	(46)	(3)	(49)
Total interest expense	5,168	(3,274)	1,894
Net interest income	$(4,315)	$7,332	$3,017

The provision for loan losses was $4.1 million for the three months ended September 30, 2009 compared with $0.3 million for the three months ended September 30, 2008. The increase in the provision for the third quarter of 2009 reflects the higher level of net loan charge-offs in the period. Net loan charge-offs increased to $3.9 million for the three months ended September 30, 2009 compared with $194,000 for the same period last year. One loan relationship that had a $2.0 million owner-occupied commercial mortgage and $5.4 million of secured business loans abruptly discontinued business during the third quarter. We recognized $3.1 million of loan charge-offs on this loan relationship, $2.6 million related to the secured business loans and $0.5 million related to the owner-occupied commercial mortgage loan.

The provision for loan losses was $10.3 million for the nine months ended September 30, 2009 compared with $1.0 million for the nine months ended September 30, 2008. The increase in the provision and the related allowance for loan losses reflects our assessment of, among other things, estimated loss factors assigned to specific types of loans, changes and trends in the level of delinquencies, nonaccrual loans and loan charge-offs, changes in the value of collateral, changes in local and regional economic and business conditions, the judgment of information available to the bank regulatory agencies at the conclusion of their examination process.

Our service charges, fees and other income for the three months ended September 30, 2009 increased to $1.3 million, up 45 percent from $0.9 million for the three months ended September 30, 2008. Our service charges, fees and other income for the nine months ended September 30, 2009 increased to $3.8 million, up 37 percent from $2.8 million for the nine months ended September 30, 2008. The increase in the amount of service charges on deposits and other income reflects the increase in our core deposit base and other business activities in the past year and the effect of the additional six branches from the FDIC-assisted 1st Centennial Bank transaction.

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We estimated the effectiveness of our interest rate swaps in off-setting changes in cash flow of hedged items and determined that a portion of these instruments were ineffective during the three and nine months ended September 30, 2008. We recognize the unrealized gains and losses related to the ineffective portion of our interest rate swaps in noninterest income. We also had an interest rate floor for which we did not designate a hedging relationship and we recognize all changes in fair value of the interest rate floor directly in current period earnings. For the three months ended September 30, 2008, we recognized losses of $1,000 and for the nine months ended September 30, 2008, we recognized gains of $857,000, all related to the ineffective interest rate swaps and the non-hedged interest rate floor. We terminated the interest rate swap contracts in the second quarter of 2008 and the interest rate floor contract expired in December 2008. We no longer own any derivative instruments in 2009.

During the first nine months of 2009, we did not sell any loans compared to loans sold of $24.7 million for a gain of $175,000 in the first nine months of 2008. In addition, we brokered loans for commissions of $76,000 for the first nine months of 2009 compared with $207,000 for the first nine months of 2008. We had no loans held-for-sale at the end of the third quarter of 2009 compared with $31.4 million at December 31, 2008.

We also recognized in noninterest income an other-than-temporary impairment loss of $565,000 on one security based upon the results of our other-than-temporary impairment analysis at June 30, 2009. We will continue to evaluate our securities portfolio for other-than-temporary impairment at each reporting date and we can provide no assurance there will not be another other-than-temporary loss in future periods.

In the third quarter of 2009, we sold $47.8 million of securities and realized gains of $1.6 million. For the first nine months of 2009 we sold $116.2 million of securities and realized gains of $4.3 million. There were no securities transactions in the first nine months of 2008.

Our noninterest expense for the three months ended September 30, 2009 was $11.3 million compared with $8.2 million for the three months ended September 30, 2008. Our noninterest expense for the nine months ended September 30, 2009 was $34.9 million compared with $25.4 million for the nine months ended September 30, 2008. The increase in noninterest expense for quarter and year-to-date periods reflects the growth in the number of offices and the number of employees arising from the FDIC-assisted 1st Centennial Bank transaction as well as several other items, most notably FDIC insurance premiums. The number of offices has grown from 12 in the third quarter of 2008 to 17 offices in the third quarter of 2009. Our number of employees also has grown by approximately 15 percent since the third quarter of 2008.

In addition to the growth in branches and personnel, we also incurred costs of approximately $51,000 for the 2009 third quarter and $774,000 for the first nine months of 2009 associated with the FDIC-assisted 1st Centennial Bank transaction. These costs represent transitional personnel, legal and professional services as well as data processing, postage, supplies, stationary and other expenses attendant to the conversion and integration of 1st Centennial. We completed the system conversion and integration of 1st Centennial in the 2009 second quarter.

During the 2009 third quarter, in response to the continuing economic recession and current business activity levels, we reduced our workforce by approximately 10 percent. We expect personnel expenses will fall approximately $2.2 annually because of this action. We incurred separation expenses of approximately $235,000 in the 2009 third quarter.

In addition, during the third quarter of 2009, we closed a branch unrelated to the FDIC-assisted 1st Centennial transaction that reduced the number of offices to 17. We expect to save approximately $175,000 annually because of this action. We transferred the deposit relationships of this office to near-by offices and we do not anticipate that we will experience a significant decline in deposit balances.

We acquired real estate through a foreclosure and sold previously foreclosed upon real estate in the quarter ended September 30, 2009. The cost of foreclosed real estate and the loss on sale of foreclosed real estate was $193,000 for the third quarter of 2009 and $442,000 for the nine months ended September 30, 2009. We had no comparable expense for all periods of 2008.

The FDIC charged all institutions a special insurance assessment as of June 30, 2009. We estimated our special insurance assessment would be $675,000 and charged that amount to noninterest expense in the second quarter of 2009. Our actual assessment was $668,000 and the difference between our estimate and the actual amount was included in third quarter noninterest expense. The FDIC may assess an additional special insurance assessment before the end of 2009. In addition, the FDIC increased regular insurance premiums. With a larger deposit base and increased premiums, our regular FDIC insurance expense for the 2009 third quarter was $720,000 compared with $168,000 for the 2008 third quarter. For the first nine months ended September 30, 2009, our regular FDIC insurance expense was $1,473,000 compared with $507,000 for the same period a year ago.

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The income tax benefit was $1.9 million for the nine months ended September 30, 2009 compared with an income tax provision of $3.3 million for the same period in 2008. The combined federal and state effective tax rate for the nine months ended September 30, 2009 was 51.4 percent compared with 39.0 percent for the same period in 2008. The effective tax rate can fluctuate from period to period based upon the expected level of taxable income for a period and the percentage impact permanent tax versus book differences have on the expected book income.

Our efficiency ratio was 86 percent for the third quarter of 2009 compared with 69 percent for the third quarter of 2008. Our efficiency ratio was 91 percent for the first nine months of 2009 compared with 70 percent for the first nine months of 2008. The efficiency ratio is the percentage relationship of noninterest expense, excluding amortization of intangibles, to the sum of net interest income and noninterest income, excluding gains or losses on security sales. The increase in the efficiency ratio for all periods reflects the integration and conversion expenses related to the FDIC-assisted 1st Centennial Bank transaction and the lag between these costs and the revenue from the full deployment of the newly acquired liquid assets as well as the expenses related to foreclosed property, the increase in FDIC deposit insurance premiums and special assessment, the market loss on loans held-for-sale and the impairment loss on securities.

Financial position – September 30, 2009 compared with December 31, 2008

Lending and credit risk

We provide a variety of loan and credit-related products and services to meet the needs of borrowers primarily located in the six Southern California counties where our branches are located. Business loans, represented by commercial real estate loans, commercial loans and construction loans comprise the largest portion of the loan portfolio. Consumer or personal loans, represented by home mortgage, home equity and installment loans, comprise a smaller portion of the loan portfolio.

Credit risk is the risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with us or otherwise to perform as agreed. All activities in which success depends on counterparty, issuer, or borrower performance have credit risk. Credit risk is present any time we extend, commit or invest funds; whenever we enter into actual or implied contractual agreements for funds, whether on or off the balance sheet, credit risk is present.

All categories of loans present credit risk. Major risk factors applicable to all loan categories include changes in international, national and local economic conditions such as interest rates, inflation, unemployment levels, consumer and business confidence and the supply and demand for goods and services.

Commercial real estate loans rely upon the cash flow originating from the underlying real property. Commercial real estate is a cyclical industry; general economic conditions and local supply and demand affect the commercial real estate industry. In the office sector, the demand for office space is highly dependent on employment levels. Consumer spending and confidence affect the demand for retail space and the levels of retail rents in the retail sector. The industrial sector has exposure to the level of exports, defense spending and inventory levels. Vacancy rates, location and other factors affect the amount of rental income for commercial property. Tenants may relocate, fail to honor their lease or go out of business. In the multifamily residential sector, the affordability of ownership housing, employment conditions and the vacancy of existing inventory heavily influences the demand for apartments. Population growth or decline and changing demographics, such as increases in the level of immigrants or retirees, are also factors influencing the multifamily residential sector.

Construction loans provide developers or owners with funds to build or improve properties; developers ultimately sell or lease these properties. Generally, construction loans involve a higher degree of risk than other loan categories because they rely upon the developer's or owner's ability to complete the project within specified cost and time limits.

Cost overruns can cause the project cost to exceed the project sales price or exceed the amount of the committed permanent funding. Any number of reasons, such as poor weather, material or labor shortages, labor difficulties, or redoing substandard work to pass inspection, can delay construction projects. Furthermore, changes in market conditions or credit markets may affect a project’s viability once completed.

Commercial loans rely upon the cash flow originating from the underlying business activity of the enterprise. The manufacture, distribution or sale of goods or sale of services are not only affected by general economic conditions but also by the ability of the enterprise’s management to adjust to local supply and demand conditions, maintain good labor, vendor and customer relationships, as well as market, price and sell their goods or services for a profit. Customer demand for goods and services of the enterprise may change because of competition or obsolescence.

Home mortgages and home equity loans and lines of credit use first or second trust deeds on a borrower’s real estate property, typically their principal residence, as collateral. These loans depend on a person’s ability to regularly pay the principal and interest due on the loan and, secondarily, on the value of real estate property that serves as collateral for the loan. Generally, home mortgages involve a lower degree of risk than other loan categories because of the relationship of the loan amount to the value of the residential real estate and a person’s reluctance to forego their principal place of residence. General economic conditions and local supply and demand, however, affect home real estate values. Installment loans and credit card lines also depend on a person’s ability to regularly pay principal and interest on a loan; however, generally these are unsecured loans or, if secured, the collateral value can rapidly decline as is the case for automobiles. A person’s ability to service debt is highly dependent upon their continued employment or financial stability. Job loss, divorce, illness and bankruptcy are just a few of the risks that may affect a person’s ability to service their debt.

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Our appraisal policy with respect to real estate secured loans is to obtain an appraisal for the following extensions of credit:

1. All business loans in excess of $1,000,000 where real estate was taken as collateral but where the sale or rental of the real estate is not the primary source of repayment;

2. All business loans in excess of $250,000 where real estate was taken as collateral and where the sale or rental of the real estate is the primary source of repayment; and

3. All real estate secured loans in excess of $250,000.

For all new loans and loans being renewed or extended that require an appraisal, a current appraisal is required, which means an appraisal report with an “as of” date and a property inspection date that are not more than six months before the date of the loan funding. Updated appraisal reports are obtained only in accordance with Uniform Standards of Professional Appraisal Practice guidelines or, in order to determine the useful life of an existing appraisal. In general, the useful life of an appraisal, regardless of amount, is deemed to be the life of the originating loan, unless:

A. There has been a deterioration in the borrower’s performance and there is an increasing likelihood of a forced liquidation of the property and the existing appraisal is older than two years, and/or

B. There has been deterioration in the property’s value due to a significant depreciation in local real estate values, lack of maintenance, changes in zoning, environmental contamination, or other circumstances.

Since the risks in each category of loan changes based on a number of factors, it is not possible to state whether a particular type of lending carries with it a greater or lesser degree of risk at any specific time in the economic cycle. Generally, in a stabilized economic environment, home mortgage loans have the least risk, followed by home equity loans, multifamily property loans, commercial property loans, commercial loans and lines and finally construction loans. However, this ordering may vary from time to time and the degree of risk from the credits with the least risk to those with the highest risk profile may expand or contract with the general economy.

We manage credit risk through Board approved policies and procedures. At least annually, the Board reviews and approves these policies. Lending policies provide us with a framework for consistent loan underwriting and a basis for sound credit decisions. Lending policies specify, among other things, the parameters for the type or purpose of the loan, the required debt service coverage and the required collateral requirements. Credit limits are also established and certain loans require approval by the Directors’ Loan Committee. The Directors’ Audit Committee also engages a third party to perform a credit review of the loan portfolio to ensure compliance with policies and assist in the evaluation of the credit risk inherent in the loan portfolio.

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Loans

Loans increased $152.4 million, or 19 percent, to $940.9 million at September 30, 2009 from $788.4 million at December 31, 2008. This increase includes the effect of the reclassification of $31.4 million of loans held-for-sale. Loan growth was primarily the result of $100 million of loans we acquired in connection with the FDIC-assisted 1st Centennial Bank transaction.

(in thousands)	At September 30, 2009	At December 31, 2008
Commercial mortgage	$ 365,540	$ 302,016
Commercial loans and lines of credit	250,422	228,958
Multifamily mortgage	134,096	51,607
Construction and land development	94,721	133,054
Home mortgage	51,747	45,202
Home equity loans and lines of credit	38,638	22,568
Installment and credit card	5,687	5,016
Total loans	940,851	788,421
Allowance for loan losses	(12,137)	(8,048)
Loans, net	$ 928,714	$ 780,373
Loans held-for-sale	$ —	$ 31,401

The loan categories above are derived from bank regulatory reporting standards for loans secured by real estate; however, a portion of the mortgage loans above are loans that we consider to be a commercial loan for which we have taken real estate collateral as additional support or from an abundance of caution. In these instances, we are not looking to the real property as its primary source of repayment, but rather as a secondary or tertiary source of repayment.

Loans held-for-sale at December 31, 2008 represented performing multifamily residential loans originated from January 2008 to December 2008 at interest rates which approximated market rates. In the first quarter of 2009, we identified two prospective buyers for these loans and they undertook their purchase due diligence shortly after year-end. We accepted a bid from one of these buyers in March subject to completion of due diligence. This prospective buyer aggregates loans and re-sells them to FNMA. Subsequent to accepting the bid, FNMA changed its underwriting and documentation standards and, while we did work with the prospective buyer and our borrowers to meet these new standards, we ultimately determined not to pursue the sale and returned these performing, multi-family mortgage loans to our regular loan portfolio. Even though these loans are performing, buyers in the current marketplace would require a yield higher than the current interest rates on these loans. We recognized a market value loss of $709,000 in noninterest expense for the second quarter of 2009 to write down these loans to the lower of cost or market value.

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Commercial mortgage loans, the largest segment of our portfolio, were 39 percent of total loans at September 30, 2009 compared with 38 percent at December 31, 2008. We had 370 commercial mortgage loans with an average balance of $991,000 at September 30, 2009 compared to 323 commercial mortgage loans with an average balance of $938,000 at December 31, 2008. Many different commercial property types collateralize our commercial mortgage loans. Our top three categories have been office, industrial, and retail, representing approximately 66 percent of commercial mortgage loans. In addition, most of our commercial property lending is in the six Southern California counties where our branches are located. The following is a table of our commercial mortgage lending by county.

Commercial mortgage loans by region/county (in thousands)	At September 30, 2009	At December 31, 2008
Southern California		
Los Angeles	$ 180,738	$ 154,669
Orange	28,377	31,808
Ventura	93,613	87,770
Riverside	22,063	8,549
San Bernardino	17,653	9,834
San Diego	16,064	2,966
Santa Barbara	237	236
Total Southern California	358,745	295,832
Northern California		
Alameda	330	342
Contra Costa	416	434
Fresno	2,489	2,512
Imperial	373	—
Kern	1,059	1,115
Madera	562	561
Placer	627	635
Sacramento	362	—
Solano	280	285
Tulare	297	300
Total Northern California	6,795	6,184
Total commercial mortgage	$ 365,540	$ 302,016

The following table shows the distribution of our commercial mortgage loans by property type.

Commercial mortgage loans by property type (in thousands)	At September 30, 2009	At December 31, 2008
Industrial/warehouse	$ 90,476	$ 60,171
Office	79,392	59,183
Retail	70,214	57,799
Hotel	14,053	14,522
Mixed use	12,547	9,334
Assisted living	11,378	11,478

Medical	11,355	15,174
Self storage	10,345	10,081
Restaurant	9,848	11,636
All other	55,932	52,638
Total commercial loans	$ 365,540	$ 302,016

We generally underwrote commercial mortgage loans with a maximum loan-to-value of 70 percent and a minimum debt service coverage ratio of 1.25. Beginning in the third quarter of 2009 we changed the maximum loan-to-value to 60 percent and the minimum debt service coverage ratio to 1.35. We believe these changes to our loan origination policies were prudent given the current economic environment. The weighted average loan-to-value percentage of our commercial real estate portfolio is 57.9 percent and the weighted average debt service coverage ratio is 1.54 at September 30, 2009. These criteria may become more conservative depending on the type of property. We focus on cash flow; consequently, regardless of the value of the collateral, the commercial real estate project must provide sufficient cash flow, or alternatively the principals must supplement the project with other cash flow, to service the debt. We generally require the principals to guarantee the loan. We also "stress-test" commercial mortgage loans to determine the potential effect changes in interest rates, vacancy rates, and lease or rent rates would have on the cash flow of the project. Additionally, at least on an annual basis, we require updates on the cash flow of the project and, where practicable, we visit the properties.

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Commercial loans represent the next largest category of loans and were 27 percent of total loans at September 30, 2009, down from 29 percent at December 31, 2008. We had 741 commercial loans with an average balance of $337,000 at September 30, 2009 compared to 796 commercial loans with an average balance of $288,000 at December 31, 2008. Unused commitments on commercial loans were $43.0 million at September 30, 2009 compared with $103.5 million at December 31, 2008. Working capital, equipment purchases or business expansion are the typical purposes for commercial loans. Commercial loans may be unsecured or secured by assets such as equipment, inventory, accounts receivables, and real property. Personal guarantees of the business owner may also be present. Additionally, these loans may also have partial guarantees from the U.S. Small Business Administration, or SBA, or other federal or state agencies. Broadly diversified business sectors with the largest sectors in real estate/construction, finance and insurance, healthcare, manufacturing and professional services comprise the commercial loan portfolio. Below is a table of our loans by business sector.

Commercial loans by industry/sector (in thousands)	At September 30, 2009	At December 31, 2008
Services	$ 68,683	$ 56,298
Information	58,965	55,510
Real estate	58,929	54,200
Trade	27,137	24,865
Manufacturing	16,111	10,620
Healthcare	12,571	13,731
Transportation and warehouse	7,815	8,796
Other	211	4,938
Total commercial loans	$ 250,422	$ 228,958

We underwrite commercial loans with maturities not to exceed seven years and we generally require full amortization of the loan within the term of the loan. We underwrite traditional working capital lines for a 12 month period and have a 30-day out-of-debt requirement. Accounts receivable and inventory financing revolving lines of credit have an annual maturity date, a maximum advance rate, and an annual field audit for lines of $200,000 or more. Third-party vendors perform field audits for our accounts receivable and inventory financing revolving lines of credit. The maximum advance rate for accounts receivable is 80 percent and the maximum advance rate for eligible inventory is 50 percent.

Construction and land loans represent 10 percent of total loans at September 30, 2009, down from 17 percent at December 31, 2008. At September 30, 2009, we had 39 projects with an average commitment of $3,078,000 compared with 49 projects with an average commitment of $3,442,000 at December 31, 2008. Construction loans represent single-family, multifamily and commercial building projects as well as land development loans. The decline in construction and land loans since the end of 2008 reflects principally the successful completion and sale of projects as well as the general reduction in new business activity. At September 30, 2009, 26 percent of these loans, or $24.7 million, represent single-family residential construction projects; 12 percent, or $11.2 million, were multi-family residential construction projects; 43 percent, or $40.5 million, were commercial projects; and, 19 percent, or $18.3 million, were land development projects.

Construction loans are typically short term, with maturities ranging from 12 to 18 months. For commercial projects, we have had a maximum loan-to-value requirement of 75 percent of the appraised value. For residential projects, the maximum loan-to-value has been 80 percent. Beginning in the third quarter of 2009 we changed the maximum loan-to-value to 70 percent for both commercial and residential projects. The weighted average loan-to-value ratio for our construction and land portfolio is 72.1 percent at September 30, 2009. At September 30, 2009, we have only eight

projects for which we capitalize interest income. Capitalized interest income for the nine months ended September 30, 2009 was $371,000 for these eight projects. At the borrower's expense, we use a third party vendor for funds control, lien releases and inspections. In addition, we regularly monitor the marketplace and the economy for evidence of deterioration in real estate values.

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Below is a table of our construction and land loans by county.

Construction and land loans by county	At September 30, 2009		At December 31, 2008	
(in thousands)	Commitment	Outstanding	Commitment	Outstanding
Los Angeles	$51,317	$46,136	$91,254	$66,390
Orange	6,872	6,670	8,550	3,650
Ventura	57,685	37,801	56,101	50,290
Riverside	4,155	4,114	2,984	2,958
San Bernardino	—	—	414	417
San Diego	—	—	736	738
Santa Barbara	—	—	8,611	8,611
Total construction and land loans	$120,029	$94,721	$168,650	$133,054

We are mindful of the recent developments in our marketplace and have supplemented our regular monitoring practices by updating project appraisals, re-evaluating estimated project marketing time and re-evaluating the sufficiency of the original loan commitment to absorb interest charges (i.e., interest reserves). We are also re-evaluating the ability of the project sponsor, where applicable, to successfully complete other projects funded by other institutions. In circumstances where the interest reserve was not sufficient, the project sponsor has made payments to us from their general resources or the project sponsor placed with us the proceeds from a portion of the project sales. While we believe that our monitoring practices are adequate, we cannot assure you that there will not be further delinquencies, lengthened project marketing time or declines in real estate values.

Multifamily residential mortgage loans were 14 percent of total loans at September 30, 2009, up from 7 percent at December 31, 2008. We had approximately 156 multifamily loans with an average balance of $862,000 at September 30, 2009, compared to approximately 68 multifamily loans with an average balance of $755,000 at December 31, 2008. Apartments mostly located in our six-county market area serve as collateral for our multifamily mortgage loans. The entire amount of $31.2 million, representing the loans held-for-sale which were transferred back to loans in the second quarter of 2009, were multifamily loans located in Los Angeles, Orange and Ventura counties. We underwrite multifamily mortgage loans in a fashion similar to commercial mortgage loans previously described. The weighted average loan-to-value percentage is 60.8% and the weighted average debt service coverage ratio is 1.28 of our multifamily portfolio at September 30, 2009. Below is a table of our multifamily mortgage loans by county.

Multifamily mortgage loans by region/county (in thousands)	At September 30, 2009	At December 31, 2008
Southern California		
Los Angeles	$ 88,529	$ 15,574
Orange	17,252	17,774
Ventura	7,712	3,842
San Bernardino	4,284	3,925
San Diego	5,078	3,016
Santa Barbara	1,135	—
Total Southern California	123,990	44,131

Multifamily mortgage loans by region/county	At	At

(in thousands)	September 30, 2009	December 31, 2008
Northern California		
Alameda	799	806
Calaveras	1,378	1,387
Fresno	252	256
Kern	2,696	—
Merced	674	681
Monterey	385	388
Mono	232	235
San Francisco	1,351	1,363
San Luis Obispo	500	504
Santa Clara	705	711
Santa Cruz	1,134	1,145
Total Northern California	10,106	7,476
Total multifamily mortgage	$ 134,096	$ 51,607

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The table below illustrates the distribution of our loan portfolio by loan size at September 30, 2009. We distributed all loans by loan balance outstanding except for construction loans, which we distributed by loan commitment. At September 30, 2009, 33 percent of our loans were less than $1 million and 75 percent of our loans were less than $5 million. We believe the high number of smaller-balance loans aids in the mitigation of credit risk; however, a prolonged and deep recession can affect a greater number of borrowers.

	September 30, 2009					
	Less than $500,000	$500,000 to $999,999	$1,000,000 to $2,999,999	$3,000,000 to $4,999,999	$5,000,000 to $9,999,999	$10,000,000 to $25,000,000
Commercial mortgage	12 %	15 %	34 %	12 %	20 %	7 %
Commercial loans and lines of credit	24 %	11 %	33 %	13 %	10 %	9 %
Construction and land development	2 %	3 %	13 %	26 %	32 %	24 %
Multifamily mortgage	12 %	31 %	42 %	0 %	15 %	0 %
Home mortgage	30 %	25 %	19 %	0 %	26 %	0 %
Home equity loans and lines of credit	37 %	24 %	19 %	20 %	0 %	0 %
Installment and credit card	88 %	12 %	0 %	0 %	0 %	0 %
Totals	17 %	16 %	31 %	11 %	17 %	8 %

Allowance for loan losses

We maintain an allowance for loan losses to provide for inherent losses in the loan portfolio. We establish the allowance through a provision charged to expense. We charge-off all loans judged to be uncollectible against the allowance while we credit any recoveries on loans to the allowance. We charge-off commercial and real estate loans – construction, commercial mortgage, and home mortgage – by the time their principal or interest becomes 120 days delinquent unless the loan is well-secured and in the process of collection. We charge-off consumer loans by the time they become 90 days delinquent unless they too are well-secured and in the process of collection. We also charge-off deposit overdrafts when they become more than 60 days old. We evaluate secured loans on a case by case basis to determine the ultimate loss potential to us subsequent to the sale of collateral. In those cases where the collateral value is less than the loan, we charge-off the loan to reduce the balance to a level equal to the net realizable value of the collateral.

Our loan policy provides procedures designed to evaluate and assess the risk factors associated with our loan portfolio, to enable us to assess such risk factors prior to granting new loans and to evaluate the sufficiency of the allowance for loan losses. We assess the allowance on a monthly basis and undertake a more critical evaluation quarterly. At the time of the monthly review, the Board of Directors will examine and formally approve the adequacy of the allowance. The quarterly evaluation includes an assessment of the following factors: any external loan review and any regulatory examination, estimated probable loss exposure on each pool of loans, concentrations of credit, value of collateral, the level of delinquency and nonaccruals, trends in the portfolio volume, effects of any changes in the lending policies and procedures, changes in lending personnel, present economic conditions at the local, state and national level, the amount of undisbursed off-balance sheet commitments, and a migration analysis of historical losses and recoveries for the prior eight quarters.

Our evaluation of the adequacy of the allowance for loan losses includes a review of individual loans to identify specific probable losses and also assigns estimated loss factors to specific groups or types of loans to calculate possible losses. In addition, we estimate the probable loss on previously accrued but unpaid interest. We refer to these as quantitative considerations. Our evaluation also considers subjective factors such as changes in local and regional economic and business conditions, financial improvement or deterioration in business sectors and industries, changes in lending practices, changes in personnel, changes in the volume and level of past due and nonaccrual loans and concentrations of credit. We refer to these as qualitative considerations.

We have historically experienced positive asset quality measures – low levels of delinquencies, low levels of nonaccrual loans, and low levels of net loan charge-offs – for an extended period of time. As a result, our 2008 quarterly loan loss provisions were not significant. Our loan loss provisions for the third quarter and nine months ended September 30, 2009 were $4.1 million and $10.3 million, respectively. The larger loan loss provision in 2009 as compared with prior periods is based upon the factors considered in the following discussion.

Our assessment of the allowance for loan losses considered, among other things, estimated loss factors assigned to specific types of loans, changes and trends in the level of delinquencies, nonaccrual loans and loan charge-offs, changes in the value of collateral, changes in the local and regional economic and business conditions, the judgment of the bank regulatory agencies at the conclusion of their examination process with respect to information available to them during such examination process and the significant growth in loans arising from the FDIC-assisted 1st Centennial Bank transaction. More specifically, we revised upward, in the first quarter of 2009, our estimated loss factors for our qualitative considerations because of the following considerations.

We considered the increased trend in the level of our delinquencies, nonaccrual loans and loan charge-offs. Total past due loans and nonaccrual loans increased to $49.6 million at September 30, 2009 from $27.2 million at June 30, 2009, $14.8 million at March 31, 2009 and $11.5 million at December 31, 2008. Foreclosed property was $6.1 million at September 30, 2009 compared with $6.8 million at June 30, 2009, $1.1 million at March 31, 2009 and $0.3 million at December 31, 2008. Net loan charge-offs were $3,935,000 for the third quarter of 2009, $430,000 for the second quarter of 2009 and $1,842,000 for the first quarter of 2009 compared with $194,000 for the third quarter of 2008, $15,000 for the second quarter of 2008 and $570,000 for the first quarter of 2008. For the first nine months of 2009, net loan charge-offs were $6.2 million compared with $0.8 million for the first nine months of 2008.

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We considered the prolonged marketing time and declining sales prices for our completed construction loan portfolio. Our construction and land loan portfolio was 10 percent of total loans at September 30, 2009 compared with 14 percent at March 31, 2009 and 17 percent at December 31, 2008. This loan portfolio declined principally from successful marketing and sales efforts, however, the continued disruption in the residential and commercial mortgage loan markets and the continued downward pressure on real estate values may adversely affect these loans.

We considered our entry into a new market area with new lending personnel arising from the FDIC-assisted 1st Centennial Bank transaction. This market area has experienced severe declines in real estate values, a large number of business and personal bankruptcies and several bank failures. We evaluated the credit risk of the loans acquired in the transaction and the loans originated since the transaction using the same standards as for our other loans; however, we are mindful the difficulties confronting businesses in this new market area may adversely affect these loans.

Finally, we considered the possible length and depth of the economic recession and the impact it might have on our borrowers and the judgment of the bank regulatory agencies at the conclusion of their examination process with respect to information available to them during such examination process.

As a result, we increased the allowance for loan losses to $12.1 million at September 30, 2009 from $8.0 million at December 31, 2008. The provision for loan losses was $4.1 million for the third quarter of 2009, compared with $0.3 million for the third quarter of 2008. The increased provision for loan losses in 2009 is primarily attributable to the increase in delinquency trends, nonaccrual loan levels and higher net loan charge-offs. For the first nine months of 2009, the provision for loan losses was $10.3 million compared with $1.0 million for the first nine months of 2008. Due to the current economic climate, we anticipate delinquency trends, nonaccrual loan levels, and net loan charge-offs to be higher than our 2008 and 2007 historical experience. As such, we anticipate our provision for loan losses will change from quarter to quarter based on our determination of the adequacy of the allowance for loan losses at each period end and that our total provision for loan losses will be higher than our 2008 and 2007 historical experience.

The ratio of the allowance for loan losses to loans was 1.29 percent at September 30, 2009 compared with 1.02 percent at December 31, 2008. While we believe that our allowance for loan losses was adequate at September 30, 2009 and December 31, 2008, the determination of the allowance is a highly judgmental process and we cannot assure you that we will not further increase or decrease the allowance or that bank regulators will not require us to increase or decrease the allowance in the future. The following table presents activity in the allowance for loan losses:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
	(Dollars in thousands)			
Beginning balance	$11,955	$7,893	$8,048	$7,828
Provision for loan losses	4,117	300	10,296	950
Loans charged-off	(4,079)	(206)	(6,590)	(917)
Recoveries on loans charged-off	144	12	383	138
Ending balance	$12,137	$7,999	$12,137	$7,999
Allowance to loans	1.29%	1.02%	1.29%	1.02%
Net loans charged-off (annualized) to average loans	1.68%	0.10%	0.91%	0.13%

The following table presents the net loan charge-offs (recoveries) by loan type for the periods indicated.

(in thousands)	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Construction	$ 853	$ —
Home mortgage	736	—
Commercial loans & lines	3,364	216
Commercial mortgage	1,269	—
Consumer	(15)	563
Total	$ 6,207	$ 779

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Net loan charge-offs for the nine months ended September 30, 2009 were $6.2 million compared with $779,000 for the same period last year. In the 2009-third quarter, one loan relationship that had a $2.0 million owner-occupied commercial mortgage and $5.4 million of secured business loans abruptly discontinued business. We realized $3.1 million of loan charge-offs on this loan relationship, $2.6 million related to the secured business loans and $0.5 million related to the owner-occupied commercial mortgage loan. In addition, we realized a $0.5 million charge-off on a $1.8 million nonaccrual commercial mortgage loan on which we began foreclosure in the 2009-third quarter. In the 2009-first quarter, we realized $0.7 million of loan charge-offs related to five home mortgage loans. We purchased 110 home mortgage loans in 2005, 2006 and 2007 with an original unpaid principal balance of $55.7 million. A national mortgage company services these loans for us. At September 30, 2009 there were 56 and $23.5 million of these purchased home mortgage loans remaining. Also in the 2009-first quarter and the 2009-second quarter, we realized a $0.6 million loan charge-off on a construction loan. The borrower could not overcome engineering issues and abandoned the project. In addition, in the 2009-second quarter, we received a $0.2 million recovery on a consumer loan charged-off in the first quarter of 2008.

The following table illustrates the significant net loan charge-offs for the nine months ended September 30, 2009:

Description	Construction and Land	Home Mortgage	Commercial Loans	Commercial Mortgage	Installment	Total
$7.4 MM business loan relationship	$ -	$ -	$ 2.6	$ 0.5	$ -	$ 3.1
$1.8 MM office building	-	-	-	0.5	-	0.5
$55.7 MM purchased home mortgage portfolio	-	0.7	-	-	-	0.7
$0.6 MM construction loan	0.6	-	-	-	-	0.6
$0.6 MM consumer loan	-	-	-	-	(0.2)	(0.2)
All other loan charge-offs and recoveries, net	0.3	-	0.8	0.3	0.1	1.5
Net loan charge-offs 2009-nine month period	$ 0.9	$ 0.7	$ 3.4	$ 1.3	$ (0.1)	$ 6.2
Average loan balance for 2009-nine month period	$ 112.7	$ 81.0	$ 226.1	$ 489.2	$ 4.3	$ 913.3
Net loan charge-offs (annualized) to average loans	1.06 %	1.15 %	2.01 %	0.35 %	-0.47 %	0.91 %

Past due loans and foreclosed assets consist of the following:

(dollars in thousands)	At September 30, 2009	At December 31, 2008
Accruing loans past due 30 - 89 days	$ 7,314	$ 2,644
Accruing loans past due 90 days or more	$ 2,970	$ 429
Nonaccrual loans	$ 39,330	$ 8,475
Foreclosed assets	$ 6,120	$ 327

Nonaccrual loans and loans past due 90 days or more and accruing increased to $42.3 million at September 30, 2009 from $8.9 million at December 31, 2008. These non-performing loans, as a percentage of total loans, were 4.5 percent

at the end of the third quarter compared with 1.1 percent at December 31, 2008. We added 12 loans or $15.3 million to nonaccrual loans in the 2009 third quarter and we received pay-offs for 2 loans of $2.7 million. Since the end of 2008, we added 21 loans or $41.3 million to nonaccrual loans; we received pay-offs for 3 loans of $2.9 million; and we foreclosed upon 3 loans for $6.6 million and reclassified them to foreclosed property.

Our largest nonaccrual loan is a $22.5 million completed office complex construction loan in Ventura County. This project began in the 2007 first quarter and consists of 31 buildings on 13 acres. We filed a notice of default in the 2009 third quarter. Nine units sold in 2008 and four units are presently in escrow. These escrows total approximately $4.0 million and we expect them to close in the 2009-fourth quarter or 2010-first quarter. We obtained our most current appraisal in the 2008 fourth quarter and will pursue a new appraisal in the 2009 fourth quarter. Our most current appraisal indicates a loan-to-value of approximately 60 percent. Accordingly, we have no specific loss allowance for this loan.

Our next largest nonaccrual loan relationship represents two completed high-end homes in the coastal communities of Los Angeles County for $7.5 million. We filed notices of default in the 2009 third quarter. Our most current appraisals indicate loan-to-value of approximately 80 percent. Accordingly, we have no specific loss allowance for this loan relationship.

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Our third largest nonaccrual loan relationship represents a $1.6 million owner-occupied commercial mortgage loan and $2.6 million of business loans to a borrower who abruptly discontinued business in the 2009 third quarter. These amounts are after charge-offs of $0.5 million and $2.6 million, respectively. We have, since the end of the 2009 third quarter, received proceeds of approximately $0.5 million from the sale of equipment and collection of accounts receivable. While we are making every attempt to maximize proceeds from the collection of accounts receivable and the sale of assets, we cannot assure you that there will not be further loan charge-offs on this relationship. We estimated at September 30, 2009 a specific loss allowance of $0.5 million for this loan relationship and this estimate may increase in subsequent periods.

We have one other nonaccrual loan in excess of $1 million and that is a $1.3 million office building in Riverside County. We filed a notice of default in the 2009 third quarter, realized a charge-off of $0.5 million in the 2009 third quarter and anticipate completing our foreclosure in the 2009 fourth quarter or 2010 first quarter. We estimate that the carrying value of the loan approximates the net proceeds we will receive through the sale of the office building.

The following table presents the activity in our nonaccrual loan category for the periods indicated.

	Three months ended September 30,				Nine months ended September 30,			
	2009		2008		2009		2008	
(dollars in thousands)	# of Loans	$ Amount	# of Loans	$ Amount	# of Loans	$ Amount	# of Loans	$ Amount
Beginning balance	11	$ 26,957	4	$ 6,627	7	$ 8,475	1	$ 5,720
New loans added	12	15,280	4	2,098	21	41,253	7	3,005
Repurchase of SBA-guaranteed participation	—	—	—	—	—	136	—	—
Loans transferred to foreclosed property	(1)	(119)	—	—	(3)	(6,612)	—	—
Payoffs of existing loans	(2)	(2,729)	—	—	(3)	(2,938)	—	—
Partial charge offs on existing loans	—	—	—	—	—	(323)	—	—
Charge offs on existing loans	—	—	(1)	(83)	(2)	(560)	(1)	(83)
Payments on existing loans	—	(59)	—	(6)	—	(101)	—	(6)
Ending balance	20	$ 39,330	7	$ 8,636	20	$ 39,330	7	$ 8,636

Foreclosed property at September 30, 2009 consists of a $6.0 million vacant land property and a $0.1 million single family 1-4 property.

The following table presents the activity of our foreclosed property for the periods indicated.

	Three months ended September 30,				Nine months ended September 30,			
	2009		2008		2009		2008	
(dollars in thousands)	# of Properties	$ Amount	# of Properties	$ Amount	# of Properties	$ Amount	# of Properties	$ Amount
Beginning balance	3	$ 6,828	1	$ 154	2	$ 327	1	$ 197
	1	126	1	119	3	6,893	1	119

New properties added								
Writedowns of existing properties	(1)	(136)	—	—	(1)	(151)	—	—
Sales proceeds received	(1)	(698)	—	—	(2)	(949)	—	(43)
Ending balance	2	$ 6,120	2	$ 273	2	$ 6,120	2	$ 273

The allowance for losses on undisbursed commitments was $97,000 and $102,000 at September 30, 2009, and December 31, 2008, respectively. The allowance for losses on undisbursed commitments is included in “accrued interest payable and other liabilities” on the consolidated balance sheets.

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The following table presents the allocation of the allowance for loan losses to each loan category and the percentage relationship of loans in each category to total loans:

	September 30, 2009			December 31, 2008		
(in thousands)	Allocation of the allowance by loan category	Percent of Loans in Category to Total loans		Allocation of the allowance by loan category	Percent of Loans in Category to Total loans	
Commercial mortgage	$3,585	39	%	$2,309	38	%
Multifamily mortgage	1,463	14	%	389	7	%
Commercial loans	3,736	27	%	2,328	29	%
Construction loans	2,529	10	%	1,986	17	%
Home equity loans	337	4	%	172	3	%
Home mortgage	438	5	%	334	6	%
Installment and credit card	49	1	%	40	—	
Subtotal	12,137	100	%	7,558	100	%
Unallocated	—			490		
Total	$12,137	100	%	$8,048	100	%

Unallocated amounts represent some of the qualitative considerations which we do not attribute to any one loan category. The decrease in the unallocated amount from December 31, 2008 to September 30, 2009 is due to attributing more of the qualitative factors to individual loan categories in the current period than was done historically. The amounts or proportions displayed above should not be interpreted as charge-offs to the allowance that we may incur. We based the amounts attributed to each loan category on the analysis described above.

We consider a loan to be impaired when, based on current information and events, we do not expect to be able to collect all amounts due according to the loan contract, including scheduled interest payments. Due to the size and nature of the loan portfolio, we determine impaired loans by periodic evaluation on an individual loan basis. The average investment in impaired loans was $32.7 million for the nine months ended September 30, 2009 and $10.6 million for the nine months ended September 30, 2008. Impaired loans were $41.4 million at September 30, 2009 and $34.5 million at December 31, 2008. Allowances for losses for individually impaired loans are computed in accordance with SFAS No. 114 Accounting by Creditors for Impairment of a Loan, and are based on either the estimated collateral value less estimated selling costs (if the loan is a collateral-dependent loan), or the present value of expected future cash flows discounted at the loan's effective interest rate. Of the $41.4 million of impaired loans at September 30, 2009, $3.7 million had specific allowances of $0.6 million. Of the $34.5 million of impaired loans at December 31, 2008, $2.0 million had specific allowances of $0.6 million.

Investing, funding and liquidity risk

Liquidity risk is the risk to earnings or capital arising from the inability to meet obligations when they come due without incurring unacceptable losses. Liquidity risk includes the inability to manage unplanned decreases or changes in funding sources as well as the failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.

We manage bank liquidity risk through Board approved policies and procedures. The Directors review and approve these policies at least annually. Liquidity risk policies provide us with a framework for consistent evaluation of risk and establish risk tolerance parameters. Management's Asset and Liability Committee meets regularly to evaluate

liquidity risk, review and establish deposit interest rates, review loan and deposit in-flows and out-flows and reports quarterly to the Directors' Balance Sheet Management Committee on compliance with policies. The Directors' Audit Committee also engages a third party to perform a review of management's asset and liability practices to ensure compliance with policies.

Our primary source of funds continues to be core deposits (representing checking, savings and small balance retail certificates of deposit). At September 30, 2009, core deposits totaled $802.0 million. At December 31, 2008, core deposits totaled $503.8 million. The increase is a result of the core deposits acquired in connection with the FDIC-assisted 1st Centennial Bank transaction and organic deposit growth throughout our branch network. Core deposits represent a significant low-cost source of funds that support our lending activities and represent a key part of our funding strategy. We seek and stress the importance of both loan and deposit relationships with customers in our business plans.

Alternative funding sources include large balance certificates of deposits, brokered deposits, federal funds purchased from other institutions, securities sold under agreements to repurchase and borrowings. Total alternative funds used at September 30, 2009 declined to $472.1 million from $480.8 million at December 31, 2008.

In addition, we have lines of credit with other financial institutions providing for federal funds facilities up to a maximum of $27.0 million. The lines of credit support short-term liquidity needs and we cannot use them for more than 30 consecutive days. These lines are unsecured, have no formal maturity date and can be revoked at any time by the granting institutions. There were no borrowings under these lines of credit at September 30, 2009 or December 31, 2008. We also have a $13.4 million secured borrowing facility with the Federal Reserve Bank of San Francisco which had no balance outstanding at September 30, 2009 or December 31, 2008. In addition, we had approximately $156.0 million of available borrowing capacity on the Bank's secured FHLB borrowing facility at September 30, 2009.

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The primary sources of liquidity for the Company, on a stand-alone basis, include the dividends from the Bank and, historically, our ability to issue trust preferred securities and secure outside borrowings. The ability of the Company to obtain funds for its cash requirements, including payments on the junior subordinated debentures underlying our outstanding trust preferred securities and the dividend on our series B preferred stock, is largely dependent upon the Bank's earnings. The Bank is subject to restrictions under certain federal and state laws and regulations which limit its ability to transfer funds to the Company through intercompany loans, advances or cash dividends. The California Department of Financial Institutions, or DFI, under its general supervisory authority as it relates to a bank's capital requirements regulates dividends paid by state banks, such as the Bank. A state bank may declare a dividend without the approval of the DFI as long as the total dividends declared in a calendar year do not exceed either the retained earnings or the total of net profits for three previous fiscal years less any dividends paid during such period. During the first nine months of 2009, we received no dividends from the Bank. The amount of dividends available for payment by the Bank to the Company at September 30, 2009 without prior approval from bank regulators was $14.9 million. The Company has $8.7 million in cash on deposit with the Bank at September 30, 2009.

As of September 30, 2009 and December 31, 2008, we had $26.7 million of junior subordinated debentures outstanding from two issuances of trust preferred securities. First California Capital Trust I's capital securities have an outstanding balance of $16.5 million, mature on March 15, 2037, and are redeemable, at par, at the Company's option at any time on or after March 15, 2012. The securities have a fixed annual rate of 6.80% until January 15, 2012, and a variable annual rate thereafter, which resets quarterly, equal to the 3-month LIBOR rate plus 1.60% per annum. FCB Statutory Trust I's capital securities have an outstanding balance of $10.3 million, mature on December 15, 2035, and are redeemable, at par, at the Company's option at any time on or after December 15, 2010. The securities have a fixed annual rate of 6.145% until December 15, 2010, and a variable annual rate thereafter, which resets quarterly, equal to the 3-month LIBOR rate plus 1.55% per annum.

Securities

We classify securities as 'available-for-sale' for accounting purposes and, as such, report them at their fair, or market, values in our balance sheets. We use quoted market prices for fair values. We report as 'other comprehensive income or loss', net of tax changes in the fair value of our securities (that is, unrealized holding gains or losses) and carry these cumulative changes as accumulated comprehensive income or loss within shareholders' equity until realized.

Securities, at amortized cost, increased by $94.4 million, or 44 percent, from $216.4 million at December 31, 2008 to $310.8 million at September 30, 2009. The increase is primarily due to the securities acquired in connection with the FDIC-assisted 1st Centennial Bank transaction, net of securities sold in the first nine months of 2009.

Net unrealized holding losses were $8.5 million at September 30, 2009 and were $14.0 million at December 31, 2008. As a percentage of securities, at amortized cost, unrealized holding losses were 2.72 percent and 6.46 percent at the end of each respective period. Securities are comprised largely of U.S. government agency mortgage-backed securities, U.S. government agency and private-label collateralized mortgage obligations and U.S. government agency notes. We perform regularly an impairment analysis on our securities portfolio. Other-than-temporary impairment occurs when it is probable that we will be unable to collect all amounts due according to the contractual terms of the debt security not impaired at acquisition. When an other-than-temporary impairment occurs, we write-down the cost basis of the security to its fair value and establish a new cost basis. We recognize the write-down as a loss in our income statement if it is credit related. Other-than-temporary declines in fair value are assessed based on the duration the security has been in a continuous unrealized loss position, the severity of the decline in value, the rating of the security, the long-term financial outlook of the issuer, the expected future cash flows and our ability and intent on holding the securities until the fair values recover.

The following table shows the gross unrealized losses and amortized cost of the Company's securities with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2009 and December 31, 2008. This table excludes the one security with an other-than-temporary impairment at September 30, 2009.

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	At September 30, 2009					
	Less Than 12 Months		Greater Than 12 Months		Total	
(in thousands)	Amortized Cost	Unrealized Losses	Amortized Cost	Unrealized Losses	Amortized Cost	Unrealized Losses
U.S. Treasury notes	$7,739	$(3)	$—	$—	$7,739	$(3)
U.S. government agency mortgage-backed securities	9,632	(38)	—	—	9,632	(38)
U.S. government agency collateralized mortgage obligations	5,045	(29)	—	—	5,045	(29)
Private-label collateralized mortgage obligations	3,959	(155)	32,138	(7,302)	36,097	(7,457)
Municipal securities	—	—	173	(2)	173	(2)
Other domestic debt securities	—	—	4,867	(2,612)	4,867	(2,612)
	$26,375	$(225)	$37,178	$(9,916)	$63,553	$(10,141)

	At December 31, 2008					
	Less Than 12 Months		Greater Than 12 Months		Total	
(in thousands)	Amortized Cost	Unrealized Losses	Amortized Cost	Unrealized Losses	Amortized Cost	Unrealized Losses
U.S. government agency mortgage-backed securities	$3,611	$(46)	$—	$—	$3,611	$(46)
U.S. government agency collateralized mortgage obligations	1,476	(5)	—	—	1,476	(5)
Private-label collateralized mortgage obligations	51,107	(15,205)	3,078	(288)	54,185	(15,493)
Municipal securities	7,360	(121)	173	(2)	7,533	(123)
Other domestic debt securities	—	—	4,941	(2,032)	4,941	(2,032)
	$63,554	$(15,377)	$8,192	$(2,322)	$71,746	$(17,699)

The majority of unrealized losses at September 30, 2009 relate to a type of mortgage-backed security also known as private-label collateralized mortgage obligations, or CMOs. As of September 30, 2009, the fair value of these securities was $36.8 million, representing 12 percent of our securities portfolio. Gross unrealized losses related to these securities amounted to $9.4 million, or 20 percent of the aggregate cost basis of these securities as of September 30, 2009. The gross unrealized losses associated with these securities were primarily due to extraordinarily high investor yield requirements resulting from an extremely illiquid market, significant uncertainty about the future condition of the mortgage market and the economy, and continued deterioration in the credit performance of loan collateral underlying these securities, causing these securities to be valued at significant discounts to their acquisition cost. All of these securities had credit rating agency grades of triple-A at purchase and, except for five of these securities, various rating agencies have reaffirmed these securities' investment grade status as of September 30, 2009. The aggregate amortized cost basis of these five securities is $27.7 million at September 30, 2009. One CMO with an amortized cost basis of $6.3 million has an unrealized loss of $1.9 million as of September 30, 2009. As of September 30, 2009, this security was rated triple-C by one rating agency. The current delinquency and default rates of the collateral for this security are above original expectations at the time of our purchase. We performed a

discounted cash flow analysis for this security using the current month, last three month and last twelve month historical prepayment speed, the cumulative default rate and the loss severity rate to determine if there was other-than-temporary impairment as of September 30, 2009. A credit loss is the difference between our best estimate of the present value of the cash flows expected to be collected and the amortized cost basis of the security. Our discounted cash flow analysis resulted in a shortfall of estimated contractual cash flows to the tranche of this security owned by us. Therefore, for this security, we recognized an other-than-temporary impairment loss of $565,000 as of June 30, 2009. We further determined that no additional other-than-temporary impairment loss was necessary for the third quarter of 2009. We will continue to monitor the credit performance of this security and if the performance deteriorates from current levels, we may recognize an additional other-than-temporary impairment loss in future periods.

We performed a similar discounted cash flow analysis as described above for the four other CMO securities rated less than investment grade at September 30, 2009. All four of these analyses indicated that there was no shortfall of future cash flows to the tranche of the securities owned by us. As we have the ability and intention to hold these securities for a sufficient amount of time, during which the fair value may recover to cost or the security matures, we did not deem these securities other-than-temporarily impaired at September 30, 2009.

The issuers of the remaining CMO securities in our portfolio have not, to our knowledge, established any cause for default on these securities and the credit performance of the underlying collateral is within expected parameters.

We also own one pooled trust preferred security, rated triple-A at purchase, with an amortized cost basis of $4.9 million and an unrealized loss of $2.6 million at September 30, 2009. The severe disruption in the market for these securities contributed to this unrealized loss. One credit rating agency has now rated the security single-A while another has rated the security triple-B-. The senior tranche owned by us has a significant collateral margin at September 30, 2009. There is minimal default experience within this security and there is no evidence of a shortage of contractual cash flows to the tranche of the security owned by us. As we have the ability and intention to hold this security for a sufficient amount of time, during which the fair value may recover to cost or the security matures, we do not consider this security to be other-than-temporarily impaired at September 30, 2009.

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The remainder of our securities portfolio consists mainly of U.S. Treasury securities, U.S. government agency mortgage-backed securities, U.S. government agency collateralized mortgage obligations and various municipal securities. One of these municipal securities has been in a continuous unrealized loss position for twelve months or longer as of September 30, 2009. This security had a credit rating agency grade of triple-A upon purchase and various rating agencies have reaffirmed this securities' long-term investment grade status of single-A at September 30, 2009. The aggregate gross unrealized loss for this security is $2,000 at September 30, 2009. The issuer of this security has not, to our knowledge, established any cause for default on this security. These securities have fluctuated in value since their purchase dates as market interest rates have fluctuated. However, we have the ability and the intention to hold these securities for a sufficient amount of time, during which their fair values may recover to cost or the securities may mature. As such, we do not consider these securities to be other-than-temporarily impaired at September 30, 2009.

If current conditions in the mortgage markets and general business and economic conditions continue to deteriorate further, the fair value of our securities may decline further and we may experience other-than-temporary impairment on other securities in future periods, as well as further impairment of the one security deemed other-than-temporarily impaired. We will continue to evaluate our securities portfolio for other-than-temporary impairment at each reporting date and we can provide no assurance that there will not be an other-than-temporary impairment loss in future periods.

The following table presents the other-than-temporary impairment activity related to credit loss, which is recognized in earnings, and the other-than-temporary impairment activity related to all other factors, which are recognized in other comprehensive income.

	Three Months Ended September 30, 2009		
(in thousands)	Impairment Related to Credit Loss	Impairment Related to Other Factors	Total Impairment
Recognized as of beginning of period	$ 565	$ —	$ 565
Charges on securities for which OTTI was not previously recognized	—	—	—
Recognized as of end of period	$ 565	$ —	$ 565

Deposits

Deposits represent our primary source of funds for funding our lending activities. The following table presents the average balance and the average rate paid on each deposit category for the periods indicated:

	Nine months ended September 30,					
	2009			2008		
(in thousands)	Average Balance	Rate		Average Balance	Rate	
Average core deposits						
Noninterest bearing checking	$ 280,036			$ 192,704		
Interest checking	77,096	0.29	%	57,667	0.79	%
Savings and money market accounts	256,122	1.08	%	200,533	1.95	%
Retail time deposits less than $100,000	109,904	2.05	%	57,427	4.91	%
Total average core deposits	723,158	0.73	%	508,331	1.42	%

Average noncore deposits						
Brokered time deposits less than $100,000	68,991	3.30	%	25,584	3.91	%
Time deposits of $100,000 or more	281,588	1.85	%	213,224	2.67	%
Total average core and noncore deposits	$1,073,737	1.19	%	$747,139	1.99	%

The significant increase in deposits from the prior period is primarily due to the acquisition of $270 million of non-brokered insured deposits in connection with the FDIC-assisted 1st Centennial Bank transaction. Interest paid on deposits decreased in 2009 compared to 2008 reflecting the significant decreases in market interest rates during the period.

Large balance certificates of deposit (that is, balances of $100,000 or more) were $282.4 million at September 30, 2009. Large balance certificates of deposit were $215.5 million at December 31, 2008. A portion of these large balance time deposits represent time deposits placed by the State Treasurer of California with the Bank. The time deposit program is one element of a pooled investment account managed by the State Treasurer for the benefit of the State of California and all participating local agencies. The pooled investment account has approximately $63 billion of investments of which approximately $8 billion represent time deposits placed at various financial institutions. At September 30, 2009, and December 31, 2008, State of California time deposits placed with us, with original maturities of three months, were $110.0 million. We believe that the State Treasurer will continue this program; we also believe, if it becomes necessary to replace these deposits, that we have sufficient alternative funding capacity or the ability to establish large balance certificates of deposit rates that will enable us to attract deposits in sufficient amounts. The remainder of time deposits represents time deposits accepted from customers in our market area.

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We use brokered time deposits to supplement our liquidity and achieve other asset liability management objectives. We include these deposits in the balance sheet line 'Certificates of deposit, under $100,000'. Brokered deposits are wholesale time deposits in denominations less $100,000 placed by rate sensitive customers that do not have any other significant relationship with us. Professionals operating under established investment criteria manage most wholesale funds and the brokered deposits are typically in amounts that are within the FDIC deposit insurance limit. As a result, these funds are generally very sensitive to credit risk and interest rates, and pose greater liquidity risk to a bank. They may refuse to renew the time deposits at maturity if higher rates are available elsewhere or if they perceive that creditworthiness is deteriorating. At September 30, 2009, we had brokered deposits of $48.0 million, all of which have maturities within 12 months. At December 31, 2008, we had brokered deposits of $115.0 million, of which $95.7 million had maturities within 12 months.

At September 30, 2009, the scheduled maturities of time certificates of deposit in denominations of $100,000 or more were as follows:

(Dollars in thousands)	
Three months or less	$157,070
Over three months to twelve months	92,329
Over twelve months	32,982
	$282,381

Borrowings

Borrowings are comprised of FHLB advances and securities sold under agreements to repurchase. At September 30, 2009, we had $149.0 million of borrowings outstanding, of which $45.0 million was comprised of securities sold under agreements to repurchase and $104.0 million of FHLB advances. For our FHLB advances, the following table presents the amounts and weighted average interest rates outstanding.

	Nine Months Ended September 30, 2009		Year Ended December 31, 2008	
(in thousands)	Federal Home Loan Bank Advances	Weighted average interest rate	Federal Home Loan Bank Advances	Weighted average Interest rate
Amount outstanding at end of period	$ 104,000	3.83 %	$ 122,000	3.88 %
Maximum amount outstanding at any month-end during the period	$ 122,000	3.88 %	$ 196,463	3.29 %
Average amount outstanding during the period	$ 113,465	3.85 %	$ 148,748	3.75 %

The following table presents the maturities of FHLB term advances:

	At September 30, 2009			At December 31, 2008		
(dollars in thousands)	Amount	Maturity Year	Weighted Average Interest Rate	Amount	Maturity Year	Weighted Average Interest Rate
	$5,500	2009	3.97 %	$28,500	2009	3.72 %
	42,000	2010	3.70 %	40,000	2010	3.82 %
	13,000	2011	3.21 %	11,000	2011	3.42 %
	18,500	2012	4.03 %	17,500	2012	4.12 %
	17,500	2014	4.24 %	17,500	2014	4.24 %
	7,500	2017	4.07 %	7,500	2017	4.07 %

	$104,000	$122,000

The following table presents maturities of securities sold under agreements to repurchase:

	At September 30, 2009				At December 31, 2008			
(dollars in thousands)	Amount	Maturity Year	Weighted Average Interest Rate		Amount	Maturity Year	Weighted Average Interest Rate	
	$15,000	2011	3.64	%	$15,000	2011	3.64	%
	20,000	2013	3.60	%	20,000	2013	3.60	%
	10,000	2014	3.72	%	10,000	2014	3.72	%
	$45,000				$45,000			

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Capital resources

The following table presents, at the dates indicated, certain information regarding the regulatory capital and required minimum amounts of regulatory capital for the period.

(in thousands)	Actual Amount	Actual Ratio	For Capital Adequacy Purposes Amount	For Capital Adequacy Purposes Ratio	To be Well Capitalized Under Prompt Corrective Action Provision Amount	To be Well Capitalized Under Prompt Corrective Action Provision Ratio
September 30, 2009						
Total capital (to risk weighted assets)						
First California Financial Group, Inc.	$134,680	12.47 %	$86,398	³8.00 %		
First California Bank	125,101	11.62 %	86,159	³8.00 %	107,699	³10.00 %
Tier I capital (to risk weighted assets)						
First California Financial Group, Inc.	122,446	11.34 %	43,199	³4.00 %		
First California Bank	112,867	10.48 %	43,080	³4.00 %	64,619	³6.00 %
Tier I capital (to average assets)						
First California Financial Group, Inc.	122,446	8.81 %	55,577	³4.00 %		
First California Bank	112,867	8.10 %	55,756	³4.00 %	69,695	³5.00 %
December 31, 2008						
Total capital (to risk weighted assets)						
First California Financial Group, Inc.	$147,680	16.62 %	$71,102	³8.00 %		
First California Bank	109,022	12.27 %	71,110	³8.00 %	88,888	³10.00 %
Tier I capital (to risk weighted assets)						
First California Financial Group, Inc.	139,530	15.70 %	35,551	³4.00 %		
First California Bank	100,873	11.35 %	35,555	³4.00 %	53,333	³6.00 %
Tier I capital (to average assets)						
First California Financial Group, Inc.	139,530	12.77 %	43,699	³4.00 %		
First California Bank	100,873	9.26 %	43,568	³4.00 %	54,460	³5.00 %

We recognize that a strong capital position is vital to growth, continued profitability, and depositor and investor confidence. Our policy is to maintain sufficient capital at not less than the well-capitalized thresholds established by banking regulators.

Financial Instruments with Off-Balance Sheet Risk

In the normal course of business to meet the financing needs of our customers, we are party to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and the issuance of letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amounts recognized in our consolidated financial statements. The contract amounts of those instruments reflect the extent of involvement we have in particular classes of financial instruments.

The contractual amount of commitments to extend credit and letters of credit written represents our exposure to credit loss in the event of nonperformance by the other party to these financial instruments. We use the same credit policies in making commitments and conditional obligations as we do for on-balance sheet instruments. We may or may not require collateral or other security to support financial instruments with credit risk, depending on our loan underwriting guidelines.

The following summarizes our outstanding commitments at September 30, 2009 and December 31, 2008:

(in thousands)	September 30, 2009	December 31, 2008
Financial instruments whose contract amounts contain credit risk:		
Commitments to extend credit	$ 180,767	$ 152,877
Commercial and standby letters of credit	1,597	444
	$ 182,364	$ 153,321

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Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Total commitment amounts do not necessarily represent future cash requirements because many expire without use. We may obtain collateral for the commitment based on our credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income-producing properties.

Letters of credit written are conditional commitments issued by us to guarantee the performance of a customer to a third party. These guarantees support public and private borrowing arrangements, including commercial paper, bond financing, and similar transactions. Credit risk for letters of credit is essentially the same as that for loan facilities to customers. When we deem collateral necessary, we will hold cash, marketable securities, or real estate as collateral supporting those commitments.

As of September 30, 2009 and December 31, 2008, we maintained an allowance for losses on undisbursed commitments of $97,000 and $102,000, respectively. The allowance is included in “accrued interest payable and other liabilities” on the consolidated balance sheets.

Interest Rate Risk

Interest rate risk is the risk to earnings or capital arising from movements in interest rates. Interest rate risk arises from differences between the timing of rate changes and the timing of cash flows (re-pricing risk), from changing rate relationships among different yield curves affecting bank activities (basis risk), from changing rate relationships across the spectrum of maturities (yield curve risk), and from interest-related options embedded in loans and products (options risk).

We manage bank interest risk through Board approved policies and procedures. The Directors review and approve these policies at least annually. Interest rate risk policies provide management with a framework for consistent evaluation of risk and establish risk tolerance parameters. Management’s Asset and Liability Committee meets regularly to evaluate interest rate risk, engages a third party to assist in the measurement and evaluation of risk and reports quarterly to the Directors’ Balance Sheet Management Committee on compliance with policies. The Directors’ Audit Committee also engages a third party to perform a review of management’s asset and liability practices to ensure compliance with policies.

We use simulation modeling techniques that apply alternative interest rate scenarios to periodic forecasts of future business activity and assess the potential changes to net interest income. In our most recent simulation, we estimated that net interest income would increase approximately 0.17% within a 12-month time horizon for an assumed 100 basis point decrease in prevailing interest rates or decrease approximately 0.03% for an assumed 100 basis point increase in prevailing interest rates. In addition, we estimated that net interest income would decrease approximately 0.07% within a 12-month time horizon for an assumed 200 basis point increase in prevailing rates. These estimated changes were within the policy limits established by the Board.

Our simulation model includes assumptions about anticipated prepayments on mortgage-related instruments, the estimated cash flow on loans and deposits, and our future business activity. These assumptions are inherently uncertain and, as a result, our modeling techniques cannot precisely estimate the effect of changes in net interest income. Actual results will differ from simulated results due to the timing, magnitude and frequency of interest rate changes, cash flow and business activity.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Please see the section above titled “Interest Rate Risk” in “Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations” which provides an update to our quantitative and qualitative disclosure about market risk. Our analysis of market risk and market-sensitive financial information contains forward-looking statements and is subject to the disclosure above under “Cautionary Statement” in Item 2 regarding such forward-looking information.

Item 4. Controls and Procedures

As of the end of the period covered by this report, an evaluation was carried out by management, with the participation of the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that these disclosure controls and procedures were effective.

There have not been any changes in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) during our most recent fiscal quarter ending September 30, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II—OTHER INFORMATION

Item 1. Legal Proceedings

The nature of our business causes us to be involved in routine legal proceedings from time to time. We are not aware of any pending or threatened legal proceedings expected to have a material adverse effect on our business, financial condition, results of operations or cash flow that arose during the fiscal quarter ended September 30, 2009 or any material developments in our legal proceedings previously reported in Item 3 to Part I of our Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

Item 1A. Risk Factors

There have been no material changes from risk factors as previously disclosed in the "Risk Factors" section of our Annual Report on Form 10-K for the period ended December 31, 2008, filed with the SEC on March 31, 2009, and Item 1A of our Form 10-Q for the period ended June 30, 2009, filed with the SEC on August 14, 2009.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits

The following Exhibits are filed as a part of this report:

Exhibit Number	Description
31.1	Certification of CEO Pursuant to Securities Exchange Act Rules 13a-14 and 15d-14 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of CFO Pursuant to Securities Exchange Act Rules 13a-14 and 15d-14 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of CEO and CFO Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

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

	First California Financial Group, Inc.	
Date: November 16, 2009	By:	/s/ Romolo Santarosa Romolo Santarosa (Principal Financial Officer and Duly Authorized Officer)

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