

Edgar Filing: CNE GROUP INC - Form 10QSB

CNE GROUP INC
Form 10QSB
November 22, 2004

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

FORM 10-QSB

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2004

Transition report under Section 13 or 15(d) of the Exchange Act of 1934

For the transition period from _____ to _____

Commission file number 1-9224

CNE GROUP, INC.

(Exact Name of Small Business Issuer as Specified in Its Charter)

DELAWARE

56-2346563

(State or Other Jurisdiction of
Incorporation or Organization)

(I.R.S. Employer
Identification No.)

200 West 57th Street, Suite 507, New York, N.Y. 10019

(Address of Principal Executive Offices)

212-977-2200

(Issuer's Telephone Number, Including Area Code)

Check whether the issuer: (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

The number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date.

| Class ----- | Outstanding at October 31, 2004 ----- |
|--|--|
| Common stock - par value \$.00001 ----- | 10,790,915 shares ----- |

PART I

FINANCIAL INFORMATION

Item 1. Financial Statements.

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The following consolidated financial statements of CNE Group, Inc. and subsidiaries (collectively referred to as the "Company," unless the context requires otherwise) are prepared in accordance with the rules and regulations of the Securities and Exchange Commission for Form 10-QSB and reflect all adjustments (consisting of normal recurring accruals) and disclosures which, in the opinion of management, are necessary for a fair statement of results for the interim periods presented. It is suggested that these financial statements be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2003, which was filed with the Securities and Exchange Commission.

The results of operations for the three and nine months ended September 30, 2004 are not necessarily indicative of the results to be expected for the entire fiscal year.

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CNE GROUP, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

| | September 30, 2004 | December 31, 2003 |
|---|-----------------------|----------------------|
| | ----- | ----- |
| | (Unaudited) | |
| ASSETS | | |
| Current: | | |
| Cash and cash equivalents | \$ 51,702 | \$ 460,832 |
| Accounts receivable, net of allowance for doubtful accounts of \$64,707 in 2004 and \$51,500 in 2003 | 152,902 | 208,358 |
| Inventory | 356,158 | 246,719 |
| Other | 13,806 | 27,840 |
| | ----- | ----- |
| Total current assets | 574,568 | 943,749 |
| Fixed assets, net | 417,497 | 447,579 |
| Intellectual property rights, net | 1,390,247 | 1,475,145 |
| Goodwill | 7,285,894 | 7,285,894 |
| Other assets | 21,962 | 18,961 |
| | ----- | ----- |
| Total assets | \$ 9,690,168 | \$ 10,171,328 |
| | ===== | ===== |
| LIABILITIES | | |
| Current: | | |
| Accounts payable and accrued expenses | \$ 1,343,772 | \$ 1,030,203 |
| Short-term credit arrangements | 86,365 | 210,093 |
| Notes payable | 639,318 | 146,988 |
| Subordinated notes payable | 941,747 | -- |
| Debenture payable | 100,000 | 100,000 |
| | ----- | ----- |
| Total current liabilities | 3,111,202 | 1,487,284 |
| Notes payable, net of current portion | 29,060 | 326,045 |

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| | | |
|----------------------------|-----------|-----------|
| Subordinated notes payable | -- | 1,767,000 |
| Deferred revenue | 16,705 | 23,620 |
| Deferred grant revenue | 300,000 | 300,000 |
| | ----- | ----- |
| Total liabilities | 3,456,967 | 3,903,949 |
| | ----- | ----- |

Commitments and contingencies (Note I)

STOCKHOLDERS' EQUITY

| | | |
|---|--------------|---------------|
| Preferred stock (Note D) | 134 | 124 |
| Common stock (Note E) | 121 | 101 |
| Paid-in surplus | 29,919,185 | 28,258,215 |
| Accumulated deficit | (20,813,139) | (19,117,961) |
| | ----- | ----- |
| | 9,106,301 | 9,140,479 |
| Less treasury stock, at cost - 1,238,656 shares | (2,873,100) | (2,873,100) |
| | ----- | ----- |
| Total stockholders' equity | 6,233,201 | 6,267,379 |
| | ----- | ----- |
| Total liabilities and stockholders' equity | \$ 9,690,168 | \$ 10,171,328 |
| | ===== | ===== |

See Notes to Consolidated Financial Statements.

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CNE GROUP, INC. AND SUBSIDIARIES

Consolidated Statements of Operations

| | Three Months Ended September 30, | | Nine Months Ended Sept |
|--------------------------------|-------------------------------------|-------------|---------------------------|
| | 2004 | 2003 | 2004 |
| | ----- | ----- | ----- |
| | (Unaudited) | (Unaudited) | (Unaudited) |
| Revenues: | | | |
| Product sales | \$ 385,711 | \$ 268,591 | \$ 1,279,111 |
| Service fee income | 215,364 | 244,413 | 798,017 |
| Internet related income | 41,920 | 39,592 | 99,127 |
| | ----- | ----- | ----- |
| | 642,995 | 552,596 | 2,176,255 |
| Cost of goods sold | 300,574 | 294,863 | 1,085,889 |
| | ----- | ----- | ----- |
| Gross profit | 342,421 | 257,733 | 1,090,366 |
| | ----- | ----- | ----- |
| Other expenses: | | | |
| Advertising | 5,909 | 6,591 | 42,837 |
| Compensation and related costs | 207,324 | 387,467 | 1,028,916 |
| General and administrative | 322,507 | 341,657 | 985,806 |
| Product development | 92,904 | -- | 130,513 |
| Depreciation and amortization | 48,848 | 70,193 | 145,204 |

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| | ----- 677,492 ----- | ----- 805,908 ----- | ----- 2,333,276 ----- |
|---|---------------------------|---------------------------|-----------------------------|
| Loss before other income (expenses) | (335,071) | (548,175) | (1,242,910) |
| Other income (expenses): | | | |
| Amortization of debt discount | (24,963) | (175,750) | (174,747) |
| Interest expense | (110,757) | (82,320) | (278,099) |
| Tax settlement adjustment | -- | 895,622 | -- |
| Interest income | 277 | -- | 576 |
| | ----- | ----- | ----- |
| (Loss) income before provision for income taxes | (470,514) | 89,377 | (1,695,180) |
| Provision for income taxes | -- | -- | -- |
| | ----- | ----- | ----- |
| (Loss) Income from continuing operations | (470,514) | 89,377 | (1,695,180) |
| Discontinued operations: | | | |
| Income from discontinued operations (Note J) | -- | 533,634 | -- |
| | ----- | ----- | ----- |
| Net (loss) income | \$ (470,514) ===== | \$ 623,011 ===== | \$ (1,695,180) ===== |

See Notes to Consolidated Financial Statements.

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CNE GROUP, INC. AND SUBSIDIARIES

Consolidated Statements of Operations, continued

| | Three Months Ended September 30, | | E |
|--|-------------------------------------|-------------------------------|-------------------------------|
| | 2004 | 2003 | 2004 |
| | ----- (Unaudited) ----- | ----- (Unaudited) ----- | ----- (Unaudited) ----- |
| (Loss) income per common share: | | | |
| Basic: | | | |
| (Loss) income from continuing operations | \$ (.04) | \$.01 | \$ |
| Income from discontinued operations | -- | .07 | -- |
| Net (loss) income | \$ (.04) ===== | \$.08 ===== | \$ ===== |
| Diluted: | | | |
| (Loss) income from continuing operations | \$ (.04) | \$.01 | \$ |
| Income from discontinued operations | -- | .07 | -- |
| Net (loss) income | \$ (.04) ===== | \$.08 ===== | \$ ===== |

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| | | | |
|---|------------|-----------|--------|
| Weighted average number of common shares outstanding: | | | |
| Basic | 10,690,915 | 7,674,253 | 10,463 |
| | ===== | ===== | ===== |
| Diluted | 10,690,915 | 7,970,808 | 10,463 |
| | ===== | ===== | ===== |

See Notes to Consolidated Financial Statements.

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CNE GROUP, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

| | Nine Months E |
|--|----------------|
| | ----- |
| | 2004 |
| | ----- |
| | (Unaudited) |
| Cash flows from operating activities: | |
| Loss from continuing operations | \$ (1,695,180) |
| Adjustments to reconcile loss from continuing operations to net cash used in operating activities: | |
| Depreciation and amortization | 145,204 |
| Provision for doubtful accounts | 13,207 |
| Issuance of common stock for services | 50,000 |
| Amortization of debt discount | 174,747 |
| Changes in: | |
| Accounts receivable | 42,249 |
| Inventory | (109,439) |
| Prepaid expenses and other assets | 11,003 |
| Accounts payable, accrued expenses and other liabilities | 346,686 |
| Deferred grant revenue | -- |
| | ----- |
| Net cash used in operating activities | (1,021,523) |
| | ----- |
| Cash flows from investing activities: | |
| Purchase of furniture and equipment | (30,224) |
| | ----- |
| Net cash used in investing activities | (30,224) |
| | ----- |
| Cash flows from financing activities: | |
| Proceeds from issuance of 10% subordinated notes payable | -- |
| Proceeds from short-term credit arrangements | 20,853 |
| Net proceeds from issuance of 1,750,000 shares of common stock | 571,000 |
| Proceeds from issuance of 10% notes payable | 150,000 |
| Proceeds from issuance of 18% notes payable | 300,000 |
| Proceeds from issuance of 24% notes payable | 150,000 |
| Principal repayments on short-term credit arrangements | (144,581) |
| Principal repayments on notes payable | (404,655) |
| Payment of accounts receivable due Sellers of Econo-Comm, Inc. | -- |

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| | |
|--|-----------|
| | ----- |
| Net cash provided by financing activities | 642,617 |
| | ----- |
| Decrease in cash and cash equivalents | (409,130) |
| Cash and cash equivalents at beginning of period | 460,832 |
| | ----- |
| Cash and cash equivalents at end of period | \$ 51,702 |
| | ===== |

See Notes to Consolidated Financial Statements.

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CNE GROUP, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows, continued

Supplemental disclosures of cash flow information related to continuing operations:

Cash paid during the period for:

Interest
Income taxes

Non-cash investing and financing activities relating to the acquisition of subsidiaries and certain intellectual property rights, conversion of debt to preferred stock, forgiveness of interest indebtedness to an officer and an employee of the Company, and issuance of common stock for services:

Accounts receivable
Inventory
Intellectual property rights
Intangibles
Other assets
Accrued expenses and other liabilities
Interest payable
8% notes payable
Issuance of preferred stock, at par
Issuance of common stock, at par
Paid in surplus

See Notes to Consolidated Financial Statements.

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CNE GROUP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

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NOTE A - THE COMPANY

Business

CNE Group, Inc. (the "Company" or "CNE") is a holding company whose primary operating subsidiaries are SRC Technologies, Inc. ("SRC") and U.S. Commlink, Ltd. ("USCL"). SRC, also a holding company, is the parent of Connectivity, Inc. ("Connectivity") and SRC-ECI, Inc. ("ECI") (d/b/a Econo-Comm, Inc. and Mobile Communications). Connectivity, ECI and USCL market, manufacture, repair and maintain remote radio and cellular-based emergency response products to a variety of federal, state and local government institutions, and other vertical markets throughout the United States. The Company has intellectual property rights to certain key elements of these products - specifically, certain communication, data entry and telemetry devices.

The Company also generates revenue from its subsidiary, CareerEngine, Inc., which is engaged in the business of e-recruiting. This segment is not significant to the operations of the Company.

Going Concern

The Company has incurred substantial losses, sustained substantial operating cash outflows and has a working capital deficit at both September 30, 2004 and December 31, 2003. The above factors raise substantial doubt about the Company's ability to continue as a going concern. The Company's continued existence depends on its ability to obtain additional equity and/or debt financing to fund its operations and ultimately to achieve profitable operations. The Company is continuously in the process of raising additional financing and has initiated a cost reduction strategy. At September 30, 2004, management believes that the working capital deficit, losses and negative cash flow will ultimately be improved by (i) the acquisition and increased operations of SRC and ECI and (ii) cost reduction strategies initiated in January and June 2004. There is no assurance that the Company can obtain additional financing or achieve profitable operations or generate positive cash flow. The 2004 and 2003 financial statements do not include any adjustments relating to the recoverability or classification of recorded asset amounts or the amount and classification of liabilities that might be necessary as a result of this going concern uncertainty.

American Stock Exchange Listing

On January 2, 2004, the Company received a notice dated December 31, 2003 from the American Stock Exchange Staff indicating that the Company had demonstrated compliance with the requirements necessary for continued listing on the American Stock Exchange.

As is the case for all listed issuers, the Company's continued listing eligibility will be assessed on an ongoing basis; however, during the year ending December 31, 2004, the Company will be subject to additional scrutiny (as set forth in Section 1009(h) of the AMEX Company Guide) as is the case for any listed company that has regained compliance.

Private Financings

On April 23, 2003, the Company completed a private financing pursuant to which it issued notes (the "Notes") in the aggregate principal amount of \$1,000,000, of which \$650,000 was to the officers of the Company, and 4,165,800 ten year

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cashless Class B Warrants, each to purchase one share of its Common

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CNE GROUP, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements

NOTE A - THE COMPANY (CONTINUED)

Stock at \$0.50 per share. The Notes bear interest at the annual rate of 10% payable quarterly and were due on April 30, 2004. The aggregate number of shares for which the Warrants may be exercised must equal 15% of the Company's outstanding Common Stock on a fully-diluted basis. These Warrants are anti-dilutive until the Notes have been repaid. The due date of the Notes may be extended at the Company's option for an additional year in consideration for the issuance of 10-year warrants to purchase an additional 4% of the Company's then outstanding common stock at \$0.50 per share. These Warrants would also be anti-dilutive until the Notes have been repaid. In addition, the Company valued the warrants, utilizing the Black-Scholes Pricing Model, at \$699,000, which is being accounted for as debt discount and is being amortized ratably over the one-year term of the Notes.

On March 12, 2004, the Company notified the Class B Warrant holders that, to satisfy the 15% non-dilutive provisions of their Warrants, these Warrants were now exercisable for an aggregate of 5,245,200 shares of the Company's common stock at approximately \$0.40 per share. On this date, the Company also exercised its option to extend the maturity date of the notes to April 30, 2005 and satisfied the requirement for the additional 4% non-dilutive interest in the Company by issuing to the noteholders Class B Warrants to purchase an additional 1,708,900 shares of the Company's common stock at \$0.50 per share. The non-dilutive provisions of the Warrants terminate when all of the notes have been paid in full.

1. On September 17, 2003, the Company sold 1,250,000 shares of its Common Stock at \$0.40 per share to an existing noteholder and stockholder of the Company.
2. On January 21, 2004, a secured factoring arrangement with an individual, which amounted to \$300,000 at December 31, 2003, was restructured into a \$300,000 unsecured Note Payable due February 10, 2005. The individual was also issued Class BB Warrants to purchase 150,000 shares of the Company's common stock at \$0.50 per share.
3. On February 10, 2004, the Company sold 1,750,000 shares of its Common Stock at \$0.40 per share. The net proceeds of the transaction amounted to \$571,000. The Company used the funds obtained from this financing primarily for working capital purposes.
4. On June 10, 2004, the two holders of the Company's 8% Subordinated Promissory Notes, in the aggregate principal amount of \$1,000,000, converted their notes into 1,000,000 shares of the Company's Series AA 8% Cumulative Preferred Stock, par value \$0.00001 per share (the "Series AA Preferred Stock"). The aggregate liquidating value of the Series AA Preferred Stock acquired by the converting noteholders, one of whom is an officer and the other an employee of a subsidiary of the Company, is \$1,000,000.
5. On June 10, 2004, an officer and employee of a subsidiary relinquished all their rights to an aggregate 420,000 vested incentive stock options of the Company for an aggregate payment of

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\$50,000 cash which is included in compensation and related costs.

6. In June 2004, in an effort to conserve the financial resources of the Company, the Board of Directors of the Company deferred 100% of the salaries of four officers of the Company until such time as the Board deems otherwise. In September 2004, three of the aforementioned officers were terminated by the Company. The accompanying financial statements include (i) the

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CNE GROUP, INC. AND SUBSIDIARIES Notes to Consolidated Financial Statements

NOTE A - THE COMPANY (CONTINUED)

accrued salary owed to the non-terminated officer for the amounts so deferred, and (ii) with regard to the terminated officers, the accrued salaries owed to these officers for the amounts so deferred until their termination. See Note I.

7. On June 28, 2004 the Company repaid, in full, one of its outstanding lines of credit amounting to approximately \$146,000. On the same date the Company issued a secured note payable to an employee of a subsidiary of the Company in the amount of \$150,000. The note is secured by the equipment of a subsidiary of the Company. The note bears interest at 10% per annum and the principal and all interest thereon was due September 28, 2004. The Company is currently negotiating new terms with regard to this note.
8. As of July 1, 2004, 80% of the holders of the Company's 10% subordinated notes agreed to defer \$20,000 of interest due on such date to October 1, 2004 in consideration of the Company issuing to them 153,846 Class B Warrants of the Company, each to give the holder thereof the right to purchase a share of common stock at \$0.39 per share. As of October 1, 2004, 75% of the holders of the Company's 10% subordinated notes agreed to further defer \$18,750 of interest from October 1, 2004 to January 1, 2005 in consideration of the Company issuing to them an additional 170,455 Class B Warrants of the Company, each to give the holder thereof the right to purchase a share of common stock at \$0.33 per share. The noteholders include two officers of the Company.
9. In July and August 2004, the Company issued \$150,000 of its 24% Secured Notes due April 30, 2005 to the wife of the Chief Executive Officer and an existing 10% subordinated noteholder of the Company. Interest on the notes is payable quarterly in arrears. The notes are secured by (i) all the stock of SRC and USCL, and (ii) the pledge of Patent Nos. 6,060,979, 6,047,173 and 5,701,338 -all owned by the Company. On October 1, 2004, 100% of the holders of the Company's 24% Secured Notes agreed to defer \$5,786 of interest due on such date to January 1, 2005 in consideration of the Company issuing to them 76,712 Class B Warrants of the Company, each to give the holder thereof the right to purchase a share of common stock at \$0.33 per share.
10. As of October 1, 2004, 75% of the holders of the Company's 10% subordinated notes agreed to defer \$18,750 of interest due on such date to January 1, 2005 in consideration of the Company issuing to them 170,455 Class B Warrants of the Company, each to give the

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holder thereof the right to purchase a share of common stock at \$0.33 per share. The noteholders include two officers of the Company.

11. In October 2004, the Company and USCL entered into a two-year Project Financing Agreement with an institutional lender relating to USCL's anticipated participation in the "Cellular Call Box Upgrade and Maintenance Service" projects for numerous Service Authority for Freeway Emergencies ("SAFE") programs within the state of California. These call box programs operate over 17,000 motorist aid analog call boxes that will require upgrades to digital cellular technology available through USCL. This agreement provides the Company with finished goods and accounts receivable financing of up to \$2,000,000 relating to these potential aforementioned projects. The effective interest rate is approximately 3% per month on the outstanding balance of

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CNE GROUP, INC. AND SUBSIDIARIES Notes to Consolidated Financial Statements

NOTE A - THE COMPANY (CONTINUED)

the amount receivables financed. The finished goods and accounts receivable to be financed, as well as all the other assets of the Company not previously pledged, will secure the borrowings under this agreement.

12. In October and November 2004, the Company issued (i) \$125,000 of its 10% Convertible Subordinated Notes due June 30, 2005 and (ii) 787,500 Class C Warrants of the Company, each to give the holder thereof the right to purchase a share of common stock at \$0.50 per share. The notes were sold to the wife of the Chief Executive Officer of the Company and other accredited investors and are convertible by the holder, at any time, into common stock of the Company at \$0.50 per share. The warrants expire on April 30, 2013. Interest on the notes is payable monthly in arrears.

The Company is using the funds obtained from these financings primarily for working capital purposes. The aforementioned financings were effected pursuant to the exemption from the registration provisions of the Securities Act of 1993 provided by Section 4(2) thereof.

NOTE B - SIGNIFICANT ACCOUNTING POLICIES

[1] Inventory:

Inventory is stated at the lower of cost (determined by first-in, first-out method) or market. The Company's inventory consists of the following:

| | September 30, 2004 | December 31, 2003 |
|------------------|-----------------------|----------------------|
| | ----- | ----- |
| Raw materials | \$298,714 | \$158,347 |
| Work in progress | 24,497 | 3,089 |
| Finished goods | 32,947 | 85,283 |
| | ----- | ----- |

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| | | |
|-------|-----------|-----------|
| Total | \$356,158 | \$246,719 |
| | ===== | ===== |

[2] Income (loss) per share:

Basic and diluted earnings (loss) per common share have been computed in accordance with SFAS No. 128, "Earnings Per Share." Basic earnings per share ("BEPS") is computed by dividing net income (loss) by the weighted-average number of common shares outstanding during the three and nine month period ended September 30, 2004. For the three and nine month period ended September 30, 2003 diluted earnings per share (diluted EPS) is computed by dividing net income (loss) used in determining basic EPS by the weighted average number of commons hares outstanding during the period, plus the incremental shares, if any, that would have been outstanding upon the assumed exercise of dilutive stock options. Common stock equivalents to purchase common stock of the Company that were outstanding at September 30, 2004 were not included in the computation of diluted net loss per share as their effect would have been anti-dilutive.

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CNE GROUP, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[3] Stock-based compensation:

As permitted under SFAS No. 123, Accounting for Stock-based Compensation (SFAS No. 123), the Company has elected to continue to follow the guidance of APB Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25), and Financial Accounting Standards Board Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation--an interpretation of APB Opinion No. 25 (FIN No. 44), in accounting for its stock-based employee compensation arrangements. Accordingly, no compensation cost is recognized for any of the Company's fixed stock options granted to employees when the exercise price of each option equals or exceeds the fair value of the underlying common stock as of the grant date for each stock option. Changes in the terms of stock option grants, such as extensions of the vesting period or changes in the exercise price, result in variable accounting in accordance with APB Opinion No. 25. Accordingly, compensation expense is measured in accordance with APB No. 25 and recognized over the vesting period. If the modified grant is fully vested, any additional compensation costs is recognized immediately. The Company accounts for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123.

At September 30, 2004 and December 31, 2003, the Company had a stock-based employee compensation plan - the 2003 Plan. Two of Company's subsidiaries each had separate stock-based employee compensation plans. These subsidiaries' plans were contractually terminated by the Company upon the acquisition of SRC and ECI on April 23, 2003. Furthermore, on March 14, 2003, all recipients of options granted pursuant to these plans rescinded all of their interests.

As permitted under SFAS No. 148, Accounting for Stock-Based

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Compensation--Transition and Disclosure, which amended SFAS No. 123, the Company has elected to continue to follow the intrinsic value method in accounting for its stock-based employee compensation arrangements as defined by APB No. 25 and related interpretations including FIN No. 44. The following table illustrates the effect on net loss and loss per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation for options granted under its plan.

| | Nine Month Period Ended September 30, | |
|---|--|--------------|
| | 2004 | 2003 |
| Net loss, as reported | \$ (1,695,180) | \$ (286,000) |
| Less, Total stock-based employee compensation expense determined under fair value-based method for all awards, net of related tax effects | (246,430) | |
| Pro forma net loss | \$ (1,941,610) | \$ (286,000) |
| Net loss per share - basic and diluted: | | |
| As reported | \$ (0.16) | \$ (0.16) |
| Pro forma | \$ (0.18) | \$ (0.16) |

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CNE GROUP, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

On April 30, 2003, incentive stock options to purchase 1,987,500 shares of the Company's Common Stock were granted by the Incentive Compensation Committee to five officers (1,800,000) and one employee (187,500) of the Company at a weighted average exercise price of \$1.32 per share. On November 4, 2003, incentive stock options to purchase 950,000 shares of the Company's Common Stock were granted by the Incentive Compensation Committee to three officers of the Company at a weighted average exercise price of \$1.09 per share. On January 21 2004, incentive stock options to purchase 601,000 shares of the Company's common stock were granted by the Incentive Compensation Committee of the Board of Directors to one officer and 18 employees of the Company at a weighted average exercise price of \$0.50 per share. On September 12, 2004, incentive stock options to purchase 500,000 shares of the Company's common stock were granted by the Incentive Compensation Committee of the Board of Directors to an officer of the Company at an exercise price of \$0.28 per share. On April 30, 2003 (435,000), November 4, 2003 (220,000), November 21, 2003 (100,000), January 21, 2004 (295,500) and September 12, 2004 (900,000), non-qualified stock options to purchase an aggregate

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1,950,500 shares of the Company's Common Stock were granted by the Board of Directors to certain independent contractors of the Company. On June 10, 2004 an officer and an employee of a subsidiary of the Company relinquished all their rights to an aggregate of 420,000 incentive stock options in consideration of \$50,000 cash. No options granted have been exercised.

[4] Research and development expenditures:

Research and development expenditures in connection with the development of new products are expensed as incurred unless the costs are related to a contractual arrangement.

[5] Recent accounting pronouncements:

In January 2003, the FASB issued FASB Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities." In general, a variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. In December 2003 the FASB issued FIN46R which revised certain elements of FIN46. The consolidation requirements of FIN 46R apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after December 15, 2003. Certain of the disclosure requirements apply in all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established. The adoption of this statement has had no effect on the Company's financial position or results of operations.

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" ("SFAS No. 149"). SFAS No. 149 amends and clarifies

CNE GROUP, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities". This Statement requires that contracts with comparable characteristics be accounted for consistently as either derivatives or hybrid instruments. This Statement is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. The adoption of this statement has had no effect on the Company's financial statements.

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In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." SFAS No. 150 changes the accounting for certain financial instruments that under previous guidance issuers could account for as equity. It requires that those instruments be classified as liabilities in balance sheets. The guidance in SFAS No. 150 is generally effective for all financial instruments entered into or modified after May 31, 2003, and otherwise is effective on July 1, 2003. The adoption of this statement has had no effect on the Company's financial statements.

NOTE C - CONVERSION OF 8% SUBORDINATED NOTES PAYABLE

On June 10, 2004, the two holders of the Company's 8% Subordinated Notes Payable, in the aggregate principal amount of \$1,000,000, converted their notes into 1,000,000 shares of the Company's Series AA 8% Cumulative Preferred Stock, par value \$0.00001 per share (the "Series AA Preferred Stock"). The aggregate liquidating value of the Series AA Preferred Stock acquired by the converting noteholders, one of whom is an officer and the other an employee of a subsidiary of the Company, is \$1,000,000. Including the aforementioned conversion, the Company currently has issued and outstanding an aggregate of 2,000,000 shares of Series AA Preferred Stock, which has a liquidating preference of \$2,000,000 over all other equity of the Company.

NOTE D - PREFERRED STOCK

Preferred Stock consists of the following:

| | September 30, 2004 | December 31, 2003 |
|--|-----------------------|----------------------|
| | ----- | ----- |
| Par value per share | \$ 0.00001 | \$ 0.00001 |
| | ===== | ===== |
| Authorized number of shares | 25,000,000 | 25,000,000 |
| | ===== | ===== |
| Issued and outstanding number of shares: | | |
| Series AA | 2,000,000 | 1,000,000 |
| Series A | 1,697,966 | 1,697,966 |
| Series B | 4,400 | 4,400 |
| Series C | 9,735,875 | 9,735,875 |
| | ----- | ----- |
| Total | 13,438,241 | 12,438,241 |
| | ===== | ===== |

The Series AA Preferred Stock has an 8% cumulative dividend, payable in common stock or cash, and a liquidating preference over all other CNE equity of \$2,000,000. The Series A Preferred Stock has a liquidating preference over all other CNE equity except the Series AA of \$1,697,961. The Series B Preferred Stock has a liquidating preference over all other CNE equity except the Series AA and A Preferred Stock of \$440,000. The Series C Preferred Stock has no liquidating preference.

NOTE E - COMMON STOCK

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Common Stock consists of the following:

| | September 30, 2004 | December 31, 2003 |
|---|-----------------------|----------------------|
| | ----- | ----- |
| Par value per share | \$ 0.00001 | \$ 0.00001 |
| | ===== | ===== |
| Authorized number of shares | 40,000,000 | 40,000,000 |
| | ===== | ===== |
| Issued number of shares | 12,029,571 | 10,129,571 |
| Less, Treasury shares | (1,238,656) | (1,238,656) |
| | ----- | ----- |
| Issued and outstanding number of shares | 10,790,915 | 8,890,915 |
| | ===== | ===== |

NOTE F - WARRANTS

Outstanding warrants to acquire common stock of the Company consists of:

| | | | | September 30, 2004 |
|--------------------|--------------------|--------------------|-------------------|-----------------------|
| Type of Warrant | Exercise Date | Expiration Date | Exercise Price | Shares of C |
| | ----- | ----- | ----- | ----- |
| Class A | October 22, 2008 | April 22, 2013 | \$1.00 | 1,697,966 |
| Class B | April 23, 2003 | April 30, 2013 | \$0.50 | -- |
| Class B | April 23, 2003 | April 30, 2013 | \$0.40 | 5,245,200 |
| Class B | March 12, 2004 | April 30, 2013 | \$0.50 | 1,708,900 |
| Class B | July 1, 2004 | April 30, 2013 | \$0.39 | 153,846 |
| Class BB | May 10, 2003 | May 10, 2006 | \$0.50 | 20,000 |
| Class BB | June 10, 2003 | June 10, 2006 | \$0.50 | 20,000 |
| Class BB | July 10, 2003 | July 10, 2006 | \$0.50 | 20,000 |
| Class BB | August 10, 2003 | August 10, 2006 | \$0.50 | 20,000 |
| Class BB | September 10, 2003 | September 10, 2006 | \$0.50 | 20,000 |
| Class BB | October 10, 2003 | October 10, 2006 | \$0.50 | 20,000 |
| Class BB | June 10, 2003 | June 10, 2006 | \$2.50 | 10,000 |
| Class BB | July 10, 2003 | July 10, 2006 | \$3.00 | 10,000 |
| Class BB | August 10, 2003 | August 10, 2006 | \$4.00 | 10,000 |
| Class BB | September 10, 2003 | September 10, 2006 | \$4.50 | 10,000 |
| Class BB | October 10, 2003 | October 10, 2006 | \$5.00 | 10,000 |
| Class BB | January 21, 2004 | February 4, 2009 | \$0.50 | 150,000 |
| Class BB | February 10, 2004 | February 10, 2014 | \$1.00 | 350,000 |
| Class BB | August 29, 2004 | August 29, 2009 | \$1.50 | 25,000 |
| Class BB | August 29, 2004 | August 29, 2009 | \$2.00 | 25,000 |
| Class BB | August 29, 2004 | August 29, 2009 | \$2.50 | 25,000 |
| Class BB | August 29, 2004 | August 29, 2009 | \$3.00 | 25,000 |
| Class BB | August 29, 2004 | August 29, 2009 | \$3.50 | 25,000 |
| Class BB | August 29, 2004 | August 29, 2009 | \$4.00 | 25,000 |
| Class C | October 22, 2008 | April 22, 2013 | \$1.00 | 9,735,875 |
| Class F | January 1, 2004 | December 31, 2009 | \$3.00 | 1,150,000 |
| Class B(1) | Immediate | March 31, 2005 | \$6.00 | 25,000 |
| Class B(1) | Immediate | June 28, 2005 | \$6.00 | 62,500 |
| | | | | ----- |
| | | | | 20,599,287 |
| | | | | ===== |

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- (1) Class B warrants and Units of a subsidiary of the Company are exercisable for the Company's common shares.

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CNE GROUP, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements

NOTE G - ACQUISITIONS AND RELATED UNAUDITED PRO FORMA FINANCIAL INFORMATION

The purchase price of the acquisition of SRC and ECI was allocated to the assets and liabilities acquired, both tangible and intangible based on fair values (as determined by an independent appraiser), with the excess of the purchase price over the fair value of the net assets acquired of \$7,285,894 being recorded as Goodwill. The fair value of the intellectual property rights, amounting to \$1,550,609, acquired in the related financing was also determined by an independent appraiser. Due to these acquisitions and related financing, SRC has acquired intellectual property rights to certain key elements of these products - specifically, certain communication, data entry and telemetry devices.

The Company's consolidated financial statements include the results of operations of SRC from its respective acquisition dates. The following unaudited pro forma information presents a summary of our consolidated results of operations as if the SRC and ECI acquisitions and the related financing had taken place on January 1, 2003 for the three and nine-month periods ended September 30, 2003. The SRC and ECI acquisitions have been recorded in accordance with SFAS No. 141; therefore, no amortization of goodwill or intangible assets without determinable lives related to SRC and ECI is reflected in the prior year amounts. These pro forma results have been prepared for comparative purposes only and do not purport to be indicative of the results of operations which actually would have resulted had the acquisitions occurred on January 1, 2003.

| | Pro forma | |
|-------------------------------|--|---|
| | Three Months Ended September 30, 2003 | Nine Months Ended September 30, 2003 |
| | (Unaudited) | (Unaudited) |
| Revenues | \$ 552,596 | \$ 1,754,529 |
| Expenses | 1,358,841 | 4,053,165 |
| Pro forma net loss | \$ (806,245) | \$ (2,298,636) |
| | ===== | ===== |
| Pro forma net loss per share: | | |
| Basic and diluted | \$ (0.11) | \$ (0.35) |
| | ===== | ===== |

NOTE H - STOCK OPTION PLANS

At September 30, 2004, the Company had a stock-based employee compensation plan - the 2003 Stock Incentive Plan. Two of Company's subsidiaries each had separate stock-based employee compensation plans prior to the acquisition of SRC and ECI. These subsidiaries' plans were contractually terminated by the Company upon the acquisition of SRC and ECI on April 23, 2003. Furthermore, on March 14, 2003, all recipients of options granted pursuant to these terminated plans rescinded all of their interests.

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2003 Stock Incentive Plan

On April 30, 2003, the Board of Directors of the Company approved the 2003 Stock Incentive Plan, which provided, among other matters, for incentive and non-qualified stock options to purchase 3,500,000 shares of the Company's common stock. On November 4, 2003, the 2003 Stock Incentive Plan was amended by the Board of Directors of the Company, ratified by a majority of the stockholders of the Company on December 18, 2003, to increase the number of shares of Common Stock for which the incentive and non-qualified stock options may be granted from 3,500,00 to 5,000,000. On April 16, 2004, the 2003 Stock Incentive Plan was further amended by the Board of Directors of the Company, ratified by

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CNE GROUP, INC. AND SUBSIDIARIES Notes to Consolidated Financial Statements

NOTE H - STOCK OPTION PLANS (CONTINUED)

a majority of the stockholders of the Company on June 18, 2004, to increase the number of shares of Common Stock for which the incentive and non-qualified stock options may be granted from 5,000,00 to 10,000,000. The purpose of the 2003 Stock Incentive Plan is to provide incentives to officers, key employees, directors, independent contractors and agents whose performance will contribute to the long-term success and growth of the Company, to strengthen the ability of the Company to attract and retain officers, key employees, directors, independent contractors and agents of high competence, to increase the identity of interests of such people with those of the Company's stockholders and to help build loyalty to the Company through recognition and the opportunity for stock ownership. The Plan is administered by the Incentive Compensation Committee of the Board.

On April 30, 2003, incentive stock options to purchase 1,987,500 shares of the Company's Common Stock were granted by the Incentive Compensation Committee to five officers (1,800,000) and one employee (187,500) of the Company at a weighted average exercise price of \$1.32 per share. On November 4, 2003, incentive stock options to purchase 950,000 shares of the Company's Common Stock were granted by the Incentive Compensation Committee to three officers of the Company at a weighted average exercise price of \$1.09 per share. On January 21, 2004, incentive stock options to purchase 601,000 shares of the Company's common stock were granted by the Incentive Compensation Committee of the Board of Directors to one officer and 18 employees of the Company at a weighted average exercise price of \$0.50 per share. On September 12, 2004, incentive stock options to purchase 500,000 shares of the Company's common stock were granted by the Incentive Compensation Committee of the Board of Directors to an officer of the Company at an exercise price of \$0.28 per share. On April 30, 2003 (435,000), November 4, 2003 (220,000), November 21, 2003 (100,000), January 21, 2004 (295,500), and September 12, 2004 (900,000) non-qualified stock options to purchase an aggregate 1,950,500 shares of the Company's Common Stock were granted by the Board of Directors to certain independent contractors of the Company. On June 28, 2004 an officer and employee of a subsidiary relinquished all their rights to an aggregate 420,000 vested incentive stock options of the Company for an aggregate payment of \$50,000 cash. No options granted have been exercised.

Stock option activity, for the nine-month period ended September 30, 2004, under the 2003 Stock Incentive Plan is summarized as follows:

Nine-Month Period Ended September 30, 2004

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| | Incentive Shares | Non-Qualified Shares | Weighted Average Exercise Price |
|--|---------------------|-------------------------|------------------------------------|
| Options outstanding at December 31, 2003 | 2,937,500 | 755,000 | \$1.14 |
| Options granted | 1,101,000 | 1,195,500 | \$0.37 |
| Options cancelled | (420,000) | -- | \$0.50 |
| Options outstanding at September 30, 2004 | 3,618,500 | 1,950,500 | \$0.87 |
| Options available at September 30, 2004 | 4,431,000 | | \$0.88 |

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CNE GROUP, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements

NOTE H - STOCK OPTION PLANS (CONTINUED)

The following table presents information relating to stock options outstanding at September 30, 2004 relating to the 2003 Incentive Stock Plan:

| Options Outstanding | | | Options Available | | |
|----------------------------------|-----------|--|--|-----------|--|
| Range of Exercise Price | Shares | Weighted Average Exercise Price | Weighted Average Remaining Life in Years | Shares | Weighted Average Exercise Price |
| \$0.15 - \$3.00 | 5,569,000 | \$.87 | 7.70 | 4,431,000 | \$ 0.88 |

NOTE I - LITIGATION

On August 19, 2004, two of the Company's officers, who are also directors, informed the Company that their employment contracts may have been breached. On August 27, 2004 these officers filed suit against the Company in the United States District Court, Southern District of Florida, alleging that (i) their employment contracts have been breached and (ii) certain future compensation relating thereto to be paid to them amounting up to an aggregate of \$1,003,000 has been accelerated. The Company does not believe that it has committed any breach of these agreements and, accordingly, has not incurred the claims that these officers are alleging. In addition, the Company believes that these officers have committed violations of their employment agreements and have taken other actions that have damaged the Company. The Company has filed a defense to this action and asserted appropriate counterclaims. This litigation is ongoing and no amounts have been accrued as of September 30, 2004 related to this matter. Since the institution of this litigation these two officers have been terminated as officers, directors and employees of the Company's subsidiaries and as officers and employees of the Company, and have been removed as members of the Company's Executive Committee. They currently remain as directors of the

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Company.

On October 5, 2004, an officer of one of the Company's subsidiaries, who is also a former director of the Company, instituted a suit against the subsidiary in the Circuit Court, 17th Judicial Circuit, Broward County, Florida, charging a breach of her employment agreement with the subsidiary and claiming that certain future compensation relating thereto to be paid to her from the subsidiary amounting up to an aggregate of \$274,000 has been accelerated. Since the institution of this litigation this officer has been terminated. The Company does not believe that its subsidiary has committed any breach of this agreement and, accordingly, has not incurred the claims that this officer is alleging. The Company has named this officer as a counterclaim defendant in the litigation pending in federal court referred to in the previous paragraph and has asserted certain claims against her in that action. The subsidiary has filed an answer to this action. This litigation is ongoing and no amounts have been accrued as of September 30, 2004 related to this matter.

NOTE J - DISCONTINUED OPERATIONS

On August 15, 2003 the Company, for a nominal amount, sold all the stock of one of the subsidiaries whose remaining assets and liabilities were transferred to a trust for the benefit of its creditors and recognized a gain amounting to approximately \$533,634.

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CNE GROUP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE K - SUBSEQUENT EVENTS

1. 80% of the holders of the Company's 10% subordinated notes agreed to defer \$20,000 of interest due July 1, 2004 to October 1, 2004. As of October 1, 2004, 75% of the holders of the Company's 10% subordinated notes agreed to further defer \$18,750 of interest from October 1, 2004 to January 1, 2005 in consideration of the Company issuing to them an additional 170,455 Class B Warrants of the Company, each to give the holder thereof the right to purchase a share of common stock at \$0.33 per share. The noteholders include two officers of the Company.
2. As of October 1, 2004, 75% of the holders of the Company's 10% subordinated notes agreed to defer \$18,750 of interest due on such date to January 1, 2005 in consideration of the Company issuing to them 170,455 Class B Warrants of the Company, each to give the holder thereof the right to purchase a share of common stock at \$0.33 per share. The noteholders include two officers of the Company.
3. In October 2004, the Company and USCL entered into a two-year Project Financing Agreement with an institutional lender relating to USCL's anticipated participation in the "Cellular Call Box Upgrade and Maintenance Service" projects for numerous Service Authority for Freeway Emergencies ("SAFE") programs within the state of California. These call box programs operate over 17,000 motorist aid analog call boxes that will require upgrades to digital cellular technology available through USCL. This agreement provides the Company with finished goods and accounts receivable financing of up to \$2,000,000 relating to these potential aforementioned projects. The effective interest rate is approximately 3% per month on the outstanding balance of the amount financed. The finished goods and accounts receivable to be financed, as well as all the other assets of the Company not previously pledged, will secure the borrowings

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under this agreement.

4. On October 1, 2004, 100% of the holders of the Company's 24% Secured Notes issued in July 2004 agreed to defer \$5,786 of interest due on such date to January 1, 2005 in consideration of the Company issuing to them 76,712 Class B Warrants of the Company, each to give the holder thereof the right to purchase a share of common stock at \$0.33 per share. The warrants expire on April 30, 2013.
5. In October and November 2004, the Company issued (i) \$125,000 of its 10% Convertible Subordinated Notes due June 30, 2005 and (ii) 787,500 Class B Warrants of the Company, each to give the holder thereof the right to purchase a share of common stock at \$0.50 per share. The notes were sold to the wife of the Chief Executive Officer of the Company and other accredited investors and are convertible by the holder, at any time, into common stock of the Company at \$0.50 per share. The warrants expire on April 30, 2013. Interest on the notes is payable monthly in arrears.

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

General

CNE Group, Inc. (the "Company," "CNE" or "we") is a holding company whose primary operating subsidiaries are SRC Technologies, Inc. ("SRC") and U.S. Commlink, Ltd. ("USCL"). SRC, also a holding company, is the parent of Connectivity, Inc. ("Connectivity") and SRC-ECI, Inc. ("ECI"). These companies, which we acquired on April 23, 2003, market, manufacture, repair and maintain remote radio and cellular-based emergency response products to a variety of federal, state and local government agencies as well as other vertical markets located throughout the United States. In addition, we engage in the business of e-recruiting through our subsidiary, CareerEngine, Inc. The e-recruiting business does not generate a significant part of our revenue, and is not significant to the operations of the Company.

Acquisition of all of the outstanding stock of SRC and ECI

On April 23, 2003, we issued (i) 899,971 shares of our common stock, (ii) 1,697,966 shares of our non-voting Series A Preferred Stock and an equal number of ten year Class A Warrants, (iii) 4,400 shares of our Series B Preferred Stock, and (iv) 9,735,875 shares of our non-voting Series C Preferred Stock and a like number of ten year Class C Warrants, for 100% ownership of SRC which at that time included USCL, and ECI. On August 19, 2004, we transferred all the stock of USCL to CNE and USCL became a wholly-owned subsidiary of CNE. In addition, ECI's sellers retained certain of ECI's trade receivables aggregating approximately \$100,000. We also acquired a patent related to the operation of ECI's business in exchange for notes aggregating \$2,000,000 bearing 8% interest. The consolidated financial statements include the operating results of SRC and ECI from the date of acquisition. The details of the foregoing transactions are set forth below.

SRC

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On April 23, 2003, we issued to Michael J. and Carol L. Gutowski, the former principal common stockholders of SRC and former executive officers of the Company, an aggregate of 4,867,937 shares of its non-voting Series C Preferred Stock and a like number of ten year Class C Warrants, each to purchase one share of its Common Stock at \$1.00 per share. The Class C Warrants are not exercisable or detachable from the Series C Preferred Stock prior to 66 months after their issuance. Mr. Gutowski is also a current director of the Company.

We issued to the other former common stockholders of SRC, including Larry M. Reid, currently one of the Company's directors and a former executive officer of the Company, an aggregate of 899,971 shares of its Common Stock, 1,697,966 shares of its non-voting Series A Preferred Stock and a like number of ten year non-detachable Class A Warrants, each to purchase one share of its Common

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Stock at \$1.00 per share. The Class A Warrants are not exercisable or detachable from the Series A Preferred Stock prior to 66 months after their issuance.

We issued an aggregate of 4,400 shares of our Series B Preferred Stock to the former holders of the SRC Series B Preferred Stock.

ECI

On April 23, 2003, the Company issued to Thomas Sullivan and Gary Eichsteadt, the former stockholders of ECI and currently, respectively, an executive officer and employee of the Company, an aggregate of 4,867,938 shares of its Series C Preferred Stock and a like number of Class C Warrants. In addition, Messrs. Eichsteadt and Sullivan retained certain of ECI's trade receivables aggregating approximately \$100,000. We also acquired a patent ("ECI Patent) related to the operation of ECI's business from Mr. Eichsteadt for notes in the aggregate principal amount of \$2,000,000, bearing interest at the annual rate of 8%, payable quarterly, and due on October 31, 2008. The notes were secured by a certain Pledge Agreement. Mr. Sullivan remained an executive officer ECI. On July 31, 2003, we transferred all the stock of ECI to SRC and ECI became a wholly-owned subsidiary of SRC.

On May 19, 2003, Mr. Eichsteadt assigned \$1,500,000 of the aforementioned 8% notes equally to Mr. Sullivan, Mr. Gutowski and Mrs. Gutowski. On August 31, 2003, Mr. and Mrs. Gutowski converted their notes aggregating \$1,000,000 into 1,000,000 shares of the Company's Series AA Preferred Stock. On June 28, 2004, Messrs. Sullivan and Eichsteadt converted their notes aggregating \$1,000,000 into 1,000,000 shares of the Company's Series AA Preferred Stock.

The Series AA Preferred Stock has an 8% cumulative dividend, payable in common stock or cash, and a liquidating preference over all other CNE equity of \$2,000,000. The Series A Preferred Stock has a liquidating preference over all other CNE equity except the Series AA of \$1,697,961. The Series B Preferred Stock has a liquidating preference over all other CNE equity except the Series AA and A

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Preferred Stock of \$440,000. The Series C Preferred Stock has no liquidating preference.

The total consideration, including acquisition costs, was allocated based on the estimated fair values of the net assets acquired on the acquisition date.

| | ECI | SRC | Total |
|-----------------|--------------|--------------|--------------|
| | ----- | ----- | ----- |
| Tangible assets | \$ 588,492 | \$ 292,979 | \$ 881,471 |
| Patents | 1,379,789 | 170,820 | 1,550,609 |
| Goodwill | 2,766,233 | 4,519,661 | 7,285,894 |
| Liabilities | (2,144,771) | (857,033) | (3,001,804) |
| | ----- | ----- | ----- |
| Net asset value | \$ 2,589,743 | \$ 4,126,427 | \$ 6,716,170 |
| | ===== | ===== | ===== |

There were no relationships between us or any of our affiliates and any of the

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sellers of the assets we acquired prior to the acquisition transactions.

Catastrophe of September 11, 2001

Our headquarters were located at Suite 2112 of Two World Trade Center in New York City. The catastrophe of September 11, 2001 involved no injury to any of our employees. However, with the complete destruction of the building, all of our leasehold improvements, furniture and fixtures, and office and computer equipment located at this site were also destroyed. Since the attack through the date of the acquisitions and financing set forth above, our management had been preoccupied with the relocation and reestablishment of our businesses, assessing and processing of insurance claims with the assistance of a risk manager with our insurers, and seeking sources of financing. The Company received insurance proceeds in amounts that have exceeded the net carrying value of the destroyed assets. We also had insurance coverage for other than assets destroyed. In 2003, we received all outstanding insurance claims relating to the catastrophe.

In addition, we applied for governmental assistance grants related to the catastrophe. In 2002 and 2003 we received grants aggregating \$300,000. The grants have a restriction that could require their repayment, specifically if we were to relocate a substantial portion our operations outside of New York City before May 1, 2005. Until such time as this restriction no longer applies, we will classify the grants as a liability of the Company. We will remove the liability and record grant income on our financial statements when these restrictions lapse or are satisfied or, alternatively, repay such grants if the above condition is not satisfied.

Critical Accounting Policies and Estimates

The preparation of financial statements in accordance with U.S.

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generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of net revenue and expenses during the reporting period. On an ongoing basis, we evaluate our estimates, including those related to our allowance for doubtful accounts, inventory reserves, goodwill and purchased intangible asset valuations, and asset impairments. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies, among others, affect the significant judgments and estimates we use in the preparation of our consolidated financial statements:

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Revenue Recognition

We recognize product revenue when persuasive evidence of an arrangement exists, the sales price is fixed, the service is performed or products are shipped to customers, which is when title and risk of loss transfers to the customers, and collectibility is reasonably assured.

Allowance for Doubtful Accounts

We evaluate the collectibility of our accounts receivable based on a combination of factors. In circumstances where we are aware of a specific customer's inability to meet its financial obligations to us, we record a specific allowance to reduce the net receivable to the amount we reasonably believe will be collected. For all other customers, we record allowances for doubtful accounts based on the length of time the receivables are past due, the prevailing business environment and our historical experience. If the financial condition of our customers were to deteriorate or if economic conditions were to worsen, additional allowances may be required in the future.

At September 30, 2004 our allowance for doubtful accounts was \$64,707 or 29.7% of gross receivables, compared to \$51,500 or 19.8% of gross receivables as of December 31, 2003. The increase in the reserve as a percentage of gross receivable from prior period is the result of a decrease in accounts receivable.

Inventory Valuation

At each balance sheet date, we evaluate our ending inventories for excess quantities and obsolescence. This evaluation includes analyses of sales levels by product and projections of future demand. If inventories on hand are in excess of forecasted demand, we provide appropriate reserves for such excess inventory. If we have previously recorded the value of such inventory determined to be in excess of projected demand, or if we determine that inventory

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is obsolete, we write off these inventories in the period the determination is made. Remaining inventory balances are adjusted to approximate the lower of our cost or market value. If future demand or market conditions are less favorable than our projects, additional inventory write-downs may be required, and would be reflected in cost of revenues in the period the revision is made.

Valuation of Goodwill, Purchased Intangible Assets and

----- Long-Lived Assets -----

We perform goodwill impairment tests on an annual basis and on an interim basis if an event or circumstance indicates that it is more likely than not that impairment has occurred. We assess the impairment of other amortizable intangible assets and long-lived assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important that could trigger an impairment review include significant

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underperformance to historical or projected operating results, substantial changes in our business strategy and significant negative industry or economic trends. If such indicators are present, we evaluate the fair value of the goodwill. For other intangible assets and long-lived assets we determine whether the sum of the estimated undiscounted cash flows attributable to the assets in question is less than their carrying value. If less, we recognize an impairment loss based on the excess of the carrying amount of the assets over their respective fair values. Fair value of goodwill is determined by using a valuation model based on market capitalization. Fair value of other intangible assets and long-lived assets is determined by future cash flows, appraisals or other methods. If the long-lived asset determined to be impaired is to be held and used, we recognize an impairment charge to the extent the anticipated net cash flows attributable to the asset are less than the asset's carrying value. The fair value of the long-lived asset then becomes the asset's new carrying value, which we depreciate over the remaining estimated useful life of the asset.

Recent Accounting Pronouncements

In January 2003, the FASB issued FASB Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities." In general, a variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. The consolidation requirements of FIN 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after December 15, 2003. Certain of the

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disclosure requirements apply in all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established. The adoption of this statement has had no effect on the Company's financial position or results of operations.

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" ("SFAS No. 149"). SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. This Statement requires that contracts with comparable characteristics be accounted for consistently as either derivatives or hybrid instruments. This Statement is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. The adoption of this statement has had no effect on our financial statements.

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In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." SFAS No. 150 changes the accounting for certain financial instruments that under previous guidance issuers could account for as equity. It requires that those instruments be classified as liabilities in balance sheets. The guidance in SFAS No. 150 is generally effective for all financial instruments entered into or modified after May 31, 2003, and otherwise is effective on July 1, 2003. The adoption of this statement has had no effect on our financial statements.

A. Results of Operations:

Three-Month Period Ended September 30, 2004 Compared to the

Three-Month Period Ended September 30, 2003

Revenues

Total revenues increased to \$642,995 for the three-month period ended September 30, 2004 from \$552,596 for the three-month period ended September 30, 2003 due to an increase in the dollar amount of the awarded contracts to USCL and SRC and its subsidiaries.

Product sales income increased to \$385,711 for the three-month period ended September 30, 2004 from \$268,591 for the three-month period ended September 30, 2003 due to an increase in the dollar amount of the awarded contracts to USCL and SRC and its subsidiaries.

Service fee income decreased to \$215,364 for the three-month period ended September 30, 2004 from \$244,413 for the three-month period ended September 30, 2003 due to the loss of certain maintenance contracts by ECI.

Internet related income increased to \$41,920 for the three-month period ended September 30, 2004 from \$39,592 for the three-month

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period ended September 30, 2003 as the operations of our subsidiary, CareerEngine, Inc. have appeared to stabilized although we have relatively small operations within the e-recruiting industry.

Cost of Goods Sold

Costs of goods sold, which relates to product sales and related service fee income increased for the three-month period ended September 30, 2004 (\$300,574) as compared to the three-month period ended September 30, 2003 (\$294,863) due to the increase in related revenues.

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Other Expenses

Total other expenses decreased to \$677,492 for the three-month period ended September 30, 2004 from \$805,908 for the three-month period ended September 30, 2003 as certain cost reduction initiatives were instituted in the three-month period ended September 31, 2004 that were not instituted in the three month period ended September 30, 2003.

Advertising expenses modestly decreased to \$5,909 for the three-month period ended September 30, 2004 from \$6,591 for the three-month period ended September 30, 2003 as we decreased our attendance at industry trade shows. These expenditures relate to the acquired operations of USCL and SRC and its subsidiaries.

Compensation and related costs decreased to \$207,324 for the three-month period ended September 30, 2004 from \$387,467 for the three-month period ended September 30, 2003 as we instituted certain payroll reduction initiatives in 2004 and certain payroll related accruals were reversed as they were deemed unnecessary due to the termination of certain officers in September, 2004.

General and administrative expenses decreased to \$322,507 for the three-month period ended September 30, 2004 from \$341,657 for the three-month period ended September 30, 2003 due to the decreased use of professional services in the operations of the Company.

Product development expenses increased to \$92,904 for the three-month period ended September 30, 2004 from nil for the three-month period ended September 30, 2003 due to certain initiatives commenced by USCL and SRC and its subsidiaries to develop products to meet our customers' future requirements.

Depreciation and amortization expenses decreased to \$48,848 for the three-month period ended September 30, 2004 from \$70,193 for the three-month period ended September 30, 2003, due to the net effect of the depreciation and amortization expense relating to the relatively long-life fixed assets and intellectual property rights associated with the acquisition of SRC and its subsidiaries in the three-month period ended September 30, 2004, and the depreciation of certain short-life assets of the Company that remained in the three-month period ended September 30, 2003.

Other Items

Amortization of debt discount decreased to \$24,963 for the

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three-month period ended September 30, 2004 from \$175,750 for the three-month period ended September 30, 2003 due to the change in the monthly rate of amortization of the debt discount (\$699,000) related to the 10% subordinated notes issued on April 23, 2003 from \$58,250 to \$8,321. The change in the amortization rate was caused

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by the extension of the maturity date of the notes from April 30, 2004 to April 30, 2005.

Interest expense increased to \$110,757 for the three-month period ended September 30, 2004 from \$82,320 for the three-month period ended September 30, 2003 due primarily to the use, by SRC and its subsidiaries of accounts receivable financing commonly referred to as factoring. Factoring when utilized has a annual interest rate in excess of 36%.

Tax Settlement adjustment of \$895,622 relates to the 2003 accepted and paid Offer in Compromise with the Internal Revenue Service (\$50,000) pertaining to a \$945,000 tax liability of a subsidiary of the Company.

Operating Loss

On a pre-tax basis, we had a loss from continuing operations of \$470,514 for the three-month period ended September 30, 2004 compared with income from continuing operations of \$89,377 for the three-month period ended September 30, 2003. This change is due to the effect of the tax settlement adjustment in 2003 offset by start-up expenses associated with the acquisition of SRC Technologies, Inc. and its subsidiaries and the related private financings in 2003.

Our loss from continuing operations for the three-month period ended September 30, 2004 was \$470,514 compared with income from continuing operations of \$89,377 for the three-month period ended September 30, 2003. This change is due to the effect of the tax settlement adjustment in 2003 offset by start-up expenses associated with the acquisition of SRC Technologies, Inc. and its subsidiaries and the related private financings in 2003. For the three-month period ended September 30, 2004, loss per common share from continuing operations, basic and diluted, was \$.04 per share. For the three-month period ended September 30, 2003, income per common share from continuing operations, basic and diluted, was \$.01 per share.

Our income from discontinued operations for the three-month period ended September 30, 2004 was nil compared with income of \$533,634 from discontinued operations for the three-month period ended September 30, 2003 due to a gain on the sale of a subsidiary of the Company. For the three-month period ended September 30, 2003, income per common share from discontinued operations, basic and diluted, was \$.07 per share.

Our net loss for the three-month period ended September 30, 2004 was \$470,514 compared with net income of \$623,011 for the three-month period ended September 30, 2003. For the three-month period ended September 30, 2004, net loss per common share, basic and diluted, was \$.04 per share. For the three-month period ended September 30, 2003, net income per common share, basic and diluted, was \$.08 per

share.

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Nine-Month Period Ended September 30, 2004 Compared to the

Nine-Month Period Ended September 30, 2003

Revenues

Total revenues increased to \$2,176,255 for the nine-month period ended September 30, 2004 from \$1,157,066 for the nine-month period ended September 30, 2003 as we had nine months of activity and an increase in the dollar amount of contracts awarded to USCL and SRC and its subsidiaries in the nine months ended September 30, 2004 compared to only five months of activity of USCL and SRC and its subsidiaries in the nine months ended September 30, 2003.

Product sales income increased to \$1,279,111 for the nine-month period ended September 30, 2004 from \$624,684 for the nine-month period ended September 30, 2003 as we had nine months of activity of USCL and SRC and its subsidiaries in the nine months ended September 30, 2004 compared to only five months of activity of USCL and SRC and its subsidiaries in the nine months ended September 30, 2003.

Service fee income increased to \$798,017 for the nine-month period ended September 30, 2004 from \$412,932 for the nine-month period ended September 30, 2003 as we had nine months of activity of USCL and SRC and its subsidiaries in the nine months ended September 30, 2004 compared to only five months of activity of USCL and SRC and its subsidiaries in the nine months ended September 30, 2003.

Internet related income decreased to \$99,127 for the nine-month period ended September 30, 2004 from \$119,450 for the nine-month period ended September 30, 2003 as the operations of our subsidiary, CareerEngine, Inc. have continued to decline due to our relatively small size in the e-recruiting industry.

Cost of Goods Sold

Costs of goods sold, which relates to product sales and related service fee income increased to \$1,085,889 for the nine-month period ended September 30, 2004 from \$573,216 for the nine-month period ended September 30, 2003 as we had nine months of activity of SRC and its subsidiaries in the nine months ended September 30, 2004 compared to only five months of activity of SRC and its subsidiaries in the six months ended September 30, 2003.

Other Expenses

Total other expenses increased to \$2,333,276 for the nine-month period ended September 30, 2004 from \$1,688,225 for the nine-month period ended September 30, 2003 as we had nine months of activity of USCL and SRC and its subsidiaries in the nine months ended September 30, 2004 compared to only five months of activity of USCL and SRC and its subsidiaries in the nine months ended September 30, 2003.

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Advertising expenses increased to \$42,837 for the nine-month period ended September 30, 2004 from \$23,682 for the nine-month period ended September 30, 2003 as we had nine months of activity of USCL and SRC and its subsidiaries in the nine months ended September 30, 2004 compared to only five months of activity of USCL and SRC and its subsidiaries in the nine months ended June 30, 2003.

Compensation and related costs increased to \$1,028,916 for the nine-month period ended September 30, 2004 from \$791,402 for the nine-month period ended September 30, 2003 as we had nine months of activity of USCL and SRC and its subsidiaries in the nine months ended September 30, 2004 compared to only five months of activity of USCL and SRC and its subsidiaries in the nine months ended September 30, 2003.

General and administrative expenses increased to \$985,806 for the nine-month period ended September 30, 2004 from \$779,678 for the nine-month period ended September 30, 2003 due to the costs associated with the acquisition and related operations of USCL and SRC and its subsidiaries, and the professional fees associated the significantly increased operations of the Company.

Product development expenses increased to \$130,513 for the nine-month period ended September 30, 2004 from nil for the nine-month period ended September 30, 2003 due to certain initiatives commenced by USCL and SRC and its subsidiaries to develop products to meet our customers' future requirements.

Depreciation and amortization expenses increased to \$145,204 for the nine-month period ended September 30, 2004 from \$93,463 for the nine-month period ended September 30, 2003, due to the net effect of the depreciation and amortization expense relating to the relatively long-life fixed assets and intellectual property rights associated with the acquisition of USCL and SRC and its subsidiaries in the nine-month period ended September 30, 2004, and the depreciation of certain short-life assets of the Company that remained in the nine-month period ended September 30, 2003.

Other Items

Amortization of debt discount decreased to \$174,747 for the nine-month period ended September 30, 2004 from \$292,250 for the nine-month period ended September 30, 2003 due the combined effect of (i) an increase in the amortization period to nine months in the nine-month period ended September 30, 2004 from five months in the nine-month period ended September 30, 2003 as the notes were issued in late April 2003, and (ii) the decrease in the rate of amortization in the nine-month period ended September 30, 2004 as compared to the rate of amortization utilized in the nine-month period ended September 30, 2003 when the notes were extended for an additional year in March 2004 .

Interest expense decreased to \$278,099 for the nine-month period ended September 30, 2004 from \$319,163 for the nine-month period ended September 30, 2003 due primarily to the combined effect of the issuance of the Company's 10% and 8% subordinated notes in April

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2003, the cessation of interest expense on a subsidiary's 12% Debentures Payable and Tax Assessment Payable in July and August 2003, and the conversion of \$1,000,000 of 8% Promissory Notes to preferred stock in July, 2003.

Tax Settlement adjustment of \$895,622 relates to the accepted and paid Offer in Compromise with the Internal Revenue Service (\$50,000) pertaining to a \$945,000 tax liability of a subsidiary of the Company.

Operating Loss

On a pre-tax basis, we had a loss from continuing operations of \$1,695,180 for the nine-month period ended September 30, 2004 compared with a loss from continuing operations of \$820,166 for the nine-month period ended September 30, 2003. This change is due to the effect of the tax settlement adjustment in 2003 offset by start-up expenses associated with the acquisition of SRC Technologies, Inc. and its subsidiaries and the related private financings in 2003.

Our loss from continuing operations for the nine-month period ended September 30, 2004 was \$1,695,180 compared with our loss from continuing operations of \$820,166 for the nine-month period ended September 30, 2003. This change is due to the effect of the tax settlement adjustment in 2003 offset by start-up expenses associated with the acquisition of SRC Technologies, Inc. and its subsidiaries and the related private financings in 2003. For the nine-month period ended September 30, 2004, loss per common share from continuing operations, basic and diluted, was \$.16 per share. For the nine-month period ended September 30, 2003, loss per common share from continuing operations, basic and diluted, was \$.12 per share.

Our income from discontinued operations for the nine-month period ended September 30, 2004 was nil compared with income of \$533,634 from discontinued operations for the nine-month period ended September 30, 2003 due to a gain on the sale of a subsidiary of the Company. For the nine-month period ended September 30, 2003, income per common share from discontinued operations, basic and diluted, was \$.08 per share.

Our net loss for the nine-month period ended September 30, 2004 was \$1,695,180 compared with our net loss of \$286,532 for the nine-month period ended September 30, 2003. For the nine-month period ended September 30, 2004, net loss per common share, basic and diluted, was \$.16 per share. For the nine-month period ended September 30, 2003, our net loss per common share, basic and diluted, was \$.04 per share.

B. Liquidity and Capital Resources

The Company has incurred substantial losses, sustained substantial cash outflows from operating activities and had a working capital deficit at September 30, 2004 and December 31, 2003. The above factors raise substantial doubt about the Company's ability to continue as a going concern. The Company's continued existence

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depends on its ability to obtain additional equity and/or debt financing to fund its operations, financial obligations as they become due, and ultimately to achieve profitable operations. The Company is continuously in the process of raising additional financing and has initiated a cost reduction strategy. At September 30, 2004 and December 31, 2003, management believed that the working capital deficit, losses and negative cash flow will ultimately be improved by (i) the acquisition and increased operations of SRC and ECI, (ii) cost reduction strategies initiated in January and June 2004, and (iii) additional equity and debt financing activities in addition to those set forth in the financial statements. On January 2, 2004, the Company received a notice dated December 31, 2003 from the American Stock Exchange indicating that the Company had demonstrated compliance with the requirement for continued listing on the Exchange. As is the case for all listed issuers, the Company's continued listing eligibility will be assessed on an ongoing basis; however, during the year ending December 31, 2004, the Company will be subject to additional scrutiny (as set forth in Section 1009(h) of the AMEX Company Guide) as is the case for any listed company that has regained compliance. There is no assurance that the Company can obtain additional financing or achieve profitable operations or generate positive cash flow.

Off-Balance Sheet Arrangements

At September 30, 2004 and December 31, 2003, the Company had no off-balance sheet arrangements.

Operating Activities

We utilized \$1,021,523 of cash in operating activities during the nine-month period ended September 30, 2004. We had a net loss of 1,695,180 during this period, which included an aggregate of \$383,158 of non-cash items, including depreciation and amortization, amortization of debt discount, allowance for doubtful accounts and a charge for the issuance of common stock of the Company for services. In addition to the impact of non-cash items, our operating activities for the nine-month period ended September 30, 2004 also reflected an increase in inventory and accounts payable, accrued expenses and other liabilities, and a decrease in accounts receivable and other assets.

We utilized \$1,114,894 of cash in operating activities during the nine-month period ended September 30, 2003. We had a net loss of \$286,532 during this period which included depreciation and amortization, non-cash items, amounting to \$93,463. In addition to the impact of non-cash items, our operating activities for the nine-month period ended September 30, 2003 also reflected an increase in deferred grant revenue and a decrease in accounts receivable, inventory, prepaid expenses, and accounts payable, accrued expenses and other liabilities.

On January 21, 2004, we took several initiatives to address our operating cash deficiency, which included, but were not limited to, the reduction and/or elimination of certain executive salaries, waiving of certain interest payments due officers and/or directors,

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waiving of certain accounts receivable due an officer and employee, and the reduction of certain administrative costs. In addition, we raised (a) gross proceeds of \$700,000 (net cash proceeds of \$571,000) in February 2004 from the sale of our common stock (see "Financing Activities" below), (b) restructured (i) certain short-term credit arrangements into a \$300,000 Note payable due in February 2005 (see Note A to our Consolidated Financial Statements) and (ii) a certain line of credit into a \$150,000 secured note payable, (c) raised \$150,000 through the issuance of our 25% Secured Notes in July and August 2004, and (d) raised \$150,000 through the issuance of our 10% Convertible Subordinated Notes and related Class C warrants in October 2004.

Financing Activities

On April 23, 2003, we issued \$1,000,000 in principal amount of our 10% Subordinated Notes due April 30, 2004 to investors for a 15% non-dilutive interest in the Company in the form of 4,165,800 cashless Class B Warrants, each to purchase one share of Common Stock at \$0.50 per share. We had the option to extend the maturity date of the notes to April 30, 2005 in consideration for issuing the noteholders an additional 4% non-dilutive interest in the Company. The notes also require prepayment in an amount equal to 100% of any net financing proceeds obtained by us after the issuance of the notes. The noteholders waived this provision to the extent of \$2,000,000 through April 15, 2004, of which \$1,200,000 was raised. The investors included two of our officers. Interest is payable, in arrears, calendar quarterly. We valued the Warrants, utilizing the Black-Scholes Pricing Model, at \$699,000, which is being accounted for as debt discount and is being amortized ratably over the initial one-year term of the Notes.

On March 12, 2004, we notified the Class B Warrant holders that, to satisfy the 15% non-dilutive provisions of their Warrants, these Warrants were now exercisable for an aggregate of 5,245,200 shares of our common stock at approximately \$0.40 per share. On this date, we also exercised our option to extend the maturity date of the notes to April 30, 2005 and satisfied the requirement for the additional 4% non-dilutive interest in the Company by issuing to the noteholders Class B Warrants to purchase an additional 1,708,900 shares of our common stock at \$0.50 per share. The non-dilutive provisions of the Warrants terminate when all of the notes have been paid in full.

In addition, on September 17, 2003, we sold 1,250,000 shares of our common stock at \$0.40 per share to an existing noteholder and stockholder of the Company.

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On February 10, 2004, the Company sold 1,750,000 shares of our common stock at \$0.40 per share in consideration of \$700,000 cash (net cash proceeds of \$571,000).

In June 2004, in an effort to conserve the financial resources of the Company, the Board of Directors of the Company deferred 100% of the salaries of four officers of the Company until such time as the Board deems otherwise. In September 2004, three of the aforementioned officers were terminated by the Company.

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On June 28, 2004 the Company repaid, in full, one of its outstanding lines of credit amounting to approximately \$146,000. On the same date the Company issued a secured note payable to an officer and employee of a subsidiary of the Company in the amount of \$150,000. The note is secured by the equipment of a subsidiary of the Company. The note bears interest at 10% per annum and the principal and all interest thereon is due September 28, 2004. The Company is currently negotiating new terms with regard to this note.

As of July 1, 2004, 80% of the holders of the Company's 10% subordinated notes agreed to defer \$20,000 of interest due on such date to October 1, 2004 in consideration of the Company issuing to them 153,846 Class B Warrants of the Company, each to give the holder thereof the right to purchase a share of common stock at \$0.39 per share. As of October 1, 2004, 75% of the holders of the Company's 10% subordinated notes agreed to defer \$18,750 of interest deferred to October 1, 2004 to January 1, 2005 in consideration of the Company issuing to them an additional 170,455 Class B Warrants of the Company, each to give the holder thereof the right to purchase a share of common stock at \$0.33 per share. The noteholders include two officers of the Company.

In July and August 2004, the Company issued \$150,000 of its 24% Secured Notes due April 30, 2005 to the wife of the Chief Executive Officer and an existing 10% subordinated noteholder of the Company. Interest on the notes is payable quarterly in arrears. The notes are secured by (i) all the stock of SRC and USCL, and (ii) the pledge of Patent Nos. 6,060,979, 6,047,173 and 5,701,338 -all owned by the Company. On October 1, 2004, 100% of the holders of the Company's 24% Secured Notes agreed to defer \$5,786 of interest due on such date to January 1, 2005 in consideration of the Company issuing to them 76,712 Class B Warrants of the Company, each to give the holder thereof the right to purchase a share of common stock at \$0.33 per share.

As of October 1, 2004, 75% of the holders of the Company's 10% subordinated notes agreed to defer \$18,750 of interest due on such date to January 1, 2005 in consideration of the Company issuing to them 170,455 Class B Warrants of the Company, each to give the holder thereof the right to purchase a share of common stock at \$0.33 per share. The noteholders include two officers of the Company.

In October 2004, the Company and USCL entered into a two-year Project Financing Agreement with an institutional lender relating to USCL's anticipated participation in the "Cellular Call Box Upgrade and Maintenance Service"

projects for numerous Service Authority for Freeway Emergencies ("SAFE") programs within the state of California. These call box programs operate over 17,000 motorist aid analog call boxes that will require upgrades to digital cellular technology available through USCL. This agreement provides the Company with finished goods and accounts receivable financing of up to \$2,000,000 relating to these potential aforementioned projects. The effective interest rate is approximately 3% per month on the outstanding balance of the amount financed. The finished goods and accounts receivable to be

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financed, as well as all the other assets of the Company not previously pledged, will secure the borrowings under this agreement.

In October and November 2004, the Company issued (i) \$125,000 of its 10% Convertible Subordinated Notes due June 30, 2005 and (ii) 787,500 Class C Warrants of the Company, each to give the holder thereof the right to purchase a share of common stock at \$0.50 per share. The notes were sold to the wife of the Chief Executive Officer of the Company and other accredited investors and are convertible by the holder, at any time, into common stock of the Company at \$0.50 per share. The warrants expire on April 30, 2013. Interest on the notes is payable monthly in arrears.

We are using the funds obtained from these financings to pay certain ECI notes payable and for working capital. The financings were effected pursuant to the exemption from the registration provisions of the Securities Act of 1993 provided by Section 4(2) thereof.

We did not have any material commitments for capital expenditures as of September 30, 2004.

C. Inflation

Due to the nature of our business, inflation does not significantly impact the Company's operations.

Item 3. Controls and Procedures

The Chief Executive Officer and Chief Financial Officer of the Company have conducted an evaluation of the effectiveness of disclosure controls and procedures pursuant to Rule 13a-14 of the Exchange Act. Based on that evaluation, they have concluded that the Company's disclosure controls and procedures are effective in ensuring that all material information required to be filed in this Quarterly Report on Form 10-QSB has been made known to them in a timely fashion. There have been no significant changes in internal controls, or in other factors that could significantly affect internal controls, subsequent to the date they completed their evaluation.

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PART II

OTHER INFORMATION

Item 1. Legal Proceedings.

The Company is a party to various vendor related litigations. Based on the opinion of management and legal counsel, the Company has accrued an estimated liability of approximately \$100,000.

On August 19, 2004, Michael J. Gutowski, then the Company's President and Chief Operating Officer and a director, and Larry M. Reid, then the Company's Executive Vice President and a director, informed the Company that their employment contracts may have been breached. On August 27, 2004, Messrs. Gutowski and Reid filed suit against the Company in the United States District Court, Southern District of Florida, alleging that (i) their employment contracts

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have been breached and (ii) certain future compensation relating thereto to be paid to them amounting up to an aggregate of \$1,003,000 has been accelerated. The name of the case is Michael J. Gutowski and Larry M. Reid v. CNE Group, Inc., Case Number 04-61125.

The Company does not believe that it has committed any breach of these agreements and, accordingly, has not incurred the claims that these officers are alleging. In addition, the Company believes that Messrs. Gutowski and Reid have committed violations of their employment agreements and have taken other actions that have damaged the Company. The Company has filed a defense to this action and asserted appropriate counterclaims. This litigation is ongoing and no amounts have been accrued as of September 30, 2004 related to this matter. Since the institution of this litigation Messrs. Gutowski and Reid have been terminated as officers, directors and employees of the Company's subsidiaries and as officers and employees of the Company, and have been removed as members of the Company's Executive Committee. They currently remain as directors of the Company.

On October 5, 2004, Carol L. Gutowski, then an officer of one of the Company's subsidiaries and a former director of the Company, instituted a suit against the subsidiary in the Circuit Court, 17th Judicial Circuit, Broward County, Florida, charging a breach of her employment agreement with the subsidiary and claiming that certain future compensation relating thereto to be paid to her from the subsidiary amounting up to an aggregate of \$274,000 has been accelerated. Since the institution of this litigation Ms. Gutowski has been terminated as an officer and director of the subsidiary. The Company does not believe that its subsidiary has committed any breach of this agreement and, accordingly, has not incurred the claims that Ms. Gutowski is alleging. The Company has named Ms. Gutowski as a counterclaim defendant in the litigation pending in federal court referred to above and has asserted certain claims against her in that action. The subsidiary has filed an answer to this action. This litigation is ongoing and no amounts have been accrued as of September 30, 2004 related to this matter.

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Item 5. Other Information.

On April 28, 2004, the Company's Board of Directors approved the Company's Code of Business Conduct and Ethics for the Directors, Officers and Employees of CNE Group, Inc. (the "Code"). The Company has posted the Code on its corporate website: www.cnegroupinc.com.

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

(a) Exhibits:

- 31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 from the Company's Chief Executive Officer
- 31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 from the Company's Chief Financial Officer

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- 32.1 Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

A statement regarding the computation of per share earnings is omitted because the computation is described in Note B of the Notes to Consolidated Financial Statements (Unaudited) in this Form 10-QSB.

(b) Reports on Form 8-K:

The Company filed a report on Form 8-K on February 10, 2004 and two reports on Form 8-K on June 14, 2004, a report on Form 8-K on July 9, 2004 and a report on Form 8-K on September 13, 2004.

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SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CNE GROUP, INC.

Date: November 22, 2004

/s/ George W. Benoit

George W. Benoit, Chairman of the Board
of Directors, and Chief Executive
Officer

Date: November 22, 2004

/s/ Anthony S. Conigliaro

Anthony S. Conigliaro, Vice President and
Chief Financial Officer

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