ION NETWORKS INC
Form 10KSB
March 30, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-KSB

|X| ANNUAL REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2003

|_| TRANSITION REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM ___________________ .

COMMISSION FILE NO.: 0-13117

ION NETWORKS, INC.
(Name of Small Business Issuer in Its Charter)

DELAWARE	22-2413505
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification Number)

120 CORPORATE BLVD., S. PLAINFIELD, NJ 07080
(Address of Principal Executive Offices) (Zip Code)

(908) 546-3900
(Issuer's telephone number, including area code)

SECURITIES REGISTERED UNDER SECTION 12(B) OF THE EXCHANGE ACT:

Title of Each Class	Name of Each Exchange On Which Registered
NONE	NONE

SECURITIES REGISTERED UNDER SECTION 12(G) OF THE EXCHANGE ACT:

COMMON STOCK, $.001 PAR VALUE
(Title of Class)

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 |X| No |_|

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B is not contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. |_|

The issuer's revenues for its most recent twelve-month ended December 31, 2003 totaled $ 3,342,620

The aggregate market value of voting stock held by non-affiliates, based on the closing price of the Common Stock, par value $0.001 (the "Common Stock") on March 25, 2004 of $0.11, as reported on the OTC Bulletin Board was approximately $2,237,760.14. Shares of Common Stock held by each officer and director and by each person who owns 5% or more of the outstanding Common Stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for any other purpose.

There were 24,875,500 shares of Common Stock outstanding as of March 15, 2004.

DOCUMENTS INCORPORATED BY REFERENCE: NONE

TRANSITIONAL SMALL BUSINESS DISCLOSURE FORMAT (CHECK ONE):

Yes |_| No |X|

Information Regarding Forward-Looking Statements

A number of statements contained in this report are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that involve risks and uncertainties that could cause actual results to differ materially from those expressed or implied in the applicable statements. These statements include, but are not limited to, statements regarding the Company's ability to gain further market recognition and the Company's cost reduction efforts. These risks and uncertainties include, but are not limited to, uncertainty as to the acceptance of the Company's products; risks related to technological factors; potential manufacturing difficulties; uncertainty of product development; uncertainty of obtaining or maintaining adequate financing; dependence on third parties; dependence on key personnel and changes in the Company's sales force and management; the risks associated with the expansion of the Company's sales channels; competition; a limited customer base; risk of system failure, security risks and liability risks; risk of requirements to comply with government regulations; vulnerability to rapid industry change and technological obsolescence; and general economic conditions. In some cases, you can identify forward-looking statements by our use of words such as "may," "will," "should," "could," "expects," "plans," "intends," "anticipates," "believes," "estimates," "predicts," "potential," or "continue" or the negative or other variations of these words, or other comparable words or phrases. Unless otherwise required by applicable securities laws, the Company assumes no obligation to update any such forward-looking statements, or to update the reasons why actual results could differ from those projected in the forward-looking statements.

PART I

Item 1: Description of Business

Overview

ION Networks, Inc ("ION" or the "Company") designs, develops, manufactures and sells network and information security and management products to corporations, service providers and government agencies. The Company's hardware and software products are designed to form a secure auditable portal to protect

IT and network infrastructure from internal and external security threats. ION's network and information security solution operates in the IP, data center, telecommunications and transport, and telephony environments and is sold by a direct sales force and indirect channel partners mainly throughout North America and Europe.

As organizations become more interconnected and dependent on networks such as the Internet, they are increasingly being exposed to a widening range of cyber-threats. These attacks occur despite the wide spread deployment of information security technologies, suggesting that it is not sufficient to only protect the electronic perimeter of an organization. With the most damaging security breaches increasingly appearing within the boundaries of organizations, network and information security has become one of the newest components of electronic security strategies. Network and information security focuses on protecting the critical infrastructure devices that support the transfer, storage, and processing of business applications and information. Network and information security also provides a method by which the tools used to manage these devices, and the administrators who keep these devices running smoothly, are protected against the threat of attack from the outside.

The ION Secure /TM/ product suite provides ION customers with secure access, authentication, authorization, audit and administrative functions that we believe form a highly scalable, robust, reliable, easy-to-use and cost-effective comprehensive network and information security solution. ION Secure solutions include ION Secure PRIISMS centralized management software; 2000, 3000 and 5000 Series security appliances and ION Secure Soft Tokens. These solutions are based on ION proprietary software and hardware developed and maintained by the Company. ION network and information security solutions use the same single-purpose embedded ION Secure Operating System (ISOS) software on all security appliance models, with the goal of simplifying the management of thousands of IT and telecommunications infrastructure devices such as servers, routers, LAN switches, PBXs, messaging systems and multiplexers. ION solutions are designed to enable administrators to securely configure, troubleshoot and manage geographically dispersed infrastructure devices from central operations centers, reducing costly on-site visits, service disruptions and skilled personnel requirements. ION network and information security solutions can be used in a variety of networks including TCP/IP-data, PBX-telephony, telecommunications and data centers ranging in size from one to thousands of infrastructure devices. ION solutions are designed to be fully compatible with information security solutions offered by, among others, Cisco, Check Point and Nortel Networks.

In addition to hardware/software products the Company offers an array of repair and maintenance programs. Services revenue is typically generated from integration and maintenance services in conjunction with the sale of ION solutions.

ION's network and information security solutions are distributed via three distinct channels: (i) a direct sales force, (ii) indirect channels, such as Value Added Resellers (VARs) and (iii) Original Equipment Manufacturers (OEMs). In addition to these distribution channels, the Company further segments its markets to (i) enterprises, (ii) service providers, and (iii) governmental agencies. Each market segment has unique characteristics and provides significant opportunities to grow the Company's business in the future.

ION Networks, Inc. is a Delaware corporation founded in 1999 through the combination of two companies, MicroFrame, Inc. (originally founded in 1982), a

New Jersey corporation and SolCom Systems Limited (originally founded in 1994), a Scottish corporation located in Livingston, Scotland. In 1999, the Company expanded its technology base through the purchase of certain assets of LeeMAH DataCom Security Corporation. References in this document to "we," "our," "us," and "the Company" refer to ION Networks, Inc. Our principal executive offices are located at 120 Corporate Blvd. South Plainfield, New Jersey 07080, and our telephone number is (908) 546-3900.

Industry Background

Pervasive Use of Corporate Security to Protect Employees and Business Assets

ION believes that a key factor to the long-term success and competitive advantage of any business is its ability to protect its people and assets from all types of security threats. Many businesses have implemented some type of corporate security strategy that physically protects employees and business assets from outsiders who may seek to harm individuals, steal proprietary information, or disrupt the operations of an organization.

Wide Acceptance of Information Security to Protect Business Applications and Information

As organizations become more interconnected and dependent on networks such as the Internet, they are increasingly being exposed to a widening range of cyber-threats -- threats that we believe transcend the need for physical access in order to cause damage to a business. To counter potential cyber-threats, organizations are seeking to secure corporate user access, business applications and information with information security strategies designed to protect the electronic doorways into an organization. Increasingly, businesses are deploying information security solutions that protect against outsiders -- people such as hackers without any legitimate access -- through the use of security tokens for user authentication, intrusion detection systems to identify attackers and firewalls to restrict remote access to corporate networks and systems.

Growing Impact of Insider Security Threats

While outsider threats present a significant challenge to organizations, the Computer Security Institute and the Federal Bureau of Investigation have reported that outsiders account for fewer than half of the reported information security incidents in the United States, although the number of such incidents continues to rise. These reports estimated the average cost of a successful attack by outsiders to be $56,000. By contrast, the average cost of a malicious act by insiders was estimated to be $2.7 million. Interestingly, these attacks occurred despite the wide spread deployment of firewalls, intrusion detection systems and anti-virus software, suggesting that simply protecting the electronic perimeter of an organization has not slowed the pace of real losses from security threats.

Increasing Need to Protect the "Electronic Interior" of Businesses -- Network and Information Security

We continue to believe that there is a growing trend of outsourcing IT professionals for services that are not core to a business, thereby creating an ever-changing climate where organizations know less and less about the backgrounds and intentions of their IT administrators. Therefore, organizations are increasingly exposed to potentially significant financial and productivity losses unless the most empowered users with access to administrative functions are adequately restricted and monitored. Information security strategies cannot be effective unless administrative services are protected through the implementation of infrastructure security strategies that safeguard infrastructure devices such as servers, routers, LAN switches, PBXs, messaging systems and multiplexers.

We believe that many of today's most damaging security threats are appearing within the boundaries of organizations, forcing organizations to extend their security protection inward from the perimeter. Network Information Security, focuses on protecting the critical infrastructure devices that support the transfer, storage, and processing of business applications and information.

The ION Networks Solution

The ION network and information security solution consists of ION Secure PRIISMS software and ION Secure 2000, 3000 and 5000 series appliances for centralized security policy management and distributed security policy enforcement. Together, the PRIISMS single sign-on portal and the security appliances form a secure management system to critical infrastructure devices. ION solutions also provide a variety of management features for improving administrator productivity and mediating alarms from these infrastructure devices. ION Secure 2000, 3000 and 5000 series security appliances also support management of discrete alarms for the physical environment surrounding infrastructure devices such as doors, lighting, air conditioners or diesel generators and monitoring environmental conditions including temperature, humidity, fire and water conditions.

The ION Secure Product Suite is Intended to Provide our Customers with the following Key Benefits:

A Complete Network and information security Solution. We believe ION offers one of the most complete, commercially available solutions in our industry for securely managing infrastructure devices. We have taken a broad approach to network and information security and developed a product suite that protects administrative interfaces with one unified solution by providing secure:

o Access -- ION solutions are designed so that administrators can only gain access to infrastructure devices through the network connectivity provided by ION Secure PRIISMS software and ION Secure 2000, 3000 and 5000 series security appliances that together form a secure and auditable environment. PRIISMS provides a single point of entry into the environment for administrators utilizing Secure Shell (SSH), Point-to-Point Tunneling Protocol (PPTP) and Telnet. Access to PRIISMS is only granted based on strong multi-factor authentication of administrators. PRIISMS servers are typically collocated in Network Operations Centers along with enterprise management and operational support systems. ION Secure 2000, 3000 and/or 5000 series security appliances are deployed throughout an organization's network to protect against unauthorized access to infrastructure devices. ION Secure PRIISMS software and ION Secure 2000, 3000 and 5000 series security appliances provide infrastructure access protection by forcing all administrative traffic through a secure management network using one or both of the following methods: (i) `Inband' meaning TCP/IP based Virtual Private Networks (IP-VPNs) with dynamic firewall capabilities and encrypted IPSec tunnels and (ii) `Out-of-band' meaning via Virtual Private Dial-up Networks (VPDNs) or over public switched telephone networks.

o Authentication -- ION network and information security solutions combine strong multi-factor authentication with "single sign-on" to the secure management environment. Administrative sessions require the use of ION Soft Tokens that use two-factor authentication. PRIISMS provides a single sign-on portal for all administrative applications. Single sign-on means that administrators need only log into PRIISMS once to easily gain secure access to the infrastructure devices they are tasked with managing. ION 2000, 3000 and 5000 series security appliances support the same strong authentication mechanisms as PRIISMS. Whether connecting in or out-of-band, multi-factor authentication is required for administrators to communicate with every ION security appliance. Private key management services are integrated into ION network and information security solutions in order to ease deployment of PRIISMS and security appliances.

- Authorization -- ION network and information security solutions provide extensive security policy management capabilities for controlling administrator actions. Policies are centrally managed via ION Secure PRIISMS software at the user or group level with distributed policy enforcement handled by the 2000, 3000 and 5000 Series security appliances. ION Secure PRIISMS multi-level authorization restricts administrator access to specific infrastructure devices, as well as prohibits the issuing of specific commands. Multi-level authorization services are intended to provide tight control over the specific commands that can be issued by administrators via command filtering.

- Audit -- ION Secure PRIISMS software and 2000, 3000 and 5000 series security appliances are designed to maintain detailed audit trails on administrator activities, infrastructure devices and security appliance health. ION security appliances maintain extensive logs on administrative sessions including administrator authentication success, failure and connection histories. The entire history of each administrative session can be captured down to the characters entered by an administrator. Command filters can be utilized to restrict which commands an administrator may enter to control an infrastructure device. ION security appliance logs are protected from tampering and can maintain the history of administrative sessions.

- Administration -- ION Secure PRIISMS software provides directory services for assigning authentication methods and privileges to users and groups and the logical partitioning of authorized infrastructure device views. Once authenticated into PRIISMS, administrators can only see and manage assigned infrastructure devices. In addition, centralized management of ION security appliances via PRIISMS simplifies the installation, configuration and upgrade of the ION Secure Operating System (ISOS) on remote ION security appliances. The ION Secure 2000, 3000 and 5000 Series appliances provide a wide range of site management services such as alarm mediation, remote diagnostics, and task automation. In addition, messages from non-standard managed infrastructure devices can be converted to Simple Network Management Protocol (SNMP) traps and sent to PRIISMS for centralized viewing and forwarding to third party enterprise management and operational support systems. Network and port-level diagnostic utilities can also be used by administrators to remotely troubleshoot infrastructure devices. The automation of administrative tasks can be implemented both in PRIISMS and ION Secure appliances. Action triggers can be set for automating common tasks such as event notification via SNMP trap, pager or e-mail, the power recycling of infrastructure devices, or the uploading of logs from ION security appliances. ION security appliances also provide a native scripting (computer programming) language and task scheduler that can run these scripts based on an alarm, date or time for custom automation requirements.

Low Total Cost of Ownership. The ION solution is designed to minimize the purchase, installation and maintenance costs of Network Information Security. The list prices for our network and information security appliances currently begin at $1,250 and scale up with products and features that address a wide array of customer requirements. Many studies have shown that the complex systems integration of multiple security products is a significant component of the total cost of implementing security solutions. We believe that our cost-effective, integrated solution, consisting of easy-to-manage security appliances and management software, enables customers to avoid the expense of costly systems integration that may otherwise be required to implement and maintain an effective network and information security solution.

Rapid Return on Investment. ION solutions help protect against the growing threat of security breaches that can result in among other losses, significant financial losses and legal liabilities, lost productivity, poor network availability, brand defamation, and theft of proprietary information. ION solutions enable customers to centrally perform administrative functions that otherwise may require a dispatch of an administrator to a remote location. Fewer service calls reduce the need for having costly technical personnel on staff.

Ease of Installation and Use. The ION Secure product family delivers `plug-and-protect' appliances designed for easy installation and use. Installation involves simply connecting an ION security appliance to the network, and providing nothing more than a network address. Appliances can be remotely configured through ION PRIISMS centralized management software, including software upgrades and configuration of new software features.

ION Networks Products and Services

ION Networks provides a complete network and information security solution that includes secure access, authentication, authorization, audit and administration functions that form a secure management environment for managing infrastructure devices. The ION Secure network and information security solution is based on centralized security policy management and distributed security policy enforcement. It consists of centralized ION Secure PRIISMS software and distributed ION Secure 2000, 3000 and 5000 series security appliances forming a secure management network. We also provide training, consulting and support services to our customers and distribution partners.

ION Secure PRIISMS Management Portal.

Through its web-based user interface, PRIISMS provides connectivity to a wide-range of managed endpoints from a plethora of vendors and platforms. This scalable portal application enables authenticated administrators to configure, troubleshoot and manage geographically dispersed critical infrastructure devices from central operations centers within a secure environment. PRIISMS also provides centralized, 24x7 surveillance and provisioning across the entire suite of ION Secure 2000, 3000 and 5000 security appliances.

Key features include:

- Single Sign-on: Additional security is often thought of as an incremental step or process that ensures the validity of a user or process. PRIISMS however simplifies this process by requiring only a single authentication procedure to take place before presenting the user with a list of endpoints he or she is authorized to access. Username, password and authentication procedures are handled by PRIISMS. Administrators can securely log into PRIISMS once instead of logging into each individual appliance, expediting any urgent operations.

- Multi-factor Authentication: Utilize a number of security measures to protect infrastructure devices, including the ability to lock out a specific administrator across the network in seconds. This feature requires the use of ION Secure tokens or commercially available RADIUS token technology.

- Multi-level Authorization: Use flexible security policies to define and enforce strict control over administrators' actions when accessing infrastructure devices. Users can be restricted to only certain types or geographical location of managed endpoints. Further restrictions can be defined such as allowable commands/operations.

- Active and Passive auditing: Real-time monitoring of user operations can alert security staff in the event of suspicious activity. All operations are stored in tamper-proof files and available for post-breach forensic analysis

- Centralized Alarm Notification and Logging: Simultaneously view alarms and events within PRIISMS for ION security appliances and managed endpoints.

- Centralized Provisioning and Job Scheduling: Centrally manage the scheduling of jobs for managing configuration files and software updates to ION appliances.

- Automatic Backups: Automatically back up configuration files for all ION security appliances on the network to the PRIISMS server.

- Real-time Inventory and Status: Track system health to ensure that ION security appliances and infrastructure devices are running properly 24 x 7.

ION Secure 2000 Series. The ION Secure 2500 security appliance combines access, console, and alarm functions into a single centrally manageable solution. With support for up to 2 physical `console' ports and up to 2 logical IP endpoints, the 2000 series is targeted at small, remote branch office locations with need for secure remote management.

ION Secure 3000 Series. The ION Secure 3100, 3200, 3300 and 3500 security appliances combine access, console, alarm and site management functions into a single centrally manageable solution. With support for up to 28 physical `console' ports and up to 32 logical IP endpoints, the 3000 series protects user access and control for a wide variety of infrastructure devices requiring in-band and out-of-band access.

ION Secure 5000 Series. The ION Secure 5010 and 5500 supports the same ISOS features as the 3000 series, providing support for up to 28 console ports and 64 IP enabled endpoints. With a LINUX core and integrated VPN router capabilities, the 5000 Series appliances are able to securely carry administrative traffic through an intranet or a public network via IPSec tunnel. The 5000 Series is specifically targeted at higher-end data center, server farm and IP-rich environments.

ION Secure Soft Tokens. ION Secure soft tokens are simple to use. Each user may be assigned a `disposable' ION Secure Soft Token via email or web which can be loaded onto a Windows(R), RIM(R) Blackberry(TM) or PalmOS(R) device. Each time the user requests connectivity to PRIISMS they are challenged to enter additional criteria generated by the token that will positively identify them to the portal. ION Secure soft tokens utilize strong 3DES encryption and can be quickly activated and deactivated through PRIISMS. Employees, business partners and customers can use ION Secure tokens whether local, remote or mobile.

Wide Range of Protected Infrastructure Devices

ION network and information security solutions protect a growing variety of infrastructure devices provided by leading IT and telecommunications network and system vendors, including vendors of:

- Access Servers
- Application Servers
- Bus & Tag Channel Extenders
- Call Management Systems
- Carrier Grade Multi-Service Switches
- Cellular Switches
- CSU/DSUs
- Databases
- Integrated Access Devices
- LAN Switches
- Mail Servers
- Messaging Servers
- Multi-Service Switches
- Optical Switches
- PBXs (Switched & IP)
- Power Protection Systems (UPS)
- Routers
- SONET Switches
- SS7 Switches
- DSLAMs
- Storage Area Networks
- Terminal Servers
- Various Types of PC Class Servers
- Various Types of UNIX Class Server
- Wireless Switches

Strategy

Our goal is to extend our market position to remain one of the industry leaders for network and information security solutions for service providers, corporations and government agencies. Key elements of our strategy include:

Extend Our Market Position in Network Infomation Security. We believe that we are establishing a growing market position as a provider of network and information security solutions designed for our target markets by offering an integrated, robust, reliable, easy-to-use suite of products at attractive prices. We intend to continue to focus our product development efforts, distribution strategies and marketing programs to satisfy the growing needs of these markets. We believe that many of the current network and information security offerings of other vendors are expensive, incomplete, technically complex and generally unable to satisfy these target markets.

Develop New Products and Reduce Manufacturing Costs. We intend to use our product design and development expertise to expand our product offerings and reduce our manufacturing costs. We believe that new product offerings and associated cost reductions will strengthen our market position and assist us in penetrating new markets.

Establish the ION Networks Brand. We believe that strong brand recognition in our target markets is important to our long-term success. We intend to continue to strengthen our ION Networks TM and ION SecureTM brand names through industry trade shows, our web site, advertising, direct mailings to both our resellers and our end-users, and public relations. The continued development of our reputation as a comprehensive, reliable, easy-to-use and cost effective network and information security vendor will contribute to our sales efforts.

Expand Our Direct Channel. We intend to continue to build and expand our base of direct relationships with customers through additional marketing programs and increased targeted advertising.

Expand Our Indirect Channels. Our distribution channels are currently in place to serve ION target markets. The Company's products have been implemented in over 50 countries by partnering with value-added resellers who sell our solutions. We intend to continue to build and expand our base of indirect channel relationships through additional marketing programs and targeted advertising.

Expand Strategic Original Equipment Manufacturer Relationships. By entering into original equipment manufacturer ("OEM") arrangements to sell our products, we intend to build upon the brand awareness and worldwide channels of major networking and telecommunications equipment suppliers to further penetrate our target markets.

Customers

During the year ended December 31,2003, 84 customers generated $3,342,620 in revenue from hardware, software, repairs and maintenance. Historically, our largest customers have been service providers primarily in the United States and in Europe. See also Risk Factors, "We rely on several key customers for a significant portion of our business, the loss of which would likely significantly decrease our revenues" on page 13. However, over the last year we have begun to diversify away from our traditional customer base. ION has begun to penetrate the corporate market and, in particular, the financial services sector.

ION customers can be categorized based on three market segments: Enterprises, Service Providers and Governmental Agencies:

Enterprises. The Enterprise market consists of non-governmental organizations that do not provide goods or services from a network infrastructure, but rather use their network infrastructure as a platform to provide their own goods or services. There are many sectors in the enterprise market, including, but not limited to, banking, financial services, insurance, energy, manufacturing, retailers, pharmaceuticals, healthcare, technology and transportation.

Service Providers. The service provider market consists of businesses that use their network infrastructure to provide services to their customers, including specific sectors such as (i) transport service providers that provide voice, data, and long-distance transport of telephone and data services, including ILECs, CLECs, long-distance carriers, cable telephony, and optical network providers; (ii) managed service providers that provide network infrastructure, managed services, and managed network services, including Internet Data Centers, ISPs and ASPs; (iii) broadband service providers that provide wire line-based broadband services to residential and business customers. Broadband services include DSL, CATV, cable modems, VoD (Voice over Data) and VoIP (Voice over IP) services; and (iv) wireless service providers that provide wireless voice and data services. This includes mobile/cellular, wireless data, satellite, and wireless LAN services.

Governmental Agencies. The Government market consists of domestic and foreign governmental agencies that do not provide services from a network infrastructure, but rather use their network infrastructure as a platform to provide their own goods and services. There are many sectors in the government market, including, but not limited to, federal and national agencies, military, state agencies, local agencies, police departments, fire departments, and emergency services.

Sales and Marketing

Our marketing programs promote ION Networks and ION Secure brand awareness and reputation as a highly scalable, robust, reliable, easy-to-use and cost-effective network and information security solution. During the year ended December 31, 2003, the Company did not have the resources to adequately strengthen our brand. ION attempted to repair damaged relationships by direct executive communications with customers. The relative effectiveness of this customer retention program should be demonstrated by improved operating results in 2004. We intend to expand and strengthen our direct and indirect channel relationships through additional marketing programs and staff, as well as increased promotional activities as resources become available.

We believe that ION solutions are suited for both direct sale to customers and indirect channels where it is not economically efficient for us to sell directly to the end users of our products.

Direct Sales. On December 31, 2003, the Company's sales and marketing headcount stood at 5. For the year ended December 31, 2003, approximately 37% of ION revenue came from direct sales.

Indirect Sales/Channel Partners. We also market and sell our solutions via indirect channels through a distribution structure of Value Added Resellers (VARs) or Channel Partners in the United States and in Europe. VARs accounted for approximately 32% of our total revenue for the year ended December 31, 2003. Our VAR partnerships are non-exclusive.

Original Equipment Manufacturers (OEMs). We enter into select original equipment manufacturer relationships in order to take advantage of the channels of well-established companies that sell into our target markets. We believe these channels expand our overall market while having a minor impact on our own indirect channel sales. The terms of our agreements with these customers vary by contract. These agreements can generally be terminated upon 30 days written notice or if ION becomes insolvent. For the year ended December 31, 2003, our original equipment manufacturer revenue accounted for approximately 31% of total revenue.

Geographic Distribution. We divide our sales organization regionally into three territories: (1) the United States and Canada; (2) Europe, the Middle East and Africa, and (3) other locations. Regional sales representatives manage our relationships with our network of channel partners, sell to and support key customer accounts, and act as a liaison between our indirect channels and our marketing organization.

For the year ended December 31, 2003, approximately 82% of ION's sales were in the United States and Canada (Direct Sales -approximately 35%, Indirect/Channel Partners -approximately 23%, and OEM - approximately 24%) and 18% Europe, the Middle East, Africa and other locations (Direct Sales -approximately 1.3%, Indirect/Channel Partners -approximately 8.9%, and OEM - approximately 7.8%). (Refer to Note 12 in the Company's Consolidated Financial Statements.)

Customer Service and Technical Support

We offer our customers a comprehensive range of support services under the ION SecureCare brand that includes electronic support, product maintenance and personalized technical support services on a worldwide basis. Our technical support staff is located at our corporate headquarters in South Plainfield, New Jersey.

Our ION SecureCare offering includes ION 24x7 support. This support offering provides replacement for failing hardware, telephone and/or web-based technical support and software updates. Incentive programs are offered to ION SecureCare customers to provide added benefits for upgrading to newer products.

Competition

The market for network and information security solutions is worldwide and highly competitive, and competition has begun to intensify. Competitors can be generally categorized as either: (i) information security vendors who provide high performance, security point products, or (ii) suppliers of network management appliances that provide limited infrastructure security features. Many of these solutions require additional security products in order to implement a comprehensive network and information security solution. Current and potential competitors in our markets include, but are not limited to the following companies, all of which sell worldwide or have a presence in most of the major markets for such products:

- Security software vendors such as RSA Security, ActivCard, Check Point Software and Symantec;
- Network equipment manufacturers such as Cisco Systems;
- Operating system software vendors such as Microsoft and Novell;
- Security solution suppliers such as Computer Associates, SafeNet and Network Associates;
- Security appliance suppliers such as SonicWall and NetScreen Technologies; and
- Low cost management-only appliance vendors, which may include limited infrastructure security functionality such as MRV Communications and Teltronics.

Many of our competitors have generally targeted large organizations' information security needs with VPN, firewall and 3A (Authorization, Authentication and Audit) products that range in price from under one thousand to hundreds of thousands of dollars. These offerings may increase competitive pressure on some of our solutions, resulting in both lower prices and gross margins. Many of our current or potential competitors have longer operating histories, greater name recognition, larger customer bases and significantly greater financial, technical, marketing and other resources than we do. Nothing prevents or hinders these actual or potential competitors from entering our target markets at any time. In addition, our competitors may bundle products competitive to ours with other products that they may sell to our current or potential customers. These customers may accept these bundled products rather than separately purchasing our products. If these companies were to use their greater financial, technical and marketing resources in our target markets, it could adversely affect our business. See also Risk Factors, " We face significant competition and if we do not compete successfully, our results of operations may be adversely affected" on page 12.

Sources And Availability Of Materials

The Company designs its security appliances utilizing readily available parts manufactured by multiple suppliers and relies on and intends to continue to rely on these suppliers. Our principal suppliers are Youngtron, Inc., TDK Systems Europe Ltd., and EXP Computer, Inc. The Company has been and expects to continue to be able to obtain the parts required to manufacture its products without any significant interruption or sudden price increase, although there can be no assurance that it will be able to continue to do so.

The Company sometimes utilizes a component available from only one supplier. If a supplier were to cease to supply this component, the Company would most likely have to redesign a feature of the affected device. In these situations, the Company maintains a greater supply of the component on hand in order to allow the time necessary to effect a redesign or alternative course of action should the need arise.

Dependence On Particular Customers

Historically, the Company has been dependent on several large customers each year, but they are not necessarily the same every year. In general, the Company cannot predict with certainty, which large customers will continue to order our products. The loss of any of these large customers, or the failure to attract new large customers, could have a material adverse effect on the Company's business.

Intellectual Property, Licenses And Labor Contracts

The Company holds no patents on its technology. Although it licenses some of its technology from third parties, the Company does not consider any of these licenses to be critical to its operation.

The Company has made a consistent effort to minimize the ability of competitors to duplicate the software technology utilized in its solutions. However, the possibility of duplication of its products remains, and competing products have already been introduced.

Governmental Approvals And Effect Of Governmental Regulation

The Company's solutions may be exported to any country in the world except those countries restricted by the anti-terrorism controls imposed by the Department of Commerce. These anti-terrorism controls prohibit the Company from exporting some of its solutions to Cuba, Libya, Iran, Iraq, North Korea, Sudan and Syria without a license. As with all U.S. origin items, the Company's solutions are also subject to the Bureau of Export Administration's ten general prohibitions that restrict exports to certain countries, organizations, and persons.

As required by law or demanded by customer contract, the Company obtains approval of its solutions by Underwriters' Laboratories. Additionally, because many of the products interface with telecommunications networks, the Company's products are subject to several key Federal Communications Commission ("FCC") rules requiring FCC approval.

Part 68 of the FCC rules contains the majority of the technical requirements with which telephone systems must comply in order to qualify for FCC registration for interconnection to the public telephone network. Part 68 registration requires telecommunication equipment interfacing with the public telephone network to comply with certain interference parameters and other technical specifications. FCC Part 68 registration for ION's products has been granted, and the Company intends to apply for FCC Part 68 registration for all of its new and future products.

Part 15 of the FCC rules requires equipment classified as containing a Class A computing device to meet certain radio and television interference requirements, especially as they relate to operation of such equipment in a residential area. Certain of ION's products are subject to and comply with Part 15.

The European Community has developed a similar set of requirements for its members and the Company has begun the compliance process for its products in Europe. Additionally, ION has certified certain of its products to the NEBS (Network Equipment Business Specification) level of certification. This is a certification that was developed by Bellcore (now Telcordia Technologies) and is required by many of ION's telecommunications customers.

Research And Development Activities

As of March 15, 2004, the Company had 5 R&D staff members devoting part of their time to research and development activities. We believe the part time effort of these employees will be minimally sufficient to allow the Company to keep up with technology advances for the foreseeable future. However, the Company intends to increase staff during 2004, as resources become available, in order to more rapidly introduce new and improved products.

The current R&D staff was primarily responsible for the successful completion and release of the most recent ION Secure 2500 and 5500 security appliances, ISOS software releases and enhancing ION Secure PRIISMS functionality. These products provide ION Networks with the ability to address a more diverse computing and IP based network market due to its ability to provide connectivity across secure IP tunnels by utilizing integrated VPN router technology.

Employees

As of March 15, 2004, the Company had 21 employees, 19 are full-time employees and 2 are part-time employees. The headcount includes 6 technical, 7 sales, marketing and support, 3 production, and 5 financial, administrative and executive capacities. None of the Company's employees are represented by labor unions. The Company considers it has generally satisfactory relations with its employees.

RISK FACTORS

We are vulnerable to technological changes, which may cause our products and services to become obsolete which could materially and negatively impact our cash flow.

Our industry experiences rapid technological changes, changing customer requirements, frequent new product introductions and evolving industry standards that may render existing products and services obsolete. As a result, more advanced products produced by competitors could erode our position in existing markets or other markets that they choose to enter and prevent us from expanding into existing markets or other markets. It is difficult to estimate the life cycles of our products and services, and future success will depend, in part, upon our ability to enhance existing products and services and to develop new products and services on a timely basis. We might experience difficulties that could delay or prevent the successful development, introduction and marketing of new products and services. New products and services and enhancements might not meet the requirements of the marketplace and achieve market acceptance. If these things happen, they would materially and negatively affect cash flow, financial condition and the results of operations.

Hardware and software incorporated in our products may experience bugs or "errors" which could delay the commercial introduction of our products and require time and money to alleviate.

Due to the complex and sophisticated hardware and software that is incorporated in our products, our products have in the past experienced errors or "bugs" both during development and subsequent to commercial introduction. We cannot be certain that all potential problems will be identified, that any bugs that are located can be corrected on a timely basis or at all, or that additional errors will not be located in existing or future products at a later time or when usage increases. Any such errors could delay the commercial introduction of new products, the use of existing or new products, or require modifications in systems that have already been installed. Remedying such errors could be costly and time consuming. Delays in debugging or modifying products could materially and adversely affect our competitive position.

We have difficulty predicting our future operating results or profitability due to the fluctuation in our quarterly and annual revenues.

In the past, we experienced fluctuations in our quarterly and annual revenues and we anticipate that such fluctuations will continue therefore making it difficult for us to predict our future operating results or profitability. Our quarterly and annual operating results may vary significantly depending on a number of factors, including:

o the timing of the introduction or acceptance of new products and services;

o changes in the mix of products and services provided;

o long sales cycles;

o changes in regulations affecting our business;

o increases in the amount of research and development expenditures necessary for new product development and innovation;

o changes in our operating expenses;

o uneven revenue streams;

o volatility in general economic conditions;

o volatility in the network and information security market; and

o threats of terror and war.

We cannot assure you that our revenues will not vary significantly among quarterly periods or that in future quarterly periods our results of operations will not be below prior results or the expectations of public market analysts and investors. If this occurs, the price of our common stock could significantly decrease. See also Risks Associated with Our Securities, "There is potential for fluctuation in the market price of our securities" page 14.

In the past we have experienced significant losses and negative cash flows from operations. If these trends continue in the future, it could adversely affect our financial condition.

We have incurred significant losses and negative cash flows from operations in the past. For the year ended December 31, 2003 and the nine months ended December 31, 2002, we experienced net losses of $603,792 and $5,628,522, respectively, and negative cash flows from operations of $376,940 and $2,972,337, respectively. These results have had a negative impact on our financial condition. There can be no assurance that our business will become profitable in the future and that additional losses and negative cash flows from operations will not be incurred. If these trends continue in the future, it could have a material adverse affect on our financial condition.

As of December 31, 2003, the Company continues to have a relatively low working capital balance, which could inhibit future growth and impact the Company's financial viability.

Although the Company's working capital balance increased to $287,930 at December 31, 2003 as compared to $184,689 as of December 31, 2002 this balance is still lower than the Company's optimal requirements. This low working capital balance while improving, may continue to impact the ability of the Company to attract new customers and employees and could have a material adverse affect upon our business.

We face significant competition and if we do not compete successfully, our results of operations may be adversely affected.

We are subject to significant competition from different sources for our different products and services. We cannot assure you that the market will continue to accept our hardware and software technology or that we will be able to compete successfully in the future. We believe that the main factors affecting competition in the network management business are:

- the products' ability to meet various network management and security requirements;
- the products' ability to conform to the network and/or computer systems;
- the products' ability to avoid becoming technologically outdated;
- the willingness and the ability of distributors to provide support customization, training and installation; and
- the price.

Although we believe that our present products and services are competitive, we compete with a number of large data networking, network security and enterprise management manufacturers which have financial, research and development, marketing and technical resources far greater than ours. Our competitors include, Cisco Systems, Network Associates, Cyclades, Digi, MRV Communications, Teltronics and NetScreen Technologies. Such companies may succeed in producing and distributing competitive products more effectively than we can produce and distribute our products, and may also develop new products which compete effectively with our products. Many of our current or potential competitors have longer operating histories, greater name recognition, larger customer bases and significantly greater financial, technical, marketing and other resources than we do. Nothing prevents or hinders these actual or potential competitors from entering our target markets at any time. In addition, our competitors may bundle products competitive to ours with other products that they may sell to our current or potential customers. These customers may accept these bundled products rather than separately purchasing our products. If our current or potential competitors were to use their greater financial, technical and marketing resources in our target markets and if we are unable to compete successfully, our business, financial condition and results of operations may be materially and adversely affected.

We may be unable to protect our proprietary rights, permitting competitors to duplicate our products and services, which could negatively impact our business and operations.

We hold no patents on any of our technology. If we are unable to license any technology or products that we may need in the future, our business and operations may be materially and adversely impacted. We have made a consistent effort to minimize the ability of competitors to duplicate our software technology utilized in our products. However, there remains the possibility of duplication of our products, and competing products have already been introduced. Any such duplication by our competitors could negatively impact our business and operations.

We rely on several key customers for a significant portion of our business, the loss of which would likely significantly decrease our revenues.

Historically, we have been dependent on several large customers each year, but they are not necessarily the same every year. For the year ended December 31, 2003, our most significant customers (stated as an approximate percentage of revenue) were Avaya 18% and Siemens 12% compared to the nine months ended December 31, 2002, of SBC 13%, Sprint 12%, Avaya 12%, and Siemens 11% In general, we cannot predict with certainty which large customers will continue to order. The loss of any of these large customers, or the failure to attract new large customers would likely significantly decrease our revenues and future prospects, which could materially and adversely affect our business, financial condition and results of operations.

We depend upon key members of our employees and management, the loss of which could have a material adverse effect upon our business, financial condition and results of operations.

Our business is greatly dependent on the efforts of our CEO, Mr. Norman E. Corn, our Chief Financial Officer, Mr. Patrick E. Delaney, and our Chief Technology Officer, Mr. Bill Whitney and other key employees, and on our ability to attract key personnel. Other than with respect to Messrs. N. Corn, P. Delaney, and W. Whitney, we do not have employment agreements with our other key employees. Our success depends in large part on the continued services of our key management, sales, engineering, research and development and operational personnel and on our ability to continue to attract, motivate and retain highly qualified employees and independent contractors in those areas. Competition for such personnel is intense and we cannot assure you that we will successfully attract, motivate and retain key personnel. While all of our employees have entered into non-compete agreements, there can be no assurance that any employee will remain with us. Our inability to hire and retain qualified personnel or the loss of the services of our key personnel could have a material adverse effect upon our business, financial condition and results of operations. Currently, we do not maintain "key man" insurance policies with respect to any of our employees.

We rely on several contract manufacturers to supply our products. If our product manufacturers fail to deliver our products, or if we lose these suppliers, we may be unable to deliver our product and our sales and revenues could be negatively impacted.

We rely on three contract manufacturers to supply our products: Youngtron, Inc., TDK Systems Europe Ltd. and EXP Computer, Inc. If these manufacturers fail to deliver our products or if we lose these suppliers and are unable to replace them, then we would not be able to deliver our products to our customers. This could negatively impact our sales and revenues and have a material adverse affect on our business, financial condition and results of operations.

Our certificate of incorporation and bylaws contain limitations on the liability of our directors and officers, which may discourage suits against directors and executive officers for breaches of fiduciary duties.

Our Certificate of Incorporation, as amended, and our Bylaws contain provisions limiting the liability of our directors for monetary damages to the fullest extent permissible under Delaware law. This is intended to eliminate the personal liability of a director for monetary damages on an action brought by or in our right for breach of a director's duties to us or to our stockholders except in certain limited circumstances. In addition, our Certificate of Incorporation, as amended, and our Bylaws contain provisions requiring us to indemnify our directors, officers, employees and agents serving at our request, against expenses, judgments (including derivative actions), fines and amounts paid in settlement. This indemnification is limited to actions taken in good faith in the reasonable belief that the conduct was lawful and in, or not opposed to our best interests. The Certificate of Incorporation and the Bylaws provide for the indemnification of directors and officers in connection with civil, criminal, administrative or investigative proceedings when acting in their capacities as agents for us. These provisions may reduce the likelihood of derivative litigation against directors and executive officers and may discourage or deter stockholders or management from suing directors or executive officers for breaches of their fiduciary duties, even though such an action, if successful, might otherwise benefit our stockholders and directors and officers.

RISKS ASSOCIATED WITH OUR SECURITIES

We do not anticipate the payment of dividends.

We have never declared or paid cash dividends on our common stock. We currently anticipate that we will retain all available funds for use in the operation of our business. Thus, we do not anticipate paying any cash dividends on our common stock in the foreseeable future.

There is potential for fluctuation in the market price of our securities.

Because of the nature of the industry in which we operate, the market price of our securities has been, and can be expected to continue to be, highly volatile. Factors such as announcements by us or others of technological innovations, new commercial products, regulatory approvals or proprietary rights developments, and competitive developments all may have a significant impact on our future business prospects and market price of our securities.

Shares that are eligible for sale in the future may affect the market price of our common stock.

As of March 15, 2004, an aggregate of 5,423,675 of the outstanding shares of our common stock are "restricted securities" as that term is defined in Rule 144 of the Securities Act of 1933 (Rule 144). These restricted shares may be sold pursuant only to an effective registration statement under the securities laws or in compliance with the exemption provisions of Rule 144 or other securities law provisions. In addition, 4,987,580 shares are issuable pursuant to currently exercisable options, 1,580,500 shares are issuable pursuant to currently exercisable warrants, and 1,668,350 shares are issuable pursuant to currently convertible preferred stock of 166,835 shares. Future sales of substantial amounts of shares in the public market, or the perception that such sales could occur, could negatively affect the price of our common stock.

Our common stock was delisted from Nasdaq.

On March 19, 2003, Nasdaq notified the Company that it has not regained compliance with the minimum bid price requirement. Nasdaq determined that the Company does not meet the initial listing requirements of the Nasdaq Small Cap Market. Consequently, our Common Stock was delisted from the Nasdaq Small Cap Market at the opening of business on March 28, 2003. The delisting of our Common Stock from Nasdaq could negatively effect the prices of our stock, impair the ability of holders to sell such stock, limit the coverage of our stock by research analysts, adversely impact our efforts to secure financing, materially and adversely affect our financial condition and results of operations and will make us ineligible to register additional shares under a Form S-3.

We may be restricted from issuing new equity securities.

In September 2002, we issued shares of Series A Preferred Stock to several investors. Under the terms of the preferred stock, any issuances of equity securities or securities convertible into or exercisable for equity securities require the prior approval of the holders of a majority of the outstanding shares of Series A Preferred Stock. While two of our directors currently own such a majority, there can be no assurance that they will remain directors or that they will continue to own such a majority. If these two directors no longer continue to remain directors, or no longer continue to own a majority of the Series A Preferred Stock, or do not vote their shares of Series A Preferred Stock to permit issuances of securities approved by the board of directors, the Company would be prevented from issuing equity securities which would preclude the Company from raising equity financing, utilizing equity based compensation plans and from other actions requiring the issuance of equity securities.

We may be in default of certain registration rights obligations

In February 2002, we issued a total of 4,000,000 shares and warrants to purchase 1,200,000 shares for a total of $3,480,000 received from various investors. In connection with this financing, we registered such securities for resale on a form S-3 pursuant to a registration rights agreement which obligated us to do so. Since our stock is no longer listed on NASDAQ, we are no longer eligible to use a Form S-3 registration statement and we may be in default under the registration rights agreement. This may render us liable for damages to the holders of the registration rights for losses they may incur as a result of the Company not maintaining an effective registration statement for their securities.

ITEM 2: DESCRIPTION OF PROPERTY

The Company entered into a lease on August 1, 2003 for approximately 7,000 square feet for its principal executive offices at 120 Corporate Blvd., South Plainfield, New Jersey. The base rent is $4,505 per month effective October 2003 through July 2006. The Company is also obligated to make additional payments to the landlord relating to certain taxes and operating expenses.

As a result of the Company being notified by the landlord to cancel its lease effective August 15, 2003, the Company no longer occupies the space at 1551 S. Washington Avenue, Piscataway, New Jersey. The Company entered into the lease on February 18, 1999 for approximately 26,247 square feet for its principal executive offices at 1551 South Washington Avenue, Piscataway, New Jersey. On March 17, 2003, the Company signed an amendment with the landlord reducing the space from 26,247 to 12,722 square feet and the rent from $50,153.64 to $20,143.17 per month effective March 1, 2003. The Company was also obligated to make additional payments to the landlord relating to certain taxes and operating expenses.

The Company abandoned the lease space at SolCom House, Meikle Road, Kirkton Campus, Livingston EH547DE, Scotland. . As a result, the Company recorded a charge of $508,458 in the quarter ended December 31, 2002 for the remainder of the lease term that expires on August 31, 2011.

The Company abandoned the lease space at 48834 Kato Road, Fremont, California in the Bedford Fremont Business Center. This lease commenced on June 1, 1999 and is for a term of 60 months with monthly rent payable by the Company to the landlord as follows: $7,360 per month for the first 12 months of the term; $7,590 per month for months 13-24; $7,820 per month for months 25-36; $8,050 per month for months 37-48; and $8,280 per month for months 49-60. The Company entered into an abandonment agreement with the landlord in March of 2003. As a result, the Company recorded a one-time charge to SG&A expense of $ 139,610 in the quarter ended March 31, 2003. This amount represents the total lease payments from December 2002 to May 2004 offset by landlords stated sub-lease rental payments. However, the Company and Landlord have no settlement agreement in place at this time.

ITEM 3: LEGAL PROCEEDINGS

On or about June 12, 2002, Xetel Corporation ("Xetel") filed a petition (Xetel Corporation vs. ION Networks Inc., Cause No.GN201901 in the 250th District Court of Travis County, Texas) against the Company alleging that the Company owes Xetel $243,070.19 in accounts receivable for finished assemblies shipped to and accepted by the Company and $23,626.02 in purchased materials and inventory being held in Xetel's warehouse pursuant to the Company's written instruction. Xetel sought actual damages in the amount of $266,696.21, plus interest, attorneys' fees and costs, and incidental damages as a result of the Company's alleged breach. The Company successfully negotiated a settlement with Xetel Corporation in the amount of $30,000 and forgiveness of debt for the remaining amount. As a result, the Company recorded a one time credit of $213,071 in the quarter ended September 30, 2003(see note 3).

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

The Company did not hold an annual meeting of the stockholders during the year ended December 31, 2003. The Company plans to hold an annual meeting during the year ending December 31, 2004.

PART II

ITEM 5: MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Market Information

The Company's common stock, par value $.001 per share (the "Common Stock"), is currently quoted on the OTC Bulletin board under the symbol "IONN.OB". The following table sets forth the high ask and low bid prices of the Common Stock for the periods indicated as reported on the NASDAQ National and Small Cap Market.

Year Ended December 31, 2003 Quarter Ending	HIGH	LOW
March 31, 2003	$0.28	$0.05
June 30, 2003	0.11	0.05
September 30, 2003	0.11	0.05
December 31, 2003	0.11	0.04
Year Ended December 31, 2002, Quarter Ending		
March 31, 2002	$1.84	$0.65
June 30, 2002	0.82	0.33
September 30, 2002	0.45	0.15
December 31, 2002	0.47	0.10

Recent Sales of Unregistered Securities

None.

Security Holders

As of February 27, 2004 there were 438 holders of record of the Common Stock

Dividends

The Company has not paid any cash dividends on its Common Stock during the year ended December 31, 2003, and the nine-month ended December 31, 2002. The Company presently intends to retain all earnings to finance its operations and therefore does not presently anticipate paying any cash dividends in the foreseeable future.

ITEM 6: MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

Overview

ION Networks, Inc. (the "Company"), designs, develops, manufactures and sells network and information security and management products to corporations, service providers and government agencies. The Company's hardware and software products are designed to form a secure auditable portal to protect IT and network infrastructure from internal and external security threats. ION's products operate in the IP, data center, telecommunications and transport, and telephony environments and are sold by a direct sales force and indirect channel partners mainly throughout North America and Europe.

The Company is a Delaware corporation founded in 1999 through the combination of two companies - MicroFrame ("MicroFrame"), a New Jersey Corporation (the predecessor entity to the Company, originally founded in 1982), and SolCom Systems Limited ("SolCom"), a Scottish corporation located in Livingston, Scotland (originally founded in 1994), The Company's principal objective was to address the need for security and network management and monitoring solutions, primarily for the PBX-based telecommunications market, resulting in a significant portion of our revenues being generated from sales to various telecommunications companies.

During 2003, the Company stabilized its excessive negative cash flow and in fact increased cash from a low of less than $100,000 at September 30, 2003 to approximately $357,000 at December 31, 2003. The Company continues to have a delicate cash position and while the future viability of the organization has significantly improved, it is necessary for it to continue to strictly manage expenditures and to increase revenues. In addition, it is the intention of the new management team, hired in the quarter ended September 30, 2003, to secure additional financing during 2004 to accelerate growth and insure long-term viability.

Results Of Operations

EXPLANATORY NOTE

ON OCTOBER 25, 2002, ION NETWORKS, INC. CHANGED ITS FISCAL YEAR END FROM MARCH 31 TO DECEMBER 31. AS A RESULT, PURSUANT TO THE RULES OF THE SECURITIES AND EXCHANGE COMMISSION, THIS ANNUAL REPORT ON FORM 10-KSB PRESENTS FINANCIAL INFORMATION FOR THE YEAR ENDED DECEMBER 31, 2003 AS COMPARED TO A PROFORMA YEAR ENDED DECEMBER 31, 2002(UNAUDITED).

The Year Ended December 31, 2003 Compared to the Year Ended December 31, 2002(Unaudited)

Revenues for the year ended December 31, 2003 were $3,342,620 as compared with revenues of $5,411,357 for the year ended December 31, 2002, a decrease of approximately 38% or $2,068,737. This decrease is attributable mainly to the reduction in the number of units sold for the year 2003. The decline in revenues was caused by several factors including a continued economic slump in the telecommunication industry, the reduction of ION's sales force and lack of resources for marketing activities. The Company's prices remained relatively consistent throughout both periods. The Company's cost of goods sold decreased to $892,373 or 26.7% for the year ended December 31, 2003 compared to $2,389,122 or 44.2% for the year ended December 31, 2002. The decrease is mainly due to lower costs associated with manufacturing of the appliances and an increase in the percentage of revenues relating to higher margins obtained from repair and service activities.

Research and development expenses, net of capitalized software development, decreased from $937,637 for the year ended December 31, 2002 to $503,146 for the year ended December 31, 2003, a decrease of 46.3%. This decrease for research and development expenditures was primarily due to the expense reduction of related headcount from 11 to 5.

Selling, general and administrative expenses decreased 66.1% from $7,233,824 or 133.5% of revenue for the year ended December 31, 2002 to $2,452,031 or 73.3% of revenue for the year ended December 31, 2003. This decline in expense was due primarily to reduced headcount of 25 to 11, reduced salaries for the remaining staff, and a sharp decrease in facilities expenditures due to certain cost containment programs implemented by management.

Depreciation and amortization was $736,694 for the year ended December 31, 2003 compared to $1,102,124 for the year ended December 31, 2002, a decrease of approximately 33.2%. The primary reason for this reduction in 2003 as compared to 2002 was that the Company did not purchase depreciable fixed assets.

The Company acquired a corporation business tax benefit certificate pursuant to New Jersey law which relates to the surrendering of unused net operating losses. For the year ended December 31, 2003 and for the year ended December 31, 2002, the Company received a benefit of $227,151 and $236,728, respectively.

During the year ended December 31, 2003 the Company recognized benefits from restructuring in the amount of $405,402 compared to charges in the amount of $835,315 for the year ended December 31, 2002. The bulk of this positive variance, $1,016,916, was due to a charge of $508,458 for the abandonment of space at SolCom House, Livingstion, Scotland for the year ended December 31, 2002. In the quarter ended June 30, 2003, the Company after analysis, under took a voluntary liquidation of it subsidiary ION Networks, LTD., which resulted in the reversal of the $508,458 charge.

The Company had a loss of $603,792 for the year ended December 31, 2003 compared to a loss of $6,846,068 for the year ended December 31, 2002 or an improvement of $6,242,276.

Financial Condition And Capital Resources

The Company's working capital balance as of December 31, 2003 was $287,930 compared to $184,689 as of December 31, 2002.

Net cash used in operating activities during the year ended December 31, 2003 was $376,940, compared to $4,201,040 in year ended December 31, 2002. The decrease in net cash used was primarily a result of the decrease in net losses of $6,242,276 for the year ended December 31, 2003 offset in part by non-cash restructuring benefits of $1,240,717 and reduced depreciation and amortization of $365,430.

Net cash used in investing activities during the year ended December 31, 2003 was $59,167, compared to net cash used of $286,951 in year ended December 31, 2002. Of the $59,167 of the net cash used in investing activities during the year ended December 31, 2003, $214,996 was for capitalized software expenditures offset in part by release of restricted cash of $125,700 and sale of certain assets of $30,129. During the year ended December 31, 2002 net cash used was $286,951, $505,936 was for capitalized software expenditures offset in part by release of restricted cash of $249,300.

Net cash used for financing activities during the year ended December 31, 2003 was $85,135, used to repay debt, compared to $3,652,523 provided by capital raising activities in year ended December 31, 2002. Financing activities during the year ended December 31, 2002 include the sale of 4,000,000 unregistered shares of the Company's common stock at $0.87 per share for a total consideration of $3,480,000 and the sale of 166,835 unregistered shares of the Company's Series A Preferred Stock ("Preferred Stock") at $1.80 per share for a total consideration of $300,303.00 in private equity transactions offset in part by repayment of debt and capital leases of $139,894.

Critical Accounting Policies

Use of Estimates -

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from those estimates.

The significant estimates include the allowance for doubtful accounts, allowance for inventory obsolescence, capitalized software including estimates of future gross revenues, and the related amortization lives, deferred tax asset valuation allowance and depreciation and amortization lives.

Allowance for Doubtful Accounts Receivable -

Accounts receivable are reduced by an allowance to estimate the amount that will actually be collected from our customers. If the financial condition of our customers were to materially deteriorate, resulting in an impairment of their ability to make payments, additional allowances could be required.

Inventory -

Inventories are stated at the lower of cost (average cost) or market. Reserves for slow moving and obsolete inventories are provided based on historical experience and current product demand. If our estimate of future demand is not correct or if our customers place significant order cancellations, inventory reserves could increase from our estimate. We may also receive orders for inventory that has been fully or partially reserved. To the extent that the sale of reserved inventory has a material impact on our financial results, we will appropriately disclose such effects. Our inventory carrying costs are not material; thus we may not physically dispose of reserved inventory immediately.

Capitalized Software -

The Company capitalizes computer software development costs in accordance with the provisions of Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed" ("SFAS No. 86"). SFAS No. 86 requires that the Company capitalize computer software development costs upon the establishment of the technological feasibility of a product, to the extent that such costs are expected to be recovered through future sales of the product. Management is required to use professional judgment in determining whether development costs meet the criteria for immediate expense or capitalization. These costs are amortized by the greater of the amount computed using (i) the ratio that current gross revenues from the sales of software bear to the total of current and anticipated future gross revenues from the sales of that software, or (ii) the straight-line method over the estimated useful life of the product. As a result, the carrying amount of the capitalized software costs may be reduced materially in the near term.

We record impairment losses on capitalized software and other long-lived assets used in operations when events and circumstances indicate that the assets might be impaired and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of those items. Our cash flow estimates are based on historical results adjusted to reflect our best estimate of future market and operating conditions. The net carrying value of assets not recoverable is reduced to fair value. While we believe that our estimates of future cash flows are reasonable, different assumptions regarding such cash flows could materially affect our estimates.

Reclassifications -

Certain amounts in the financial statements for the nine months ending December 31, 2002 have been reclassified to conform to the presentation of the financial statements for the year ended December 31, 2003.

ITEM 7: FINANCIAL STATEMENTS

The financial statements required hereby are located on pages 40 through 61.

ITEM 8: CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES

The Company with the Approval of the Audit Committee of the Company's Board of Directors appointed Deloitte & Touche LLP as the Company's independent public accountants for the nine months ended December 31, 2002.

On November 11, 2003 the Company filed an 8-K/A announcing the appointment of Marcum and Kliegman, LLC as the Company's independent public accountants for the year ended December 31, 2003, effective as of October 7, 2003. The Board of Directors formally approved the appointment at its October 16, 2003 meeting.

On November 11, 2003 the Company filed an 8-K/A announcing Deloitte & Touche LLP declination to be reappointed as the Company's independent public accountants. During the nine month period ended December 31, 2002 and the fiscal year ended March 31,2002 and the subsequent interim period through October 06, 2003, there were no disagreements with Deloitte & Touche LLP regarding any matters of accounting principles or practices, financial statement disclosure or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of Deloitte & Touche LLP, would have caused Deloitte & Touche LLP to make reference to the subject matter of the disagreement in their report on the financial statements for such years. The Company requested that Deloitte & Touche LLP furnish it with a letter addressed to the Securities and Exchange Commission stating whether it agrees with the above statements. The letter, dated October 31, 2003 has been filed as Exhibit 16.1 to the Company's Form 10KSB for the year ended December 31, 2003.

ITEM 8A: CONTROLS AND PROCEDURES

Prior to the filing date of this annual report, the Company's management, under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer, performed an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to their evaluation.

PART III

ITEM 9: DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(A) OF THE EXCHANGE ACT.

As of March 15, 2004 the directors and executive officers of the Company were as follows:

Name	Age	Position Held with the Company
Norman E. Corn	57	Chief Executive Officer
Patrick E. Delaney	50	Chief Financial Officer
William Whitney	49	Chief Technology Officer and Vice President of Research and Development
Stephen M. Deixler	68	Chairman of the Board of Directors
Baruch Halpern	53	Director
Frank S. Russo	61	Director

NORMAN E. CORN has served as Chief Executive Officer since August 15, 2003. Prior to joining ION, from 2000 until 2003, Mr. Corn was Executive Vice President of Liquent, Inc., a Pennsylvania-based software company that provides electronic publishing solutions, focused on the life sciences industry. Mr. Corn has also served from 1994 to 2000 as CEO of TCG Software, Inc., an offshore software services organization providing custom development to large corporate enterprises in the US. Mr. Corn has led other companies, including Axiom Systems Group, The Cobre Group, Inc., The Office Works, Inc. and Longview Results, Inc., having spent the early part of his career in sales, marketing and executive positions in AT&T and IBM.

PATRICK E. DELANEY has served as Chief Financial Officer since September 15, 2003. Prior to joining ION, from 2000 until 2003, Mr. Delaney was the President of Taracon, Inc. a privately owned independent consulting firm that provides management consulting for early and mid-stage technology and financial services companies. Mr. Delaney also served as Chief Financial Officer for two publicly traded telecommunications providers, Pointe Communications Corporation from 1993 to 2000 and Advanced Telecommunications Corporation from 1986 to 1993. Mr. Delaney has served other companies in executive capacities including: RealCom Communications, Argo Communications and ACF Industries.

WILLIAM WHITNEY has served as Vice President of Research and Development since March 2002 and Chief Technology Officer since October 1, 2002. Prior to joining ION, from April 2000 to February 2002, Mr. Whitney served as the Vice President of Development and Chief Technology Officer for Outercurve Technologies, a provider of wireless application development and deployment solutions. Previously from, May 1998 to March 2002, Mr. Whitney served as President of CTO Systems.

STEPHEN M. DEIXLER has been Chairman of the Board of Directors since May 1982 and served as Chief Executive Officer of the Company from April 1996 to May

1997. He was President of the Company from May 1982 to June 1985 and served as Treasurer of the Company from its formation in 1982 until September 1993. During the period since March 2003 to September 2003, Mr. Deixler has served as the interim Chief Financial Officer of the Company. He also serves as Chairman of the Board of Trilogy Leasing Co., LLC and President of Resource Planning Inc. Mr. Deixler was the Chairman of Princeton Credit Corporation until April 1995 and Chief Financial Officer of Multipoint Communications, LLC until November 2002.

BARUCH HALPERN has served as a director of the Company since October 1999. From January 1995 to May 1999, Mr. Halpern was an institutional research analyst with Goldsmith & Harris Incorporated, where he advised institutions about investment opportunities. He was also an advisor in connection with a leveraged buy-out of a public company and several private placements. In 1999, Mr. Halpern formed Halpern Capital as a DBA entity under Goldsmith & Harris Incorporated. The DBA was subsequently moved to Magna Securities (Member: NASD/SIPC) and then UVEST Investment Services (Member: NASD/SIPC). In January 2003, Mr. Halpern formed his own broker-dealer, Halpern Capital, Inc. Over the last few years Baruch Halpern's entities were involved in numerous financings, having raised over $300 million in capital for several public entities.

FRANK RUSSO has served as a director of the Company since November 2000. Mr. Russo was with AT&T Corporation from September 1980 to September 2000 and most recently served as its Corporate Strategy and Business Development Vice President. While at AT&T Solutions, Mr. Russo held a number of other positions including that of General Manager, Network Management Services from which he helped architect and launch AT&T's entry into the global network outsourcing and professional services business. Mr. Russo retired from AT&T in 2000. Prior to joining AT&T, Mr. Russo was employed by IBM Corporation in a variety of system engineering, sales and sales management positions. Mr. Russo served on the Board of Directors of Oak Industries, Inc., a manufacturer of highly engineered components, from January1999 to February 2000, and currently serves on the Board of Directors of Advance-com, a private e-commerce company headquartered in Boston, Massachusetts.

Financial Expert

The Company's board of directors has determined that none of its current members meets the standard of an audit committee "financial expert" as defined in the Sarbanes-Oxley Act of 2002. The Company has determined that its current financial position makes it impractical to obtain the services of an additional director meeting this standard.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities and Exchange Act of 1934, as amended (the "Exchange Act"), requires the Company's directors, executive officers and persons who own more than 10% of the Company's Common Stock (collectively, "Reporting Persons") to file reports of ownership and changes in ownership of the Company's Common Stock with the Securities and Exchange Commission and The Nasdaq Stock Market, Inc. Copies of these reports are also required to be delivered to the Company.

The Company believes, based solely on its review of copies of such reports received or written representations from certain Reporting Persons, that during the Company's fiscal year Messrs. Deixler, Russo and Halpern failed to file various Forms 4s and 5s with respect to the reporting of various stock options granted to them and Messrs. Corn and Delaney failed to file Forms 3s with respect to becoming executive officers of the Company in August and September 2003, respectively.

The Company has a Code of Ethics in place for all of its employees. A copy of the Company's Code of Ethics will be provided free of charge, upon written request to ION Networks, Inc 120 Corporate Blvd., South Plainfield, NJ 07080

21

ITEM 10: EXECUTIVE COMPENSATION

The following table sets forth the compensation earned, whether paid or deferred, by the Company's Chief Executive Officer, its other four most highly compensated executive officers during the year ended December 31, 2003, and up to four additional individuals for whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer at the end of the year ended December 31, 2003 (the "Named Executive Officers") for services rendered in all capacities to the Company.

Summary Compensation Table

		Annual Compensation	
Principal Position	Year Ending*	Salary($)	Bonus($)
Current CEO and Executive Officers:			
Norman E. Corn/(10)/ Chief Executive Officer	12/31/2003	60,000	--
Patrick E. Delaney/(11)/ Chief Financial Officer	12/31/2003	35,323	--
William Whitney/(4)(6)/	12/31/2003	117,692	--
Vice President &	12/31/2002	112,500	--
Chief Technology Officer	03/31/2002	9,135	--
Former Executive Officers:			
Kam Saifi/(2)(6)/(7)/	12/31/2003	163,570/(8)/	--
President & Chief	12/31/2002	273,300/(7)/	--
Executive Officer	03/31/2002	132,681/(9)/	50,000
Cameron Saifi/(3)(6)/(8)/	12/31/2003	85,130	--
Executive Vice President	12/31/2002	139,500	--
President & Chief Operating Officer	03/31/2002	90,519	25,000
Ted I. Kaminer/(5)/(6)/	12/31/2003	14,145	--

Vice President & Chief Financial Officer	12/31/2002	90,625	--

Summary Compensation Table

		Long-term Compensation			
		Awards			Pa
Principal Position	Other Annual Compen-sation ($)	Restricted Stock Award(s)($)	Securities Underying Options (#)	LTIP Payouts($)	
Current CEO and Executive Officers:					
Norman E. Corn/(10)/ Chief Executive Officer	--	--	--	--	
Patrick E. Delaney/(11)/ Chief Financial Officer	--	--	--	--	
William Whitney/(4)(6)/	--	--	--	--	
Vice President &	--	--	--	--	
Chief Technology Officer	--	--	100,000/(12)/	--	
Former Executive Officers:					
Kam Saifi/(2)(6)/(7)/	--	--	--	--	
President & Chief	--	--	--	--	
Executive Officer	--	260,000/(13)/	--	--	
Cameron Saifi/(3)(6)/(8)/	--	--	--	--	
Executive Vice President	--	--	--	--	
President & Chief Operating Officer	--	186,000/(14)/	--	--	
Ted I. Kaminer/(5)/(6)/	--	--	--	--	
Vice President & Chief Financial Officer	--	--	200,000/(9)/	--	

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*Please note that the 12/31/03 year end represents the twelve month period from 1/1/03 to 12/31/03 and the 12/31/02 year end represents the nine-month period from 4/1/02 to 12/31/02.

(1) Represents contribution of the Company under the Company's 401(k) Plan.

(2) Mr. K. Saifi joined the Company on 10/1/01. Pursuant to his employment agreement, he received an annualized base salary of $350,000 for the nine-months ended December 31, 2002. Mr. K. Saifi separated from the

Company on July 7, 2003.

(3) Mr. C. Saifi joined the Company on 10/17/01. Pursuant to his employment agreement, he received an annualized base salary of $186,000. Mr. C. Saifi separated from the Company on July 7, 2003.

(4) Mr. Whitney joined the Company on 3/11/02. Pursuant to his employment agreement, he receives an annualized base salary of $150,000.

(5) Mr. Kaminer joined the Company on 5/20/02 and separated from the Company on 2/6/03.

(6) Refer to the Employment Contracts, Termination of Employment and Change of Control Arrangements section below for a more detailed description of all consulting and employment agreements.

(7) Includes $14,400 in auto allowance.

(8) Includes $7,200 in auto allowance.

(9) 25,000 shares vested on May 20, 2002. The remaining shares vest as follows: 43,000 on May 20, 2003, and 16,500 at the end of each three month period, commencing with the period ending August 20,2003 and ending with the period ending May 20, 2005

(10) Mr. N. Corn joined the Company on 08/15/03. Pursuant to his employment agreement, he receives an annualized base salary of $180,000 for the fiscal year ended December 31, 2003.

(11) Mr. P. Delaney joined the Company on 09/15/03. Pursuant to his employment agreement, he receives an annualized base salary of $120,000 for the fiscal year ended December 31, 2003.

(12) These shares vest as follows: 34,000 on March 11, 2003, and 8,250 at the end of each three month period, commencing with the period ending June 11, 2003, and ending with the period ending March 11, 2005.

(13) These shares vest as follows: 250,000 on October 4, 2001, 550,000 on September 30, 2002 and 150,000 at the end of each quarter, commencing with the quarter ended December 31, 2002, and ending with the quarter ending September 30, 2004, for a total of 1,200,000.

(14) These shares vest as follows: 75,000 on October 17, 2001, 165,000 on September 30, 2002 and 45,000 at the end of each quarter, commencing with the quarter ended December 31, 2002, and ending with the quarter ending September 30, 2004, for a total of 360,000.

Option Grants for Year Ended December 31, 2003

During the year ended December 31, 2003 there were no option grants awarded to any employees.

Aggregated Option Exercises for Year Ended December 31, 2003
And Year Ended Option Values

The following table sets forth certain information concerning each exercise of stock options during year ended December 31, 2003 by each of the Named Executive Officers and the number and value of unexercised options held by each of the Named Executive Officers on December 31, 2003.

Name	Shares Acquired on Exercise (#)	Value Realized($)	Number of Securities Underlying Unexercised Options at FY-End(#) Exercisable/Unexercisable	E
Current CEO and Executive Officers:				
Norman E. Corn	--	--	--	
Patrick E. Delaney	--	--	--	
William Whitney	--	--	58,750/41,250	
Former Executive Officers:				
Kam Saifi	--	--	--	
Cameron Saifi	--	--	--	
Ted Kaminer	--	--	--	

(1) The average price for the Common Stock as reported by the Nasdaq Bulletin Board on December 31, 2003, was $.04 per share. Value is calculated on the basis of the difference between the option exercise price and $.04 multiplied by the number of shares of Common Stock underlying the options.

Compensation of Directors

Standard Arrangements: During the year ended December 2003 no compensation was paid to any Board member.

Employment Contracts, Termination of Employment and Change of Control Arrangements

The Company entered into an employment agreement with Norman E. Corn dated August 15, 2003. Pursuant to the agreement Mr. Corn shall serve as Chief Executive Officer at the will of the Company. Mr. Corn's annual base salary as of March 15, 2004 was $200,000. In addition, he will receive a monthly car allowance of $900 plus, reimbursement for additional life and disability insurances. On January 28, 2004, the Company awarded Mr. Corn 1,550,000 options to purchase common stock at $0.115 per share for 800,000 incentive stock options and $0.07 per share for 750,000 non-incentive stock options. These options vested immediately. If the Company terminates Mr. Corn's employment no severance payment is contemplated by the contract.

The Company entered into an employment agreement with Patrick E. Delaney dated

September 15, 2003. Pursuant to the agreement Mr. Delaney shall serve as Chief Financial Officer at the will of the Company. Mr. Delaney's annual base salary as of March 15, 2004 was $170,000.In addition, he will receive a monthly car allowance of $900 plus, reimbursement for additional life and disability insurances. On January 28, 2004, the Company awarded Mr. Delaney 1,050,000 options to purchase common stock at $0.115 per share for 800,000 incentive stock options and $0.045.per share for 250,000 non-incentive stock options. These options vested immediately. If the Company terminates Mr. Delaney's employment no severance payment is contemplated by the contract.

Effective July 7, 2003, Mr. Kam Saifi and Mr. Cameron Saifi ceased to be employed by the Company. As of the date of this filing, neither Mr. Kam Saifi nor Mr. Cameron Saifi has executed separation agreements. However, the parties continue to negotiate and seek an appropriate settlement. Presented below are these former executives employment disclosure from the period ended December 31, 2002 form 10KSB.

The Company entered into an employment agreement with Kam Saifi dated October 4, 2001. Pursuant to the agreement, Mr. Saifi served as Chief Executive Officer and President commencing October 1, 2001 and continuing through July 7, 2003. Mr. K. Saifi received a base salary at an annual rate of $250,000 during the period of October 1, 2001 and ending March 31, 2002. He received a base salary at an annual rate of $350,000 commencing April 1, 2002 and continuing through July 7, 2003. In addition he received a monthly car allowance of $1,200. Pursuant to the agreement, Mr. K. Saifi was granted restricted stock consisting of 2,000,000 shares of the Company's Common Stock at a price of $0.13 per share. As of December 31, 2003, all 2,000,000 shares were vested, but are subject to a loan and pledge in favor of the Company.

The Company entered into an employment agreement with Cameron Saifi dated October 17, 2001. Pursuant to the agreement, Mr. C. Saifi served as Chief Operating Officer and Executive Vice President commencing October 17, 2001 and continuing through July 7, 2003. Mr. C. Saifi received a base salary at an annual rate of $186,000. In addition he received a monthly car allowance of $600. Pursuant to the agreement, Mr. C. Saifi was granted restricted stock consisting of 600,000 shares of the Company's Common Stock at a price of $0.31 per share. As of December 31, 2003, all 600,000 shares were vested, but are subject to a loan and pledge in favor of the Company.

The Company entered into an employment agreement with William Whitney dated March 11, 2002. Pursuant to the agreement, Mr. Whitney shall receive a base salary at an annual rate of $150,000. Pursuant to the agreement, Mr. Whitney was granted stock options consisting of 100,000 shares of the Company's Common Stock at a price of $0.70 per share. These options vest as follows: 34,000 vest on March 11, 2003, and 8,250 at the end of each three month period, commencing with the period ending June 11, 2003, and ending with the period ending March 11, 2005. In the event of a change in control event (as described in the employment agreement) all options will become immediately vested.

The Company entered into an employment agreement with Ted Kaminer dated May 20, 2002. Pursuant to the agreement, Mr. Kaminer was to serve as Chief Financial Officer and Vice President commencing May 20, 2002 and continuing until June 30, 2005 unless earlier terminated as provided in the agreement. On February 6, 2003, Mr. Kaminer voluntarily separated employment from the Company and, as a result, no severance was paid to him.

ITEM 11: SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Equity Compensation Plan Information
As of December 31, 2003

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants, and rights	(b) Weighted-average exercise price of outstanding options, warrants, and rights	
Equity compensation plans approved by security holders/(1)/	1,435,155	1.62	1
Equity compensation plans not approved by security holders/(2)/	608,000	1.22	
Total	2,043,155	1.53	1

(1) Shareholder Approved Plans

In June 2002, the Company adopted its 2002 Stock Incentive Plan (the "2002 Plan"). The 2002 Plan provides for the issuance of stock options, grants of common stock and stock appreciation rights covering up to 1,250,000 shares of common stock; provided, however, no more than 250,000 shares may be issued in connection with awards or stock appreciation rights. In January 2004, the Company discovered that the 2002 Plan was improperly approved without regard to rights granted to the holders of its Series A preferred stock which required prior approval of the holders of majority of Series A preferred stock prior to issuance or authorization of equity securities or instruments convertible into or exercisable for equity securities. No awards were made under 2002 Plan. The Company is taking the position that the 2002 Plan is invalid.

In November 2000, the Company adopted its 2000 Stock Option Plan (the "2000 Plan"). The aggregate number of shares of common stock for which options may be granted under the 2000 Plan is 3,000,000. The maximum number of options which may be granted to an employee during any calendar year under the 2000 Plan is 400,000. The term of these non-transferable stock options may not exceed ten years. The exercise price of these stock options may not be less than 100% (110% if the person granted such options owns more than ten percent of the outstanding common stock) of the fair value of one share of common stock on the date of grant. During the year ended December 31, 2003 and the nine month period ended December 31, 2002, the Company granted options to purchase zero and 838,000, shares, respectively. As of December 31, 2003, 868,775 options were outstanding under the 2000 Plan, of which 660,875 options were exercisable.

The aggregate number of shares of common stock for which options may be granted under the 1998 Stock Option Plan (the "1998 Plan") is 3,000,000. The maximum number of options which may be granted to an employee during any calendar year under the 1998 Plan is 400,000. The term of these non-transferable stock options may not exceed ten years. The exercise price of these stock options may not be less than 100% (110% if the person granted such options owns more than ten percent of the outstanding common stock) of the fair value of one share of common stock on the date of grant. During the year ended December 31, 2003 and the nine months ended December 31, 2002, the Company granted no options to purchase shares. As of December 31, 2003, 533,629 options were outstanding under the 1998 Plan, of which 482,800 options were exercisable.

In August 1994, the Company adopted its 1994 Stock Option Plan (the "1994 Plan"). The 1994 Plan, as amended, increased the number of shares of common stock for which options may be granted to a maximum of 1,250,000 shares. The term of these non-transferable stock options may not exceed ten years. The exercise price of these stock options may not be less than 100% (110% if the person granted such options owns more than ten percent of the outstanding common stock) of the fair market value of one common stock on the date of grant. During the year ended December 31, 2003 and the nine month ended December 31, 2002 , there were no option grants provided under the 1994 Plan. As of December 31, 2003, 32,751 options were outstanding under the 1994 Plan, of which 32,751 options were exercisable.

During the year ended December 31, 2003, and nine month period ended December 31, 2002, there were no options granted under the Company's Time Accelerated Restricted Stock Award Plan ("TARSAP"). The options vest after seven years, however, under the TARSAP, the vesting is accelerated to the last day of the fiscal year in which the options are granted if the Company meets certain predetermined sales targets. The Company did not meet the targets for 2001 and, as such, all options granted under the TARSAP in 2001 will vest seven years from the original date of grant.

(2) Non-Shareholder Approved Awards

The Company as of December 31, 2003 has granted options and warrants to purchase 608,000 shares of Common Stock outside of the shareholder approved plans. The awards have been made to employees, directors and consultants, and except as noted below, have been granted with an exercise price equal to the fair market value of the Common Stock on the date of grant. The Company has not reserved a specific number of shares for such awards. The non-shareholder approved awards are more specifically described below.

During July 2001 in connection with services being performed by a consultant, the Company issued warrants to purchase 48,000 shares of the Company's Common Stock at $0.62 per share. The warrants vested immediately and expire five years from the date of the grant.

During January 2002 in connection with services being performed by a consultant, the Company issued warrants to purchase 100,000 shares of the Company's Common Stock at $1.35 per share and 50,000 shares of Common Stock at $1.80 per share. The warrants vested immediately and expire three years from the date of the grant.

On March 19, 1999, the Company issued options to certain consultants and employees to purchase an aggregate of 20,000 shares of the Company's Common Stock, all of which vested on the first year anniversary of the date of grant. The options expire six years from the date of grant. However, in the event of (a) the liquidation or dissolution of the Company or (b) a merger in which the Company is not the surviving corporation or a consolidation involving the Company, the options shall terminate, unless other provision is made therefore in the transaction. The exercise price of the options is $2.41 and equals to the market value of the Company's Common Stock on the date of grant. At December 31, 2003, 10,000 options were outstanding and exercisable.

On September 25, 1996, the Company issued options to certain officers and directors to purchase 400,000 shares of the Company's Common Stock, of which 200,000 vested immediately and 100,000 vested on April 1, 1998 and 1999. The options expire ten years from the date of grant. However, in the event of (a) the liquidation or dissolution of the Company or (b) a merger in which the Company is not the surviving corporation or a consolidation involving the Company, the options shall terminate, unless other provision is made therefore in the transaction. The exercise price of the options is $1.156 and equals to the market value of the Company's Stock on the date of grant. At December 31, 2003, 400,000 options were outstanding and exercisable.

Beneficial Ownership Information

The following table sets forth certain information regarding the beneficial ownership of the Company's Common Stock as of February 28, 2004 by each person (or group within the meaning of Section 13(d)(3) of the Securities Exchange Act of 1934) known by the Company to own beneficially 5% percent or more of the Company's Common Stock, and by the Company's directors and named executive officers, both individually and as a group.

As used in this table, "beneficial ownership" means the sole or shared power to vote or direct the voting or to dispose or direct the disposition of any security. A person is deemed to be the beneficial owner of securities that can be acquired within sixty days from March 15, 2004 through the exercise of any option, warrant or right. Shares of Common Stock subject to options, warrants or rights (including conversion from Preferred Stock) which are currently exercisable or exercisable within sixty days are deemed outstanding for computing the ownership percentage of the person holding such options, warrants or rights, but are not deemed outstanding for computing the ownership percentage of any other person. The amounts and percentages are based upon 24,875,500 shares of Common Stock and 166,835 shares of Preferred Stock outstanding as of February 28, 2004.

	Common Stock	Percent of Class
Current, Directors, CEO and Executive Officers:		
Norman E. Corn	1,565,000/(8)/	5.9%
Patrick E. Delaney	1,050,000/(9)/	4.1%
Stephen M. Deixler	1,457,772/(1)/	5.7%

Frank Russo	361,280/(2)/	1.4%
Baruch Halpern	1,001,760/(3)/	3.9 %
William Whitney	168,704(6)	*
Former Executive Officers:		
Kam Saifi	2,308,890/(4)/	9.2%
Cameron Saifi	685,000/(5)/	2.7%
5% or more beneficial owners:		
AWM Investment Company 153 East 53rd Street, 55th Floor New York, NY 10022	2,731,000/(7)/	11.03%
Directors and Executive Officers as a group 8 persons)	8,598,406	28.8%

(1) Does not include 220,000 shares of Common Stock owned by Mr. Deixler's wife, mother, children and grandchildren as to which shares Mr. Deixler disclaims beneficial ownership. Includes 480,560 shares of Common Stock subject to conversion from 48,056 shares of Preferred Stock within 60 days of March 15, 2004 and 382,500 shares of Common Stock subject to options that are currently exercisable or exercisable within 60 days of March 15, 2004.

(2) Includes 277,780 shares of Common Stock subject to conversion from 27,778 shares of Preferred Stock within 60 days of March 15, 2004 and 83,500 shares of Common Stock subject to options that are currently exercisable or exercisable within 60 days of March 15, 2004.

(3) Does not include 17,000 shares of Common Stock owned by Mr. Halpern's daughter as to which Mr. Halpern disclaims beneficial ownership. Includes 480,560 shares of Common Stock subject to conversion from 48,056 shares of Preferred Stock within 60 days of March 15, 2004, 287,500 shares of Common Stock subject to options that are currently exercisable or exercisable within 60 days of March 15, 2004 and 100,000 shares of Common Stock subject to warrants that are currently exercisable or exercisable within 60 days of March 15, 2004.

(4) Includes 138,890 shares of Common Stock subject to conversion from 13,889 shares of Preferred Stock within 60 days of March 15, 2004.

(5) Includes 85,000 shares of Common Stock subject to conversion from 8,500 shares of Preferred Stock within 60 days of March 15, 2004.

(6) Includes 38,890 shares of Common Stock subject to conversion from 3,889 shares of Preferred Stock within 60 days of March 15, 2004 and 67,000 shares of Common Stock subject to options that are currently exercisable or exercisable within 60 days of March 15, 2004.

(7) Based on American Stock and Transfer & Trust list of shareholders dated February 27, 2004 plus 1,120,000 warrants to purchase common stock.

(8) Includes 15,000 shares of Common Stock and 1,550,000 shares of Common Stock subject to options that are currently exercisable.

(9) Consists of 1,050,000 shares of Common Stock subject to options that are currently exercisable.

(10) Unless otherwise noted, the address of each such person is c/o the Company, 120 Corporate Blvd., S. Plainfield, New Jersey 07080.

*Indicates ownership of Common Stock of less than one (1%) percent of the total issued and outstanding Common Stock on March 15, 2004.

ITEM 12: CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The Company entered into a definitive Sublease Agreement with Multipoint Communications, LLC (the "Tenant") on April 17, 2002 to sublease approximately 5,400 square feet of its Piscataway, NJ facility for a period of 24 months. The rental rate and the other material terms of the lease with Multipoint Communications, LLC ("Multipoint") were negotiated through a real estate broker and separate attorneys representing each party. The rental rate was established by prorating the amount of space leased by Multipoint by the current rent paid by the Company to its landlord. Given the current real estate market condition in the area, the Company believes that the terms of the lease with Multipoint are comparable to terms of leases that might have been obtained from a non-affiliate. The rent will be $5,200 per month for the first nine months and $10,400 per month for the last fifteen months, but with a 100% abatement for the first three months. As part of the rental payment the Tenant was to issue shares totaling the value of $77,400, which were to be based on the per share price of the Tenant's common stock as priced in the first round of institutional financing (the "Financing") which were to have closed on or before June 30, 2002. These shares were to have had the registration rights as other shares issued in the Financing. Since the Financing did not close on or before June 30, 2002, the Tenant owes the Company additional rent in the amount of $4,300 per month commencing on July 1, 2002. The Chairman of the Board of Directors of the Company served as the Chief Financial Officer of the Tenant until November 2002. On or about January 16, 2003, the Tenant filed for voluntary Ch. 7 bankruptcy with the U.S. Bankruptcy Court for the District of New Jersey. As a result, the Company wrote off an amount of $122,550 which is included in selling, general and administrative expenses.

During April 2000, the Company made a loan (the "Loan") to the former Chief Executive Officer (the "Former CEO") of the Company in the amount of $750,000. At the time that the Loan was made to the Former CEO in April 2000, the Company was contemplating a secondary public offering and potential mergers and acquisitions opportunities. As a result, the Company did not want the Former CEO to exercise his stock options. In consideration for not exercising his stock options at that time, the Company issued the Loan to him. At that time, the Company had sufficient cash and it was contemplated that the Loan would be repaid within one year. The Loan accrues interest at a rate of LIBOR plus 1%. The LIBOR plus one percent interest rate in April 2000 was 7.197% as compared to the first mortgage interest rate in April 2000 of 6.90% for a 1-year ARM, 7.97% for a 15-year FRM and 8.30% for a 30-year FRM. This Loan had an original maturity date of the earlier of April 2005 or thirty days after the Company for any reason no longer employed the Former CEO. The Former CEO resigned his position at the Company effective September 29, 2000. On October 5, 2000, the Company entered into an agreement with the Former CEO pursuant to which the $750,000 promissory note for the Loan was amended to extend the due date to April 30, 2001, and to provide that interest on the note shall accrue through September 29, 2000 (the "Separation and Forbearance Agreement"). The Loan is collateralized by a first mortgage interest on the personal residence of the Former CEO. The Company agreed to extend the repayment date of the Loan so that the Former CEO would be able to repay the Loan to the Company by selling his personal residence. In addition to the Loan, pursuant to the terms of the Separation and Forbearance Agreement between the Company and the Former CEO, the Former CEO also agreed to reimburse the Company for certain expenses totaling $200,000, to be paid over a period of six months ending March 31, 2001. These certain expenses were incurred by the Former CEO as part of his personal expense account arrangement with the Company. During the year ended March 31, 2001, $50,000 of the amounts owed to the Company by the Former CEO was repaid and $22,000 has been recorded as a non-cash offset as a result of earned but unpaid vacation owed to the Former CEO. During the year ended March 31, 2002, $813,593 was repaid which included proceeds in the amount of $777,713.48 received by the Company on August 3, 2001 for the sale of the Former CEO's personal residence. At December 31, 2003, the total amount owed to the Company by the Former CEO was approximately $175,154, which includes interest accrued through December 31, 2003. The full amount has been recorded as a reserve against the note receivable. Because these amounts were not paid by their respective maturity dates, interest is accruing at the default interest rate of 12%. The Company will continue to attempt to collect the note receivable.

Effective October 2001, the Company approved and granted 2,600,000 shares of restricted stock to two executives: Messrs. Kam Saifi (2,000,000 shares at $0.13 per share), and Cameron Saifi, (600,000 shares at $0.31 per share) at fair value. The restricted shares vest at the rate of 12.5% on the date of grant, 27.5% on September 30, 2002, and thereafter 7.5% at the end of each quarter which commenced on December 31, 2002. These restricted shares were subject to a repurchase right which permitted the Company to repurchase any shares which have not yet vested at the effective date of termination of the officers' employment, as defined in their employment agreements, for an amount equal to the purchase price per share paid by the officers. The Company received a series of partial recourse interest bearing (5.46% on an annual basis) promissory notes for the value of the shares to be repaid by the officers. The notes are to be repaid by the officers at the earlier of ten years or the date upon which the employees dispose of their shares. As of December 31, 2003 Mr. Kam Saifi owes approximately $290,718 (including approximately $32,718 of interest) for 2,000,000 Restricted Shares and; Mr. Cameron Saifi owes approximately $208,526 (including approximately $23,126 of interest) for 600,000 Restricted Shares. The issuance of the restricted shares and the notes receivable due from the officers is recorded in the Company's financial statements. The Company is continuing to negotiate agreements relating to the disposition of the loans due to the separation of the officers from the Company. As of December 31, 2003, all 2,600,000 shares were vested, but are subject to a loan and pledge in favor of the Company.

ITEM 13. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

Exhibit No.	Description

3.1	Certificate of Incorporation of the Company, as filed with the Secretary of State of the State of Delaware on August 5, 1998./(2)/
3.2	Certificate of Amendment of the Certificate of Incorporation, as filed with the Secretary of State of the State of Delaware on December 11, 1998./(2)/
3.3	Certificate of Amendment of the Certificate of Incorporation, as filed with the Secretary of state of the State of Delaware an October 12, 1999./(3)/
3.4	By-Laws of the Company./(2)/
3.5	Form of Specimen Common Stock Certificate of the Company./(4)/
4.1	1994 Stock Option Plan of the Company. /(1)/
4.2	1998 Stock Option Plan of the Company./(2)/
4.3	1998 U.K. Sub-Plan of the Company, as amended./(2)/
4.4	Amended and Restated Certificate of Designation of Rights Preferences, Privileges and Restrictions of Series A Preferred Stock of ION Networks, Inc. /21/
4.5	2000 Stock Option Plan of the Company./(17)/
4.6	2002 Stock Option Plan of the Company./(19)/
4.7	Form of Warrant Agreement dated July 17, 2001./(13)/
4.8	Form of Warrant Agreement dated January 4, 2002./(13)/
4.9	Form of Non-Qualified Stock Option Agreement dated March 19, 1999 by and between the Company's predecessor, Microframe, Inc. and its consultants./(13)/
4.10	Form of Non-Employee Director Stock Option Contract dated March 10, 1998 between the Company's predecessor, Microframe, Inc. and its non-employee directors./(13)/
4.11	Form of Non-Employee Director Stock Option Contract dated September 17, 1997 by and between the Company's predecessor, Microframe, Inc. and its non-employee directors./(13/)
4.12	Form of Non-Qualified Stock Option Agreement dated September 25, 1996 by and between the Company's predecessor, Microframe, Inc. and its employees./(13)/

Exhibit No.	Description
4.13	Amended and Restated Non-Qualified Stock Option Agreement dated May 19, 1997 by and between the Company's Predecessor, Microframe, Inc. and its employees./(9)/

10.3	Agreement dated as of December 19, 1994 by and between LeeMAH DataCom Security Corporation and Siemens Rolm Communications Inc./(4)/
10.4	Equipment Lease Agreements dated June 10, 1999 and May 5, 1999 by and between the Company and Siemens Credit Corporation./(4)/
10.5	Equipment Lease Agreement dated June 17, 1999 by and between the Company and Lucent Technologies./(4)/
10.6	(i) Non-negotiable Promissory Note in the principal amount of $750,000 issued by Stephen B. Gray to the Company./(5)/
	(ii) First Amendment to Promissory Note dated as of August 5, 2000 by and between the Company and Stephen B. Gray./(5)/
10.7	Line of Credit Agreement with United Nations Bank dated September 30, 1999./(5)/
10.8	(i) Separation and Forbearance Agreement made as of October 5, 2000 between the Company and Stephen B. Gray./(7)/
	(ii)Promissory Note in the amount of $163,000 dated October 5, 2000 made by Stephen B. Gray to the Company./(7)/
10.9	Materials and Services Contract dated January 16, 2001, between the Company and SBC Services, Inc./(8)/
10.10	Stock Purchase Agreement dated August 11, 2000 by and between the Company and the parties identified therein./(8)/
10.11	Purchase Agreement by and between the Company and the Selling Shareholders set forth therein dated February 7, 2002./(18)/
10.12	Employment Agreement dated October 4, 2001 between the Company and Kam Saifi./(11)/
10.13	Employment Agreement dated October 17, 2001 between the Company and Cameron Saifi./(12)/
10.14	Sublease Agreement dated April 17, 2002 between the Company and Multipoint Communications, LLC./(14)/

32

Exhibit No.	Description
10.15	Agreement and General Release dated August 15, 2002 between the Company and Ron Forster./(16)/
10.16	Rescission Agreement dated September 29, 2002 between the Company and David Arbeitel./(16)/
10.17	Separation Agreement and General Release dated October 31, 2002 between the Company and David Arbeitel./(16)/

10.18	Employment Agreement dated May 20, 2002 between the Company and Ted Kaminer./(15)/
10.19	Employment Agreement dated February 25, 2002, between the Company and William Whitney./21/
10.20	Employment Agreement dated August 15, 2003, between the Company and Norman E. Corn./22/
10.21	Employment Agreement dated September 15, 2003, between the Company and Patrick E. Delaney./20/
10.22	Lease Agreement dated July 21, 2003 by and between the Company and 116 Corporate Boulevard, LLC, Inc.*
16.1	Letter dated October 31,2003, from Deloitte & Touche, LLP. to the Securities and Exchange Commission./(10)/
21.1	List of Subsidiaries./(14)/
31.1	Certification of CEO Pursuant to Section 302 of the Sarbanes Oxley Act of 2002.*
31.2	Certification of CFO Pursuant to Section 302 of the Sarbanes Oxley Act of 2002.*
32.1	Certification of CEO Pursuant to Section 906 of the Sarbanes Oxley Act of 2002.*
32.2	Certification of CFO Pursuant to Section 906 of the Sarbanes Oxley Act of 2002.*

(1) Incorporated by Reference to the Company's Registration Statement on Form S-8 filed on August 15, 1995.

(2) Incorporated by Reference to the Company's Registration Statement on Form S-8 filed on April 22, 1999.

(3) Incorporated by reference to the Company's Registration Statement on Form S-8 filed on March 17, 2000.

(4) Incorporated by reference to the Company's Annual Report on Form 10-KSB for the fiscal year ended March 31, 1999.

(5) Incorporated by reference to the Company's Annual Report on Form 10-KSB filed on June 28, 2000.

(6) Incorporated by Reference to the Company's Current Report on Form 8-K filed on March 12, 1999.

(7) Incorporated by reference to the Company's Quarterly report on Form 10-QSB filed on November 14, 2000

(8) Incorporated by reference to the Company's Annual report on Form 10-KSB filed on June 29, 2001.

(9) Incorporated by reference to the Company's Registration Statement on Form S-8 filed on November 17, 2000.

(10) Incorporated by reference to the Company's Annual report on Form 8-KSB filed on October 31, 2003.

(11) Incorporated by Reference to the Company's Current Report on Form 8-K filed on October 23, 2001.

(12) Incorporated by Reference to the Company's Current Report on Form 8-K filed on October 24, 2001.

(13) Incorporated by reference to the Company's Annual Report on Form 10-KSB for the fiscal year ended March 31, 2002, as filed on July 1, 2002.

(14) Incorporated by reference to the Company's Annual Report on Form 10-KSB/A, Amendment No.2, for the fiscal year ended March 31, 2002, as filed on August 2, 2002.

(15) Incorporated by reference to the Company's Quarterly Report on Form 10-QSB filed on August 14, 2002.

(16) Incorporated by reference to the Company's Quarterly Report on Form 10-QSB filed on November 14, 2002.

(17) Incorporated by Reference to the Company's Registration Statement on Form S-8 filed on January 11, 2002.

(18) Incorporated by Reference to the Company's Registration Statement on Form S-3 filed on March 4, 2002.

(19) Incorporated by Reference to the Company's Definitive Proxy Statement filed on September 16, 2002.

(20) Incorporated by reference to the Company's Quarterly Report on Form 10-QSB filed on November 17, 2003.

(21) Incorporated by reference to the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2002, as filed on April 15, 2003.

(22) Incorporated by reference to the Company's Quarterly Report on Form 10QSB filed on September 12, 2003.

* Filed herewith

(b) Reports on Form 8-K

On November 3, 2003, the Company filed a report on Form 8-K reporting the change of its independent principal accountants.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

	YEAR ENDED DECEMBER 31, 2003	YEAR ENDED DECEMBER 31, 2002
Audit Fees	$116,870	$ 73,657
Audit Related Fees	0	0

Tax Fees (1)	$ 15,000	$ 30,000
All Other Fees	0	0

(1) Preparation of federal, state and local income and franchise taxes.

34

SIGNATURES

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

Dated: March 29, 2004

ION NETWORKS, INC.

By: /s/ Norman E. Corn

Norman E. Corn
Chief Executive Officer

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 29, 2004:

Signature	Title
/s/ Norman E. Corn ------------------------------- Norman E. Corn	Chief Executive Officer
/s/ Patrick E. Delaney ------------------------------- Patrick E. Delaney	Chief Financial Officer
/s/ Stephen M. Deixler ------------------------------- Stephen M. Deixler	Chairman of the Board of Directors
/s/ Baruch Halpern ------------------------------- Baruch Halpern	Director
/s/ Frank Russo ------------------------------- Frank Russo	Director

ION NETWORKS, INC. AND SUBSIDIARIES CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEAR ENDED DECEMBER 31, 2003 AND NINE MONTHS ENDED DECEMBER 31, 2002

ION NETWORKS, INC. AND SUBSIDIARIES

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEAR ENDED DECEMBER 31, 2003 AND NINE MONTHS ENDED DECEMBER 31, 2002

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of
ION Networks, Inc.

South Plainfield, New Jersey

We have audited the accompanying balance sheet of ION Networks, Inc. as of December 31, 2003, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ION Networks, Inc. as of December 31, 2003, and the consolidated results of their operations and thier cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the financial statements, the Company's recurring losses from operations and its difficulty in generating sufficient cash flow to meet its obligations and sustain its operations raise substantial doubt about its ability to continue as a going concern. Management's plans concerning these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Marcum & Kliegman LLP

New York, New York
February 19, 2004

38

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of
ION Networks, Inc. and Subsidiaries
Piscataway, New Jersey

We have audited the consolidated balance sheet (not separately included herein) of ION Networks, Inc. and subsidiaries (the "Company") as of December 31, 2002, and the related consolidated statements of operations, stockholders' equity, and cash flows for the nine months ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company at December 31, 2002, and the results of its operations and its cash flows for the nine months ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the 2002 financial statements, the Company's recurring losses from operations and its difficulty in generating sufficient cash flow to meet its obligations and sustain its operations raise substantial doubt about its ability to continue as a going concern. Management's plans concerning these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As discussed in Note 1 to the financial statements, effective April 1, 2002, the Company changed its fiscal year end from March 31 to December 31.

/s/ DELOITTE & TOUCHE LLP

March 11, 2003
Parsippany, New Jersey

ION NETWORKS, INC.

BALANCE SHEET

ASSETS	December 31 2003
Current assets	
Cash and cash equivalents	$ 357,711
Accounts receivable, less allowance for doubtful accounts of $66,549	397,744
Inventory, net	702,042
Prepaid expenses and other current assets	128,138
Total current assets	1,585,635
Property and equipment, net	57,432
Capitalized software, less accumulated amortization of $3,796,836	448,288
Other assets	13,301

Total assets	$ 2,104,656

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities	
Current portion of capital leases	$ 73,551
Current portion of long-term debt	2,202
Accounts payable	340,740
Accrued expenses	574,930
Deferred income	200,305
Sales tax payable	52,640
Other current liabilities	53,337
Total current liabilities	$ 1,297,705
Long term debt, net of current portion	9,441
Commitments and contingencies	
Stockholders' Equity	
Preferred stock - par value $.001 per share; authorized 1,000,000 shares, 200,000 shares designated Series A; 166,835 shares issued and outstanding (Aggregate Liquidation Preference $300,303)	167
Common stock - par value $.001 per share; authorized 50,000,000 shares; 24,875,500 shares issued and outstanding	24,876
Additional paid-in capital	44,585,740
Notes receivable from former officers	(486,535
Accumulated deficit	(43,326,738
Total stockholders' equity	797,510
Total liabilities and stockholders' equity	$ 2,104,656

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

40

ION NETWORKS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31, 2003	Nine Months E December 3 2002
Net sales	$ 3,342,620	$ 3,335,1
Cost of sales	866,371	1,142,9
	2,476,249	2,192,2

Less inventory write downs	26,002	285,1
Gross Margin	2,450,247	1,907,1
Research and development expenses	503,146	766,5
Selling, general and administrative expenses	2,452,031	5,519,6
Depreciation and amortization expenses	736,694	835,3
Restructuring, asset impairments and other (credits) charges	(405,402)	662,8
Loss from operations	(836,222)	(5,877,2
Interest income	19,872	36,7
Interest expense	(14,593)	(19,5
	(830,943)	(5,859,9
Loss before income taxes		
Income tax benefit	227,151	231,4
Net loss	$ (603,792)	$ (5,628,5
Per share data		
Basic and diluted	$ (0.03)	$ (0.
Weighted average number of common shares outstanding		
Basic and diluted	23,900,500	22,843,0

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

41

ION NETWORKS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31, 2003	Ni
Cash flows from operating activities		
Net loss	$ (603,792)	
Adjustments to reconcile net loss to net cash from operating activities:		
Restructuring, asset impairments and other charges, non-cash	(405,402)	
Depreciation and amortization	736,694	
Provision for inventory obsolescence	(26,002)	
Non-cash stock-based compensation charge	(95,000)	
(Cancellation) of restricted stock	--	
Notes receivable from officers	(13,130)	
Reserve allowance of related party note receivable	--	

Deferred compensation	--
Changes in operating assets and liabilities:	
Accounts receivable	164,018
Inventory	583,228
Prepaid expenses and other current assets	75,796
Other assets	1,577
Accounts payable and other accrued expenses	(690,303)
Accrued payroll and related liabilities	(82,543)
Deferred income	45,284
Sales tax payable	(31,385)
Other current liabilities	(35,980)
Net cash used in operating activities	(376,940)
Cash flows from investing activities	
Acquisition of property and equipment	--
Capitalized software expenditures	(214,996)
Proceeds from sale of equipment	30,129
Restricted cash	125,700
Net cash used in investing activities	(59,167)
Cash flows from financing activities	
Repayment of restricted stock note	--
Repayment of debt	(85,135)
Issuances of preferred stock, net	--
Net cash (used in) provided by financing activities	(85,135)
Effect of exchange rates on cash	13,269
Net decrease in cash and cash equivalents	(507,973)
Cash and cash equivalents - beginning of period	865,684
Cash and cash equivalents - end of period	$ 357,711
Supplemental information	
Cash paid during period for interest	$ 13,650
Cash paid for taxes	$ 0

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

42

ION NETWORKS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
FOR THE NINE MONTHS ENDED DECEMBER 31, 2002 AND
FOR THE YEAR ENDED DECEMBER 31, 2003

	Preferred Shares	Preferred Stock	Common Shares	Common Stock	Additional Paid-In Capital	Accum Def
Balance, March 31, 2002	-	-	25,138,000	$ 25,138	$44,381,454	$(37,
Comprehensive loss						
Net loss						(5,6
Translation adjustments						
Total comprehensive loss						
Issuances of preferred stock	166,835	167			285,136	
Cancellation of restricted shares			(262,500)	(262)	(80,850)	
Notes receivable from officers						
Deferred compensation						
Non-cash stock-based compensation					95,000	
Balance, December 31, 2002	166,835	$ 167	24,875,500	$ 24,876	$44,680,740	(42,7
Comprehensive loss						
Net loss						(6
Translation adjustments						
Total comprehensive loss						
Notes receivable from officers						
Non-cash stock-based compensation					(95,000)	
Balance, December 31, 2003	166,835	$ 167	24,875,500	$ 24,876	$44,585,740	$ (43,

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

ION NETWORKS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
FOR THE NINE MONTHS ENDED DECEMBER 31, 2002 AND
FOR THE YEAR ENDED DECEMBER 31, 2003

	Notes Receivable from former Officers	Deferred Compensation	Total Stockholders' Equity
Balance, March 31, 2002	$ (549,914)	$ (62,893)	$ 6,727,227
Comprehensive loss			
Net loss			(5,628,522)
Translation adjustments			(41,135)
Total comprehensive loss			(5,669,657)
Issuances of preferred stock			285,303
Cancellation of restricted shares			(81,112)
Notes receivable from officers	76,509		76,509
Deferred compensation		62,893	62,893
Non-cash stock-based compensation			95,000
Balance, December 31, 2002	$ (473,405)	-	$ 1,496,163
Comprehensive loss			
Net loss			(603,792)
Translation adjustments			13,269
Total comprehensive loss			(590,523)
Notes receivable from officers	(13,130)		(13,130)
Non-cash stock-based			

compensation			(95,000)
Balance, December 31, 2002	$ (486,535)	-	$ 797,510

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

44

ION NETWORKS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION AND BASIS OF PRESENTATION

The Company

ION Networks, Inc. (the "Company"), a Delaware corporation founded in 1999 through the combination of two companies -- MicroFrame, a New Jersey Corporation (the predecessor entity to the Company, originally founded in 1982), and SolCom Systems Limited, a Scottish corporation located in Livingston, Scotland (originally founded in 1994), designs, develops, manufactures and sells network and information security and management products to corporations, service providers and government agencies. The Company's hardware and software suite of products are designed to form a secure auditable portal to protect IT and network infrastructure from internal and external security threats. ION's products operate in the IP, data center, telecommunications and transport, and telephony environments and are sold by a direct sales force and indirect channel partners mainly throughout North America and Europe.

Our consolidated financial statements have been prepared on the basis that we will continue as a going concern, which contemplates the realization and satisfaction of liabilities and commitments in the normal course of business. At December 31, 2003, we had an accumulated deficit of $43,326,738 and a working capital position of $287,930. We also had net losses of $603,792 for the year ended December 31, 2003 and $5,628,522 for the nine months ended December 31, 2002.

During 2003, the Company stabilized its excessive negative cash flow and in fact increased its cash and cash equivalent position from a low of less than $100,000 at September 30, 2003 to approximately $357,000 at December 31, 2003. The Company continues to have a delicate cash position and while the future viability of the organization has significantly improved, it is necessary for it to continue to strictly manage expenditures and to increase revenues. In addition, it is the intention of the new management team, hired in the quarter ended September 30, 2003, to secure additional financing during 2004 to accelerate growth and insure long-term viability.

Basis of Presentation

Effective April 1, 2002, the Company changed its fiscal year end from March 31 to December 31. The consolidated financial statements include the presentation of the transition period beginning April 1, 2002 and ending on December 31, 2002.

The following table presents certain financial information for the years ended December 31, 2003 and 2002:

	YEAR ENDED DECEMBER 31, 2003	YEAR ENDED DECEMBER 31, 2002 (UNAUDITED)
Net Sales	$ 3,342,260	$ 5,411,357
Gross Margin	2,450,247	3,022,235
Loss from operations before income tax	(830,943)	(7,053,131)
Income tax benefit	227,151	255,791
Net loss	$ (603,792)	$ (6,846,068)
Basic and Diluted earnings per share	$ (0.03)	$ (0.30)
Weighted average common shares	23,900,500	22,843,009

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of ION Networks, Inc. and its subsidiaries (collectively, the "Company"). All material inter-company balances and transactions have been eliminated in consolidation.

Due to cost containment in 2003, the Company ceased its operations in Belgium and Scotland.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from those estimates.

The significant estimates include the allowance for doubtful accounts, allowance for inventory obsolescence, capitalized software including estimates of future gross revenues, and the related amortization lives, deferred tax asset valuation allowance and depreciation and amortization lives.

Cash and Cash Equivalents

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

Allowance for Doubtful Accounts Receivable

Accounts receivable are reduced by an allowance to estimate the amount that will actually be collected from our customers. Many of our customers have been adversely affected by economic downturn in the telecommunications industry. If the financial condition of our customers were to materially deteriorate, resulting in an impairment of their ability to make payments, additional allowances could be required.

Inventory, net

Inventories are stated at the lower of cost (average cost) or market. Reserves for slow moving and obsolete inventories are provided based on historical experience and current product demand. If our estimate of future demand is not correct or if our customers place significant order cancellations, inventory reserves could increase from our estimate. We may also receive orders for inventory that has been fully or partially reserved. To the extent that the sale of reserved inventory has a material impact on our financial results, we will appropriately disclose such effects. Our inventory carrying costs are not material; thus we may not physically dispose of reserved inventory immediately.

Property and Equipment

Property and equipment are stated at cost. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets, which are generally two to five years. Expenditures for maintenance and repairs, which do not extend the economic useful life of the related assets, are charged to operations as incurred. Gains or losses on disposal of property and equipment are reflected in the statements of operations in the period of disposal.

Capitalized Software

The Company capitalizes computer software development costs in accordance with the provisions of Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed" ("SFAS No. 86"). SFAS No. 86 requires that the Company capitalize computer software development costs upon the establishment of the technological feasibility of a product, to the extent that such costs are expected to be recovered through future sales of the product. Management is required to use professional judgment in determining whether development costs meet the criteria for immediate expense or capitalization. These costs are amortized by the greater of the amount computed using (i) the ratio that current gross revenues from the sales of software bear to the total of current and anticipated future gross revenues from the sales of that software, or (ii) the straight-line method over the estimated useful life of the product. As a result, the carrying amount of the capitalized software costs may be reduced materially in the near term.

We record impairment losses on capitalized software and other long-lived assets used in operations when events and circumstances indicate that the assets might be impaired and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of those items. Our cash flow estimates are based on historical results adjusted to reflect our best estimate of future market and operating conditions. The net carrying value of assets not recoverable is reduced to fair value. While we believe that our estimates of future cash flows are reasonable, different assumptions regarding such cash flows could materially affect our estimates.

The Company capitalized $214,996 and $339,688 of software development costs for the year ended December 31, 2003 and the nine months ended December 31, 2002, respectively. Amortization expense totaled $531,136 and $483,723 for the year December 31, 2003 and for the nine months ended December 31, 2002, respectively.

ION NETWORKS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Research and Development Costs

The Company charges all costs incurred to establish the technological feasibility of a product or enhancement to research and development expense in the period incurred.

Advertising Costs

The Company expenses advertising cost as incurred. The Company incurred approximately $1,000 and $17,726 for the year ended December 31, 2003 and the nine months ended December 31, 2002, respectively.

Revenue Recognition Policy

The Company recognizes revenue from product sales to end users, value-added resellers (VARs) and original equipment manufacturers (OEMs) upon shipment if no significant vendor obligations exist and collectibility is probable. We do not offer our customers the right to return products, however the Company records warranty costs at the time revenue is recognized. Management estimates the anticipated warranty costs but actual results could differ from those estimates. Maintenance contracts are sold separately and maintenance revenue is recognized on a straight-line basis over the period the service is provided, generally one year.

Shipping and Handling Costs

Shipping and handling costs incurred are billed to the customer and included as part of cost of sales.

Fair Value of Financial Instruments

The carrying value of items included in working capital and debt approximates fair value because of the relatively short maturity of these instruments.

Net Loss Per Share of Common Stock

Basic net loss per share excludes dilution for potentially dilutive securities and is computed by dividing net loss attributable to common shareholders by the weighted average number of common shares outstanding during the period. Diluted net loss per share reflects the potential dilution that could occur if securities or other instruments to issue common stock were exercised or converted into common stock. Potentially dilutive securities are excluded from the computation of diluted net loss per share when their inclusion would be antidilutive. A reconciliation between basic and diluted weighted average shares outstanding is as follows:

	Year Ended December 31, 2003	Nine Months Ended December 31, 2002
Weighted average shares outstanding, basic	23,900,500	22,843,009
Dilutive shares issuable in connection with stock plans and warrants granted	--	327,870
Conversion of preferred stock to common stock	1,668,350	661,273
Weighted average shares outstanding, diluted*	25,568,850	23,832,152

* Since there was a loss attributable to common shareholders in these periods, the basic weighted average shares outstanding were used in calculating diluted loss per share, as inclusion of the incremental shares shown in this calculation would be antidilutive. Potential common shares of 3,115,155 and 989,143 for the year ended December 31, 2003 and the nine month period ended December 31, 2002, repectively, were excluded from the computation of diluted earnings per share.

Stock Compensation

The Company records stock-based employee compensation arrangements in accordance with provisions of Accounting Principals Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees", and complies with the disclosure requirements of Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation" as amended by SFAS No. 148 "Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123," issued in December 2002. Under APB Opinion No. 25, compensation expense is based on the difference, if any, generally on the date of grant, between the fair value of our stock and the exercise price of the option. Equity instruments issued to non-employee vendors are recorded in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force ("EITF") Issue No. 96-18, "Accounting for Equity Instruments That are Issued to Other Than Employees from Acquiring, or in Conjunction with Selling, Goods and Services". All transactions in which goods or services are the consideration received for the issuance of equity instruments are accounted for based on the fair value of the consideration received or the fair value of the equity instrument issued, whichever is more reliably measurable. The measurement date of the fair value of the equity instrument issued is the date on which the counter party's performance is complete.

During the year ended December 31, 2003 there were no options issued. The weighted-average fair values at date of grant for options granted during the nine months ended December 31, 2002 was $0.32. The fair value of each option grant for the Company's common stock is estimated on the date of the grant using the Black Scholes option pricing model.

	December 31, 2002
Expected Volatility	135.27%
Risk-free interest rate	3.96
Expected option lives	5.48 years

If the Company had elected to recognize compensation costs based on the fair value at the date of grant for awards. Compensation expense for the year ended December 31, 2003 and the nine months ended December 31, 2002, consistent with the provisions of SFAS No. 123, the Company's net loss and basic and diluted net loss per share would have increased to the pro forma amounts indicated below: by $217,158 and $.01 and $201,279 and $.01, respectively, for the year ended December 31, 2003 and the nine months ended December 31, 2002.

	Year Ended December 31, 2003	Nine months ended December 31, 2002
Net loss		
As reported	$ (603,792)	$(5,628,522)
Deduct: Stock based employee compensation determined under the fair value methods	217,158	201,279
Pro forma net loss	$ (820,950)	$(5,829,801)
Basic and diluted net loss per share of common stock		
As reported	(0.03)	(0.25)
Pro forma	(0.03)	(0.26)

Foreign Currency Translation

The financial statements of the foreign subsidiaries were prepared in local currency and translated into U.S. dollars based on the current exchange rate at the end of the period for the balance sheet and a weighted-average rate for the period on the statement of operations. Translation adjustments are reflected as foreign currency translation adjustments in stockholders' equity and, accordingly, have no effect on net loss. Transaction adjustments for the foreign subsidiaries are included in income and are not material. The Company ceased its foreign operations during the year ended December 31, 2003.

Income Taxes

Deferred income tax assets and liabilities are computed annually based on enacted tax laws and rates for temporary differences between the financial accounting and income tax bases of assets and liabilities. A valuation allowance is established, when necessary, to reduce deferred income tax assets to the amount that is more likely than not to be realized.

ION NETWORKS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Warranty Costs

The Company estimates its warranty costs based on historical warranty claim experience. Future costs for warranties applicable to sales recognized in the current period are charged to cost of sales. The warranty accrual is reviewed quarterly to reflect the remaining obligation. Adjustments are made when actual warranty claim experience differs from estimates. The warranty accrual included in other current liabilities as of December 31, 2003 approximated $48,400.

Reclassifications

Certain amounts in the financial statements for the nine month period ended December 31,2002 and year ended March 31, 2002 have been reclassified to conform to the presentation of the financial statements for the year ended December 31, 2003.

3. RESTRUCTURING, ASSET IMPAIRMENTS AND OTHER CHARGES

As a result of the Company being notified by the landlord to cancel its lease effective August 15, 2003 at the Piscataway, NJ facility, the net book value of leasehold improvements amounting to $28,955 were written-off. In addition, the Company was required to sell property and equipment in order to move into its smaller newly leased facility. At June 30, 2003 the Company recorded an impairment of $163,662 which represents the difference between the cash proceeds of the August 2003 sale and carrying value prior to the impairment.

During the quarter ended June 30, 2003, the Company completed its voluntary liquidation of its UK subsidiary. As a result of the liquidation, the Company reversed its prior restructuring accrual of $508,458, which was recorded in fourth quarter 2002, related to the remaining long-term lease, and other operating accruals of $294,704. These accruals were reflected in the consolidated statement of operations as part of restructuring and SG&A expenses.

During the quarter ended September 30,2003 the Company successfully negotiated a settlement of a $243,071 open payable due to Xetel for a payment of $30,000 and a forgiveness of debt in the amount of $213,071.

The components of the restructuring, asset impairments and other charges are as follows:

	Asset Impairment	Restructuring	Other Charges	Total
First Quarter 2003 charges	$ --	$ 123,510	$ --	$ 123,51
Second Quarter 2003 charges	192,617	(508,458)	--	(315,84

Third Quarter 2003 charges	--	--	(213,071)	(213,07
Fourth Quarter 2003 charges	--	--	--	-
Total	$ 192,617	$ (384,948)	$ (213,071)	$ (405,40

The Company is in negotiations with the landlord from the Fremont, California location for the disposition of the reserved amount of $123,510. The Company has not occupied the space since approximately March 2003 and the successful outcome of the negotiations cannot be assured, however, the Company believes that the amount should not exceed the reserved amount of $123,510.

During the quarter ended December 31, 2002 the Company separated with thirteen employees which resulted in a restructuring charge during the quarter of $154,370 in severance and other related matters, all of which has been paid prior to December 31, 2002.

Also during the quarter ended December 31, 2002, the Company abandoned the space at SolCom House, Livingston, Scotland that was leased by its subsidiary ION Networks, Ltd. As a result, the Company recorded a charge of $508,458 in the quarter ended December 31, 2002 for the remainder of the lease term that expires on August 31, 2011.

In January 2003, the Company's sub-tenant, Multipoint voluntarily filed for Chapter 7 Bankruptcy with the U.S. Bankruptcy Court for the District of New Jersey. As a result of consideration of Multipoint's financial condition, culminating with the bankruptcy, the Company wrote-off an amount of $122,550 for the unpaid balance of rent due from Multipoint which is included in selling and general and administrative expenses.

4. INVENTORY

Inventory, net of reserves of $198,734, consists of the following:

	December 31, 2003
Raw materials	$ 62,851
Work-in-progress	47,044
Finished goods	592,147
Inventory , net	$ 702,042

Consistent with the downturn in markets served by us, we evaluated our inventory levels in light of actual and forecasted revenue. As a result, we recorded a charge of $26,002 and $285,135 to cost of sales for the year ended December 31, 2003 and the nine months ended December 31, 2002, respectively, related to reserves for excess and obsolete inventory. We will continue to monitor our excess reserves and to the extent that inventory that has been reserved as excess is ultimately sold by us, such amounts will be disclosed in the future.

5. PROPERTY AND EQUIPMENT, NET

Property and equipment consists of the following:

	December 31, 2003
Computer and other equipment	$ 807,123
Furniture and fixtures	68,408
	875,531
Less accumulated depreciation	818,099
Property and equipment, net	$ 57,432

Depreciation expense for property and equipment for the year ended December 31, 2003 and the nine months ended December 31, 2002, amounted to $205,558 and $351,592. During the year ended December 31, 2003 and the nine months ended December 31, 2002, the Company retired both fully and not fully depreciated assets amounting to $1,730,369 and $847,785, respectively. During the year ended December 31, 2003 the Company relocated it's headquarters and therefore, recorded an asset impairment charge of $192,617 to recognize the retirement of assets not fully depreciated.

6. DEBT

In 1998, the Company entered into two equipment loan agreements for its Belgium subsidiary. The first loan is for approximately $50,000, the loan was due July 2003 and bore an interest rate of 5.2%. The second loan was for approximately $30,000, the loan was due February 2003 and bore an interest rate of 2.5%. At December 31, 2003 there is no outstanding balance under either term loan. During the year ended December 31, 2003, the Company ceased its operations in Belgium.

Due to the expiration of the Company's $1,500,000 line of credit on September 30, 2000, the Company pledged $375,000 on September 7, 2000 as collateral on an outstanding letter of credit related to the required security deposit for the Company's Piscataway, New Jersey corporate headquarters facility. On November 9, 2001, the Company entered into an agreement with the landlord for its Piscataway, NJ facility to amend the Lease Agreement dated February 18, 1999.

The amendment allowed the Company to use $250,000 of its restricted cash from the letter of credit towards the rent payments for 10 months starting January 2002. On January 10, 2002, the Landlord received the $250,000 from the letter of credit per the above mentioned lease amendment. The Company agreed to replenish the letter of credit by November 2003. On March 17, 2003 the Company entered into an agreement with the landlord to amend the lease for its Piscataway, NJ facility to reduce the letter of credit to $60,000 and to replenish it by December 2003. The Company moved its corporate location as of August 15, 2003 from its Piscataway, NJ facility and no longer holds any obligations for a security deposit.

7. INCOME TAXES

As of December 31, 2003, the Company has available federal and state net operating loss carry forwards of approximately $42,188,000 and $23,836,000, respectively, to offset future taxable income. The federal net operating loss carry forwards expire during the years 2011 through 2024. In addition, the Company has investment credit and research and development credit carry forwards aggregating approximately $405,000, which may provide future tax benefits, expiring from 2008 through 2020.

The Company acquired a corporation business tax benefit certificate pursuant to New Jersey law which relates to the surrendering of unused net operating losses. For the year ended December 2003 and the nine months ended December 31, 2002, the Company received a benefit of $227,151 and $236,728, respectively.

The components of the income tax benefit for the year ended December 31, 2003 and the nine months ended December 31, 2002 are as follows:

	December 31, 2003	December 31, 2002
Current		
Federal	$ 227,151	$ 236,728
State	--	--
Foreign	--	(5,301)
Subtotal	$ 227,151	$ 231,427
Deferred		
Federal	--	--
State	--	--
	$ 227,151	$ 231,427

The reasons for the difference between the Company's effective tax rate and the United States federal statutory rate are as follows:

	December 31, 2003	December 31, 2002
Effective tax rate reconciliation		
Statutory federal tax rate	(34)%	(34)%
State taxes, net of federal benefit	(6)	(6)
Effect of recording valuation allowance on net operating loss carry forwards	39	39
Sale of state net operating losses and other	1	(8)

	--	-9%

ION NETWORKS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The tax effect of temporary differences which make up the significant components of the net deferred tax asset and liability at December 31, 2003 and 2002 are as follows:

	December 31, 2003	December 2002
Current deferred tax assets		
Inventory reserves	$ 132,850	$ 367
Accrued expenses	36,610	71
Allowance for doubtful accounts	60,100	69
Total current deferred tax assets	229,560	508
Valuation allowance	(229,560)	(508
Net current deferred tax assets	--	
Noncurrent deferred tax assets		
Depreciation and amortization	250,000	250
Net operating loss carry forwards	14,343,920	16,304
Research and development credit	405,078	254
Alternative minimum tax credit	--	20
Total noncurrent deferred tax assets	14,998,998	16,828
Valuation allowance	(14,784,003)	(16,329
Net noncurrent deferred tax assets	214,995	499
Noncurrent deferred tax liabilities		
Capitalized software	(214,995)	(499
Total noncurrent deferred tax liabilities	$ (214,995)	$ (499
Net noncurrent deferred tax (liabilities) assets	$ --	$

The Company has recorded a full valuation allowance against the deferred tax assets, including the federal and state net operating loss carry forwards as management believes that it is more likely than not that substantially all of the deferred tax assets will not be realized.

8. STOCKHOLDERS' EQUITY

PREFERRED STOCK - On September 13, 2002 the Company received equity financing in the amount of $300,303 ($285,303, net of issuance costs) for the issuance of 166,835 unregistered shares of the Company's preferred stock at $1.80 per share. The Company has designated 200,000 of the 1,000,000 authorized shares of preferred stock as Series A Preferred Stock ("Preferred Stock"). Each share of Preferred Stock is convertible into 10 shares of the Company's common stock at the conversion price of $0.18 per share of common stock, which was the closing bid price of the Company's common stock on September 13, 2002. The Preferred Stock is non-voting, has a standard liquidation preference equal to its purchase price, and does not pay dividends. Proceeds of the equity financing will be used for working capital and general corporate purposes. All of the shares of Preferred Stock were purchased by directors and management of the Company.

RESTRICTED STOCK - Effective October 2001, the Company approved and granted 2,600,000 shares of restricted stock (the "Restricted Shares") to two executives stockholders at fair value. The Restricted Shares are subject to a repurchase right which will permit the Company to repurchase any shares which have not yet vested at the effective date of termination of the officers' employment, as defined in their employment agreements, for an amount equal to the purchase price per share paid by the officers. The Company received a series of partial recourse interest bearing (5.46% on an annual basis) promissory notes for the value of the Restricted Shares to be repaid by the officers. As of December 31, 2003 Mr. Kam Saifi owes approximately $290,718 (including approximately $32,718 of interest) for 2,000,000 Restricted Shares and; Mr. Cameron Saifi owes approximately $208,526 (including approximately $23,126 of interest) for 600,000 Restricted Shares.

The notes are to be repaid by the officers at the earlier of ten years or the date upon which the employees dispose of their shares or under certain circumstances, when the borrower's employment with the Company terminates for any reason. The issuance of the restricted shares and the notes receivable due from the former officers is recorded in the Company's financial statements. On July 7, 2003, Mr. Kam Saifi and Mr. Cameron Saifi separated from the Company. The Company is in the process of negotiating settlement agreements with the former officers.

The variable accounting method used to account for the partial recourse restricted stock granted to management resulted in a cashless charge of $95,000 for the period ended December 31, 2002. In accordance with accounting guidance for the partial recourse restricted stock granted to management resulted in a reversal of the cashless charge of $95,000 for the period ended December 31, 2003

COMMON STOCK - On February 14, 2002 the Company sold 4,000,000 shares of common stock at a price of $0.87 per share, for total consideration of $3,480,000. In connection with this sale, warrants to purchase 1,120,000 shares of common stock with an exercise price of $1.25 were issued. The warrants expire on February 14, 2007.

STOCK OPTION PLANS

In June 2002, the Company adopted its 2002 Stock Incentive Plan (the "2002 Plan"). The 2002 Plan provides for the issuance of stock options, grants of common stock and stock appreciation rights covering up to 1,250,000 shares of common stock; provided, however, no more than 250,000 shares may be issued in connection with awards or stock appreciation rights. In January 2004, the Company discovered that the 2002 Plan was improperly approved without regard to rights granted to the holders of its Series A preferred stock which required prior approval of the holders of majority of Series A preferred stock prior to issuance or authorization of equity securities or instruments convertible into or exercisable for equity securities. No awards were made under 2002 Plan. The Company is taking the position that the 2002 Plan is invalid.

In November 2000, the Company adopted its 2000 Stock Option Plan (the "2000 Plan"). The aggregate number of shares of common stock for which options may be granted under the 2000 Plan is 3,000,000. The maximum number of options which may be granted to an employee during any calendar year under the 2000 Plan is 400,000. The term of these non-transferable stock options may not exceed ten years. The exercise price of these stock options may not be less than 100% (110% if the person granted such options owns more than ten percent of the outstanding common stock) of the fair value of one share of common stock on the date of grant. During the year ended December 31, 2003 and the nine month period ended December 31, 2002, the Company granted options to purchase zero and 838,000, shares, respectively. At December 31, 2003, 868,775 options were outstanding under the 2000 Plan, of which 660,875 options were exercisable.

The aggregate number of shares of common stock for which options may be granted under the 1998 Stock Option Plan (the "1998 Plan") is 3,000,000. The maximum number of options which may be granted to an employee during any calendar year under the 1998 Plan is 400,000. The term of these non-transferable stock options may not exceed ten years. The exercise price of these stock options may not be less than 100% (110% if the person granted such options owns more than ten percent of the outstanding common stock) of the fair value of one share of common stock on the date of grant. During the year ended December 31, 2003 and the nine months ended December 31, 2002, the Company granted no options to purchase shares. At December 31, 2003, 533,629 options were outstanding under the 1998 Plan, of which 482,800 options were exercisable.

In August 1994, the Company adopted its 1994 Stock Option Plan (the "1994 Plan"). The 1994 Plan, as amended, increased the number of shares of common stock for which options may be granted to a maximum of 1,250,000 shares. The term of these non-transferable stock options may not exceed ten years. The exercise price of these stock options may not be less than 100% (110% if the person granted such options owns more than ten percent of the outstanding common stock) of the fair market value of one share of common stock on the date of grant. During the year ended December 31, 2003 and the nine month period ended December 31, 2002, there were no option grants provided under the 1994 Plan. At December 31, 2003, 32,751 options were outstanding under the 1994 Plan, of which 32,751 options were exercisable.

WARRANTS

During July 2001 in connection with services being performed by a consultant, the Company issued warrants to purchase 48,000 shares of the Company's common stock at $0.62 per share, as of December 31, 2003 no warrants have been exercised. The warrants vested immediately and expire five years from the date of the grant. The Company recorded compensation expense of $13,199 based upon the fair value of the vested warrants as determined using the Black Scholes pricing model. In connection with the sale of common stock on February 14, 2003, warrants to purchase 1,120,000 shares of common stock with an exercise price of $1.25 were issued. The warrants expire on February 14, 2007.

During January 2002 in connection with services being performed by a consultant through June 30, 2002, the Company issued warrants to purchase 100,000 shares of the Company's common stock at $1.35 per share. Warrants to purchase an additional 50,000 shares of common stock are exercisable at $1.80, and the warrants vested immediately and expire three years from the date of the grant. The Company recorded compensation expense of $62,893 based upon the fair value of the vested warrants as determined using the Black Scholes pricing model.

OTHER OPTIONS

During September 1996, the Company issued options to certain officers and directors to purchase 620,000 shares of the Company's common stock, of which 420,000 vested immediately and 100,000 vested on April 1, 1998 and 1999. Options expire ten years from the date of grant. The exercise price of the options is equal to the market value of the Company's stock on the date of grant. There were no stock option exercised during the year ended December 31, 2003 and the nine months ended December 31, 2002. At December 31, 2003, 400,000 options were outstanding and exercisable.

During March 1999, the Company issued options to certain employees and consultants to purchase 20,000 shares of the Company's common stock, all of which vested on the first year anniversary of the date of the grant. The options expire six years from the date of the grant. The exercise price of the options is equal to the market value of the Company's common stock on the date of the grant. There were no stock options exercised during the year ended December 31, 2003 and the nine month period ended December 31, 2002. At December 31, 2003, 10,000 options were outstanding and exercisable.

ACCOUNTING FOR STOCK-BASED COMPENSATION

The Company continues to apply Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" and related Interpretations in accounting for its options. During the year ended December 31, 2003 and the nine months ended December 31, 2002 the Company had recorded no compensation expense as no options were granted to employees below market value.

Details of the options granted are as follows:

	Shares	Weighted Average Exercise Price ($)
Options outstanding at March 31, 2002	4,928,260	1.
Granted	838,000	0.
Canceled	(2,099,158)	1.

Exercised	-	
Options outstanding at December 31, 2002	3,667,102	1.
Granted	-	
Canceled	(1,821,947)	3.
Exercised	-	
Options outstanding at December 31, 2003	1,845,155	1.
Options exercisable at December 31, 2003	1,586,426	1.

Range of Exercise	Number Outstanding	Weighted Average Remaining Years of Contractual Life	Weighted Average Exercise Price
$0.00 - 7.53	1,774,990	3.2	$ 0.98
$7.54 - 15.06	57,105	4.0	11.60
$15.06 - 22.59	3,000	1.05	22.00
$22.59 - 30.12	1,500	1.26	29.25
$30.12 - 37.65	8,560	1.44	34.47
$0.00 - 37.65	1,845,155	3.21	$1.52

9. COMMITMENTS

Operating Leases

The Company entered into a lease on August 1, 2003 for approximately 7,000 square feet for its principal executive offices at 120 Corporate Blvd., South Plainfield, New Jersey. The base rent is $4,505 per month effective October 2003 through July 2006. The Company is also obligated to make additional payments to the landlord relating to certain taxes and operating expenses.

As a result of the Company being notified by the landlord of their intent to cancel its lease effective August 15, 2003, the Company no longer occupies the space at 1551 S. Washington Avenue, Piscataway, New Jersey. The Company entered into the lease on February 18, 1999 for approximately 26,247 square feet for its principal executive offices. On March 17, 2003, the Company signed an amendment with the landlord reducing the space from 26,247 to 12,722 square feet and the rent from $50,153.64 to $20,143.17 per month effective March 1, 2003. The Company was also obligated to make additional payments to the landlord relating to certain taxes and operating expenses.

The Company abandoned the lease space at 48834 Kato Road, Fremont, California in the Bedford Fremont Business Center. This lease commenced on June 1, 1999 and is for a term of 60 months with monthly rent payable by the Company to the landlord as follows: $7,360 per month for the first 12 months of the term; $7,590 per month for months 13-24; $7,820 per month for months 25-36; $8,050 per month for months 37-48; and $8,280 per month for months 49-60. The Company entered into an abandonment agreement with the landlord in March of 2003. As a result, the Company recorded a one-time restructure charge of $ 139,610 in the quarter Capital Leases Operating Leases ended March 31, 2003. This amount represents the total lease payments from December 2002 to May 2004 offset by landlords stated sub-lease rental payments. However, the Company and Landlord have no settlement agreement in place at this time.

The Company leases certain equipment under agreements which are classified as capital leases. Each of the capital lease agreements expire within five years and have purchase options at the end of the lease term.

Future minimum payments, by year and in the aggregate, under non-cancelable operating and capital leases as of December 31, 2003 are as follows:

	Capital Leases	Operating Leases
Year ending December 31,		
2004	$ 76,410	$ 77,016
2005	-	77,016
2006	-	44,926
Total minimum lease payments	$ 76,410	$ 198,958
Less amount representing interest	2,859	
Present value on net minimum lease payment	$ 73,551	

Rent expense under operating leases for the year ended December 31, 2003 and the nine months ended December 31, 2002 was $210,796 and $1,165,118 (including a charge of $508,458 for abandoning the Livingston, Scotland lease), respectively.

10. CONTINGENT LIABILITIES

In the normal course of business the Company and its subsidiaries may be involved in legal proceedings, claims and assessments arising in the ordinary course of business. Such matters are subject to many uncertainties, and outcomes are not predictable with assurance.

11. EMPLOYEE BENEFIT PLANS

Effective April 1, 1993, the Company adopted a defined contribution savings plan. The terms of the plan provide for eligible employees who have met certain age and service requirements to participate by electing to contribute up to 15% of their gross salary to the plan, as defined, with the Company matching 30% of an employee's contribution in cash up to a maximum of 6% of gross salary, as defined. Company contributions vest at the rate of 25% of the balance at each employee's second, third, fourth, and fifth anniversary of employment. The employees' contributions are immediately vested. The Company's contribution to the savings plan for the nine months ended December 31, 2002 was $26,342. As of January 1, 2003, the Company per the provisions of the plan decided not to make discretionary contribution until further notice.

12. GEOGRAPHIC INFORMATION

The Company's headquarters, physical production and shipping facilities are located in the United States. The Company's domestic and foreign export sales for the year ended December 31, 2003 and the nine months ended December 31, 2002 are as follows:

	Year Ended December 31, 2003	Nine Months Ending December 31, 2002
United States	$ 2,743,170	$ 2,811,899
Europe	477,153	430,859
Pacific Rim	122,188	48,685
Other	109	43,717
	$ 3,342,620	$ 3,335,160

The Company sold a substantial portion of its products to four customers. Sales to these customers amounted to $1,562,410 (46% of net sales) and $1,591,107 (48% of net sales) for the year ended December 31, 2003 and the nine months ended December 31, 2002, respectively. For the year ended December 31, 2003, our most significant customers were Avaya, Inc. (18% of net sales), Siemens (12% of net sales), Qwest (9% of net sales) and MCI Worldcom (7% of net sales). For the nine-months ended December 31, 2002, our most significant customers were SBC (13% of net sales), Sprint (12% of net sales) Avaya Inc.(12% of net sales) and Siemens (11% of net sales).

The loss of any of these four customers or a significant decline in sales volumes from any of these four customers could have a material adverse effect on the Company's financial position, results of operations and cash flows.

13. CONCENTRATION OF CREDIT RISK

The Company maintains deposits in a financial institution which is insured by the Federal Deposit Insurance Corporation ("FDIC") up to $100,000. At December 31, 2003 and periodically throughout 2003, the Company had deposits in this financial institution in excess of the amount insured by the FDIC.

The Company designs its products utilizing readily available parts manufactured by multiple suppliers and the Company currently relies on and intends to continue to rely on these suppliers. The Company has been and expects to continue to be able to obtain the parts generally required to manufacture its products without any significant interruption or sudden price increase, although there can be no assurance that the Company will be able to continue to do so.

The Company sometimes utilizes a component available from only one supplier. If a supplier were to cease to supply this component, the Company would most likely have to redesign a feature of the affected device. In these situations, the Company maintains a greater supply of the component on hand in order to allow the time necessary to effectuate a redesign or alternative course of action should the need arise.

56

ION NETWORKS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

14. SUPPLEMENTAL CASH FLOW INFORMATION

	Year Ended December 31, 2003	Nin De
Other Non-Cash Investing and Financing Activities		
Options and warrants issued to consultants as non-cash compensation	$ --	$
Non-cash stock-based compensation charge	$ (95,000)	$

15. RELATED PARTY TRANSACTIONS

During April 2000, the Company issued a loan (the "Loan") to the former Chief Executive Officer (the "Former CEO") of the Company in the amount of $750,000. The Loan accrues interest at a rate of LIBOR plus 1%. This Loan had an original maturity date of the earlier of April 2005 or thirty days after the Company for any reason no longer employed the Former CEO.

The Former CEO resigned his position at the Company effective September 29, 2000. On October 5, 2000, the Company entered into an agreement with the Former CEO pursuant to which the $750,000 promissory note for the Loan was amended to extend the due date to April 30, 2001, and to provide that interest on the note shall accrue through September 29, 2000. Pursuant to the terms of the Separation and Forbearance Agreement between the Company and the Former CEO, the Former CEO also agreed to reimburse the Company for certain expenses totaling $200,000, to be paid over a period of six months ending March 31, 2001. During the year ended March 31, 2001, $50,000 of the amounts owed to the Company by the Former CEO was repaid and $22,000 has been recorded as a non-cash offset as a result of earned but unpaid vacation owed to the Former CEO. During the year ended March 31, 2002, $813,593 was repaid. At December 31, 2003, the total amount owed to the Company by the Former CEO was approximately $175,154, which includes interest accrued through December 31, 2003. The full amount has been recorded as a reserve against the note receivable. The Company will continue to attempt to collect the note receivable.

The Company entered into a definitive Sublease Agreement with Multipoint Communications, LLC (the "Tenant") on April 17, 2002 to sublease approximately 5,400 square feet of its facility for a period of 24 months. As part of the rental payment the Company was to be issued shares totaling the value of $77,400, which shall be based on the per share price of the Tenant's common stock as priced in the first round of institutional financing (the "Financing") which was intended to close on or before June 30, 2002. The Financing did not close by June 30, 2002, consequently, the Tenant was required to pay the Company additional rent in the amount of $4,300 per month commencing on July 1, 2002. The Chairman of the Board of Directors of the Company served as a Chief Financial Officer of the tenant until November 2002. On or about January 16, 2003, the Tenant voluntarily filed for Chapter 7 bankruptcy with the U.S. Bankruptcy Court for the District of New Jersey. As a result, the Company wrote off an amount of $122,550 which is included in selling, general and administrative expenses.

16. NEW ACCOUNTING PRONOUNCEMENTS

In January 2003, the FASB issued Interpretation No. 46 ("FIN 46", "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity 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 financial support from other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31,2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after December 15, 2003. In December 2003, the FASB issued Interpretation No. 46R ("FIN 46") which revised certain provisions of FIN 46. Publicly reporting entities that are small business issuers may apply FIN 46R to all entities subject to FIN 46R no later than the end of the first reporting period that ends after December 15, 2004 (as of December 31, 2004, for a calendar enterprise). The effective date includes those entities to which FIN 46 had previously been applied. However, prior to the application of FIN 46R, a public entity that is a small business issuer shall apply FIN46 or FIN 46R to those entities that are considered special-purpose entities no later than as of the end of the first reporting period that ends after December 15, 2003(as of December 31, 2003 for the calendar year).

In April 2003, SFAS 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" (SFAS 149) was issued. SFAS 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 ("SFAS 133"), " Accounting for Derivative Instruments and Hedging Activities". This statement is effective for contracts entered into or modified after June 30, 2003.

During 2003, SFAS150, "Accounting for Certain Financial Instruments with

Characteristics of both Liabilities and Equity" ("SFAS 150") was issued. SFAS 150 establishes standards for classification and measurement of certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in certain cases). The provisions of SFAS 150 are effective for instruments entered into or modified after May 31,2003 and pre-existing instruments as of July 1, 2003. On October 29, 2003, the FASB voted to indefinitely defer the effective date of SFAS 150 for mandatory redeemable instruments as they relate to minority interests in consolidated finite-lived entities through the issuance of FASB Staff Position 150-3.

In December 2003, a revision of SFAS 132 "Employers' Disclosures about Pensions and Other Postretirement Benefits" was issued, revising disclosures about pension loans and other post retirements benefits plans and requiring additional disclosures about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other defined benefit postretirement plans.

The Company expects that the adoption of the new statements will not have a significant impact on its financial statements.

EXHIBIT INDEX

Exhibit No.	Description
3.1	Certificate of Incorporation of the Company, as filed with the Secretary of State of the State of Delaware on August 5, 1998./(2)/
3.2	Certificate of Amendment of the Certificate of Incorporation, as filed with the Secretary of State of the State of Delaware on December 11, 1998./(2)/
3.3	Certificate of Amendment of the Certificate of Incorporation, as filed with the Secretary of state of the State of Delaware an October 12, 1999./(3)/
3.4	By-Laws of the Company./(2)/
3.5	Form of Specimen Common Stock Certificate of the Company./(4)/
4.1	1994 Stock Option Plan of the Company. /(1)/
4.2	1998 Stock Option Plan of the Company./(2)/
4.3	1998 U.K. Sub-Plan of the Company, as amended./(2)/
4.4	Amended and Restated Certificate of Designation of Rights Preferences, Privileges and Restrictions of Series A Preferred Stock of ION Networks, Inc. /21/
4.5	2000 Stock Option Plan of the Company./(17)/
4.6	2002 Stock Option Plan of the Company./(19)/

4.7	Form of Warrant Agreement dated July 17, 2001./(13)/
4.8	Form of Warrant Agreement dated January 4, 2002./(13)/
4.9	Form of Non-Qualified Stock Option Agreement dated March 19, 1999 by and between the Company's predecessor, Microframe, Inc. and its consultants./(13)/
4.10	Form of Non-Employee Director Stock Option Contract dated March 10, 1998 between the Company's predecessor, Microframe, Inc. and its non-employee directors./(13)/
4.11	Form of Non-Employee Director Stock Option Contract dated September 17, 1997 by and between the Company's predecessor, Microframe, Inc. and its non-employee directors./(13/)
4.12	Form of Non-Qualified Stock Option Agreement dated September 25, 1996 by and between the Company's predecessor, Microframe, Inc. and its employees./(13)/

Exhibit No.	Description
4.13	Amended and Restated Non-Qualified Stock Option Agreement dated May 19, 1997 by and between the Company's Predecessor, Microframe, Inc. and its employees./(9)/
10.3	Agreement dated as of December 19, 1994 by and between LeeMAH DataCom Security Corporation and Siemens Rolm Communications Inc./(4)/
10.4	Equipment Lease Agreements dated June 10, 1999 and May 5, 1999 by and between the Company and Siemens Credit Corporation./(4)/
10.5	Equipment Lease Agreement dated June 17, 1999 by and between the Company and Lucent Technologies./(4)/
10.6	(i) Non-negotiable Promissory Note in the principal amount of $750,000 issued by Stephen B. Gray to the Company./(5)/
	(ii) First Amendment to Promissory Note dated as of August 5, 2000 by and between the Company and Stephen B. Gray./(5)/
10.7	Line of Credit Agreement with United Nations Bank dated September 30, 1999./(5)/
10.8	(i) Separation and Forbearance Agreement made as of October 5, 2000 between the Company and Stephen B. Gray./(7)/
	(ii)Promissory Note in the amount of $163,000 dated October 5, 2000 made by Stephen B. Gray to the Company./(7)/
10.9	Materials and Services Contract dated January 16, 2001, between the Company and SBC Services, Inc./(8)/

10.10	Stock Purchase Agreement dated August 11, 2000 by and between the Company and the parties identified therein./(8)/
10.11	Purchase Agreement by and between the Company and the Selling Shareholders set forth therein dated February 7, 2002./(18)/
10.12	Employment Agreement dated October 4, 2001 between the Company and Kam Saifi./(11)/
10.13	Employment Agreement dated October 17, 2001 between the Company and Cameron Saifi./(12)/
10.14	Sublease Agreement dated April 17, 2002 between the Company and Multipoint Communications, LLC./(14)/

Exhibit No.	Description
10.15	Agreement and General Release dated August 15, 2002 between the Company and Ron Forster./(16)/
10.16	Rescission Agreement dated September 29, 2002 between the Company and David Arbeitel./(16)/
10.17	Separation Agreement and General Release dated October 31, 2002 between the Company and David Arbeitel./(16)/
10.18	Employment Agreement dated May 20, 2002 between the Company and Ted Kaminer./(15)/
10.19	Employment Agreement dated February 25, 2002, between the Company and William Whitney./21/
10.20	Employment Agreement dated August 15, 2003, between the Company and Norman E. Corn./22/
10.21	Employment Agreement dated September 15, 2003, between the Company and Patrick E. Delaney./20/
10.22	Lease Agreement dated July 21, 2003 by and between the Company and 116 Corporate Boulevard, LLC, Inc.*
16.1	Letter dated October 31,2003, from Deloitte & Touche, LLP. to the Securities and Exchange Commission./(10)/
21.1	List of Subsidiaries./(14)/
31.1	Certification of CEO Pursuant to Section 302 of the Sarbanes Oxley Act of 2002.*
31.2	Certification of CFO Pursuant to Section 302 of the Sarbanes Oxley Act of 2002.*
32.1	Certification of CEO Pursuant to Section 906 of the Sarbanes

Oxley Act of 2002.*

32.2 Certification of CFO Pursuant to Section 906 of the Sarbanes Oxley Act of 2002.*

(1) Incorporated by Reference to the Company's Registration Statement on Form S-8 filed on August 15, 1995.

(2) Incorporated by Reference to the Company's Registration Statement on Form S-8 filed on April 22, 1999.

(3) Incorporated by reference to the Company's Registration Statement on Form S-8 filed on March 17, 2000.

(4) Incorporated by reference to the Company's Annual Report on Form 10-KSB for the fiscal year ended March 31, 1999.

(5) Incorporated by reference to the Company's Annual Report on Form 10-KSB filed on June 28, 2000.

(6) Incorporated by Reference to the Company's Current Report on Form 8-K filed on March 12, 1999.

(7) Incorporated by reference to the Company's Quarterly report on Form 10-QSB filed on November 14, 2000

(8) Incorporated by reference to the Company's Annual report on Form 10-KSB filed on June 29, 2001.

(9) Incorporated by reference to the Company's Registration Statement on Form S-8 filed on November 17, 2000.

(10) Incorporated by reference to the Company's Annual report on Form 8-KSB filed on October 31, 2003.

(11) Incorporated by Reference to the Company's Current Report on Form 8-K filed on October 23, 2001.

(12) Incorporated by Reference to the Company's Current Report on Form 8-K filed on October 24, 2001.

(13) Incorporated by reference to the Company's Annual Report on Form 10-KSB for the fiscal year ended March 31, 2002, as filed on July 1, 2002.

(14) Incorporated by reference to the Company's Annual Report on Form 10-KSB/A, Amendment No.2, for the fiscal year ended March 31, 2002, as filed on August 2, 2002.

(15) Incorporated by reference to the Company's Quarterly Report on Form 10-QSB filed on August 14, 2002.

(16) Incorporated by reference to the Company's Quarterly Report on Form 10-QSB filed on November 14, 2002.

(17) Incorporated by Reference to the Company's Registration Statement on Form S-8 filed on January 11, 2002.

(18) Incorporated by Reference to the Company's Registration Statement on Form S-3 filed on March 4, 2002.

(19) Incorporated by Reference to the Company's Definitive Proxy Statement filed on September 16, 2002.

(20) Incorporated by reference to the Company's Quarterly Report on Form 10-QSB filed on November 17, 2003.

(21) Incorporated by reference to the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2002, as filed on April 15, 2003.

(22) Incorporated by reference to the Company's Quarterly Report on Form 10QSB filed on September 12, 2003.

* Filed herewith

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FILM COSTS, net of accumulated amortization of $8,497,211 and

$5,653,477, respectively
23,133,560 23,808,869
PROPERTY AND EQUIPMENT, net of accumulated depreciation of

$94,910 and $90,968, respectively
24,540 26,389
TOTAL ASSETS
$27,945,645 $28,624,810 LIABILITIES AND SHAREHOLDERS' EQUITY
CURRENT LIABILITIES:

Bank overdraft
$987 $-
Accounts payable
2,569,275 2,304,009
Accrued liabilities
2,382,916 2,414,963
Participation and residuals
503,187 480,357
Other loans
1,755,250 1,534,591
Film and production loans
10,890,430 16,766,689
Deferred income
407,763 1,460,230
VAT payable
1,477,584 1,463,497
Total current liabilities
19,987,392 26,424,336

TOTAL LIABILITIES
19,987,392 26,424,336
SHAREHOLDERS' EQUITY
Convertible redeemable preference shares, £1.00 par value, 6,000,000 shares authorized; no shares issued and outstanding
Ordinary stock, £0.25 par value, 20,527,360 shares authorized;

2,643,131 and 1,495,460 shares issued and outstanding
1,121,208 641,126
Deferred stock, £0.45 par value, 13,184,000 shares authorized;

13,184,000 and 13,184,000 shares issued and outstanding
11,636,594 11,636,594
Deferred stock, £1.00 par value, 2,268,120 and 1,495,460

shares issued and outstanding
3,876,745 2,564,504
Additional paid in capital
11,118,198 9,248,415
Convertible debentures
3,432,450 3,432,450
Receivable from Employee Benefit Trust
(1,237,417) (2,121,458)
Accumulated deficit
(19,952,188) (21,413,746)
Translation reserve
(2,037,337) (1,787,411)
Shareholders' equity
7,958,253 2,200,474
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY
$27,945,645 $28,624,810

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

F-25

SEVEN ARTS PICTURES PLC.

CONSOLIDATED STATEMENTS OF OPERATIONS AND
OTHER COMPREHENSIVE INCOME
FOR THE YEARS ENDED JUNE 30, 2011 AND 2010

	Year Ended June 30, 2011	Year Ended June 30, 2010
Revenue		
Film revenue	$2,758,359	$1,974,516
Fee related revenue - related party	570,029	4,442,919
Total revenue	3,328,388	6,417,435
Cost of sales		
Amortization and impairment of film costs	2,843,734	1,770,650
Other cost of sales	604,262	628,326
Cost of sales	3,447,996	2,398,976
Gross profit/(loss)	(119,608)	4,018,459
Operating expenses		
General and administrative expenses	1,852,303	2,619,205
Bad debt expense	234,429	319,344
Total operating expenses	2,086,732	2,938,549
Income (loss) from operations	(2,206,340)	1,079,910
Non-operating income (expense)		
Other income	4,458,621	533,874
Interest expense	(829,878)	(2,199,844)
Interest income	71,681	110,409
Total non-operating income (expense)	3,700,424	(1,555,561)
Profit (loss) before taxes	1,494,084	(475,651)
Change in debt derivative	(32,530)	-
	1,461,554	(475,651)
Provision for income tax (benefit)	-	-
Net income (loss)	$1,461,554	$(475,651)
Comprehensive income (loss):		
Net income (loss)	1,461,554	(475,651)
Foreign exchange translation gain (loss)	(249,926)	420,963
Comprehensive income (loss)	$1,211,628	$(54,688)

Weighted average number of ordinary shares used in the profit (loss) per share calculation:		
Basic	1,888,712	1,402,720
Diluted	1,888,712	1,402,720
Basic profit (loss) per share	$0.77	$(0.34)
Diluted profit (loss) per share	$0.77	$(0.34)

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

SEVEN ARTS PICTURES PLC.
CONSOLIDATED STATEMENTS OF DEFICIENCY IN STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED MARCH 31, 2008, JUNE 30, 2008, JUNE 30, 2009, JUNE 30, 2010 and JUNE 30, 2011

	£1 Conv, Redeem Pref Shares		Non Red Conv Loans		Common Stock		Deferred Stock 2		Defer
	Shares	GBP	Shares	USD	Shares	USD	Shares	USD	Share
Balance, June 30, 2009	500,000	£1,539,800	1,750,000	$3,432,450	1,385,460	$599,684	1,385,460	$2,398,736	13,1
Chris Bialek options-Oct 27, 09					2,000	807	2,000	3,230	
Adjust payable by SAP Inc on above @ par value					8,000	3,230	8,000	12,918	
Receiveable from SAP Inc on above transaction									
Translation Adj - Dec 09									
Tfr Share options M Garstin to loan 2 Dec 08 pd $200,000									
Eden loan 100,000 shres @ 25p Dec 09					20,000	7,481	20,000	29,924	
Pref Share Conversion - EBT (£0.25 per share)	(500,000)	(748,100)			80,000	29,924	80,000	119,696	
23/4/10 EBT - 60,000 @ $2.285 exc $1.5793/£1 shares to Eden									
8/6/10 EBT - 122,000 @ $1.7 exc									

$1.457/£1 shares to Inc									
Interest charged to EBT									
Interest reversed to EBT									
Transfer balance of Redeem to Sh Prem		(791,700)							
Profit & Loss - June 30, 2010									
Translation adjustment									
Balance, June 30, 2010	-	£-	1,750,000	$3,432,450	1,495,460	641,126	1,495,460	$2,564,504	$13,1
Asher & Trafalgar shares Dec 10					267,522	126,850	267,522	507,400	
EBT shares sold									
Translation adjustment									
Trafalgar, Isaac & New Moon shares Feb 2011					355,138	142,497	355,138	569,988	
Correction to AsherTrafalgar 2010								(5,987)	
Palm Finance shares Mar 2011					150,000	60,210	150,000	240,840	
TCA & Eden shares May 2011					275,011	110,385			
J Shapiro shares June 2011					100,000	40,140			
EBT shares sold									
Net loss									
Translation adjustment									
Balance, June 30, 2011	-	£-	1,750,000	$3,432,450	2,643,131	$1,121,208	2,268,120	$3,876,745	13,1

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

SEVEN ARTS PICTURES PLC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2011 AND 2010

	2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES:	$1,461,554	$(475,651)
Net income/ (loss)		
Adjustments to reconcile net income (loss)		
to net cash provided by (used in) operating activities:		
Depreciation of property and equipment	14,026	13,884
Amortization of film cost	2,022,783	1,575,093
Impairment of film cost	820,951	195,557
Write off of previously capitalized film assets	-	244,640
Forgiveness of debt	(1,000,000)	(150,000)
Forgiveness of interest by lender	(3,458,621)	(383,874)
(Increase)/reduction of EBT interest receivable	(71,966)	178,904
Write-off of other receivables and prepayments	-	572,509
Ordinary shares issuance in exchange for I/R fees and to repay loans	2,977,208	257,159
Bad debt expense and provision for doubtful accounts	234,429	319,345
Write-off of previously accrued participations	-	(215,250)
Change in operating assets and liabilities		
Trade receivables	812,080	(218,659)
Due to and due from related parties, net	969,570	(907,699)
Capitalized film assets	(2,168,426)	(2,470,299)
Other receivables and prepayments	(1,357,745)	(66,008)
Accounts payable	233,219	541,212
Other current liabilities	36,919	2,205,483
Deferred income	(1,052,464)	96,620
Net cash provided by operating activities	473,517	1,312,966
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(12,177)	(2,808)
Net cash (used in) investing activities	(12,177)	(2,808)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from/(repayment of) participation equity/investment		
and notes payable	(230,434)	(1,353,958)
Issuance of common stock for cash	-	23,818
Net cash (used in) financing activities	(230,434)	(1,330,140)
Effect of exchange rate changes on cash and cash equivalents	(249,926)	18,007
NET (DECREASE) IN CASH & CASH EQUIVALENTS	(19,020)	(1,975)
CASH & CASH EQUIVALENTS, BEGINNING OF YEAR	26,818	28,793
CASH & CASH EQUIVALENTS, END OF YEAR	$7,798	$26,818

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the year or period for:		
Interest	$149,326	$1,173,528
Income taxes	$-	$-
NON CASH INVESTING AND FINANCING TRANSACTIONS:		
Accounts receivable applied against loan set off	$-	$475,374
Production loan settled by shares owned by EBT	$-	$133,661
Reclassification of share premium to accrued liabilities	$-	$221,142
Related party advances settled by shares owned by EBT	$164,500	$212,800
Interest of loan payable capitalized on film assets	$50,262	$429,142
Accrued interest included in loan payable amount	$2,244,903	$1,946,705
Share based compensation expense	$87,026	$-

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

SEVEN ARTS PICTURES, PLC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2011 AND 2010

NOTE 1 - NATURE OF ACTIVITIES AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Activities, History and Organization

Seven Arts Pictures, Plc. (herein referred to as “PLC” or collectively as “the Group”, “the Company”, or “Seven Arts”), was founded in 2002 as an independent motion picture production and distribution company engaged in the development, acquisition, financing, production, and licensing of theatrical motion pictures for exhibition in domestic (i.e., the United States and Canada) and foreign theatrical markets, and for subsequent worldwide release in other forms of media, including home video and pay and free television. The Company currently owns interests in 33 completed motion pictures, subject in certain instances to the prior financial interests of other parties.

The consolidated financial statements include the financial statements of Seven Arts Pictures Plc. (“PLC”), and its wholly owned subsidiaries, Seven Arts Filmed Entertainment Limited (“SAFE Ltd”), Seven Arts Filmed Entertainment (UK) Limited, Cinematic Finance Limited and Cinematic Finance (Equicap) Ltd, herein referred to as (the “Group”, the “Company” or “Seven Arts”). See below for detail on consolidated entities.

On June 11, 2010, Seven Arts Entertainment, Inc. (“SAE”), a Nevada Corporation, was formed and became a 100% owned subsidiary of Seven Arts Pictures Plc. The Company entered into an Asset Transfer Agreement, as amended on January 27, 2011 and again on August 31, 2011, to transfer all of the assets with a cost basis from PLC to SAE, in exchange for assumption by SAE of certain indebtedness and for one share of common stock of SAE for each ordinary share of PLC which have been distributed to shareholders. Additionally, 2,000,000 shares of SAE were issued to PLC in order to satisfy any remaining obligations. This transfer was approved by the PLC shareholders at an Extraordinary General Meeting on June 11, 2010. The purpose of this transfer was to eliminate our status as a foreign private issuer and to assume compliance with all obligations of a domestic issuer under all applicable state and Federal securities laws. Our intention in executing this transaction was to redomicile our business in the United States of America with no change in the economic interests of our shareholders.

As of January 27, 2011, net assets with a book value totaling approximately $7,200,000 plus convertible debentures with no redemption date, which are accounted for as equity, were transferred to SAE in accordance with the asset transfer agreement.

On August 31, 2011, NASDAQ approved the substitution of one share of SAE stock for the Company's NASDAQ listing, effective at the opening of trading on September 1, 2011. On that date, each of the Company's ordinary shares were exchanged for one share of common stock of SAE, and commenced trading on NASDAQ as the successor to the Company's NASDAQ listing. This transaction was approved by the Company’s shareholders at the Company’s Extraordinary General Meeting on June 11, 2010.

SAE’s authorized capital consists of 50,000,000 shares of stock, $.01 par value per share, of which the board of directors has approved 25,000,000 shares as common stock. As of September 1, 2011, there were 6,476,344 shares of common stock outstanding, all of which are fully paid and non-assessable. Each outstanding share of common stock entitles the holder thereof to one vote per share on matters submitted to a vote of stockholders.

SAE is now a United States issuer and commenced regular quarterly reporting for the first quarter ended September 30, 2011.

On November 8, 2011, PLC, was placed into involuntary creditors liquidation under English law (See NOTE 16 – Commitments and Contingencies). Certain indebtedness of PLC remained with PLC and will be subject to administration or payment in those administration proceedings. In accordance with the asset transfer agreement, PLC has been issued 2,000,000 shares of common stock of SAE in order to satisfy these obligations.

Basis of Consolidation

The Company consolidates its subsidiaries in accordance with Accounting Standards Codification ("ASC") 810, "Business Combinations", and specifically ASC 810-10-15-8 which states, "The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule, ownership by one reporting entity, directly or indirectly, or over 50% of the outstanding voting shares of another entity is a condition pointing toward consolidation."   The Company does not have any variable interest or special purpose entities.

The consolidated financial statements include the financial statements of Seven Arts Pictures Plc ("PLC"), and its wholly owned subsidiaries, Seven Arts Filmed Entertainment Limited ("SAFE Ltd"), Seven Arts Filmed Entertainment (UK) Limited, Cinematic Finance Limited and Cinematic Finance (Equicap) Ltd, herein referred to as (the "Group", the "Company" or "Seven Arts").

The accompanying consolidated financial statements include the accounts of Seven Arts Pictures Plc. ("SAP Plc.") and its wholly owned subsidiaries as follows:

	Years Ended June 30, 2011 and 2010	
Seven Arts Pictures Plc.	100	%
Seven Arts Filmed Entertainment Limited	100	%
Seven Arts Filmed Entertainment (UK) Limited	100	%
Cinematic Finance Limited	100	%
Cinematic Finance (Equicap) Ltd	100	%

The Group acquired SAFCO's in May 2009. SAFCO's refers to 17 companies formed by investors in the Zeus transaction (as described in NOTE 16). The Group intends to liquidate the SAFCO's under the applicable laws of the United Kingdom upon obtaining full control of the books, records and operation of the SAFCO's. The Group does not anticipate any material assets or liabilities related to the SAFCO's except the contingent liability for VAT on the Zeus transaction. The SAFCO's results have not been and will not be consolidated as the Group does not have control.

All significant intercompany balances and transactions have been eliminated on consolidation.

Significant Accounting Policies

The Company's management selects accounting principles generally accepted in the United States of America and adopts methods for their application. The application of accounting principles requires the estimating, matching and timing of revenue and expense. The accounting policies used conform to generally accepted accounting principles which have been consistently applied in the preparation of these financial statements.

The financial statements and notes are representations of the Company's management which is responsible for their integrity and objectivity. Management further acknowledges that it is solely responsible for adopting sound accounting practices, establishing and maintaining a system of internal accounting control and preventing and detecting fraud. The Company's system of internal accounting control is designed to assure, among other items, that 1) recorded transactions are valid; 2) valid transactions are recorded; and 3) transactions are recorded in the proper period in a timely manner to produce financial statements which present fairly the financial condition, results of operations and cash flows of the Company for the respective periods being presented.

Basis of Accounting

The Company prepares its financial statements on the accrual basis of accounting and in accordance with Generally Accepted Accounting Principles of the United States of America ("US GAAP"). All material intercompany balances and transactions are eliminated. Management believes that all adjustments necessary for a fair presentation of the results of the years ended June 30, 2011 and 2010, respectively, have been made.

The Group has also engaged in various transactions under which it has received cash proceeds from the transfer of tax credits or other tax benefits associated with its motion picture productions. Any such proceeds are generally treated as a reduction in the production costs of the applicable motion picture.

a) To the extent such tax benefit proceeds would exceed the capitalized cost of the film or represent fee income not applied to production cost, such proceeds are accounted for as producers' fees income where relevant producers contracts are in place.

b) To the extent that the Group were to receive benefits from tax advantaged investments relating to:

i. a picture that has not commenced production by a particular date and that investment is forfeited such that the Group has no further obligations to the investor or

ii. third party productions taken on by the Group as sales agent/distributor, then such benefits are also recorded as producer fees income.

Revenue Recognition

Revenue earned by the Group can be classified into two categories:

1. Film revenue: Revenue is earned from the exploitation of new productions, back catalogue and third party productions taken on as sales agent.

2. Fee-related revenue: Producer's fees income earned by the Group on productions controlled by the Group is earned when the Group is entitled to receive, under a binding agreement a fixed sum irrespective of the distribution revenue from that picture.

Film Revenue

The Group recognizes revenue from the sale (minimum guarantee or non-refundable advances) or licensing arrangement (Royalty agreement) of a film in accordance with ASC 605-15 "Revenue Recognition". Revenue will be recognized only when all of the following criteria have been met:

a) Persuasive evidence of a sale or licensing arrangement with a customer exists.
b) The film is complete and, in accordance with the terms of the arrangement, has been delivered or is available for immediate and unconditional delivery. (i.e. the "notice of delivery" (NOD) has been sent and there is a master negative available for the customer)
c) The license period of the arrangement has begun and the customer can begin its exploitation, exhibition, or sale.
d) The arrangement fee is fixed or determinable.
e) Collection of the arrangement fee is reasonably assured.

A written agreement with clients (purchase order, letter, contract, etc.) indicating the film name, territory and period is required for the recognition of revenue. Revenue is recognized when the performance criteria in the contracts have been met. The customer generally confirms agreement by their signature on the contract.

Minimum guarantee revenue (i.e. non-refundable advances) is recognized as and when the film is available for delivery to the respective territories. Cash deposits received on the signing of the contracts are recorded as deferred income until the film is available for delivery (as described above) at which point the deposit revenue is recognized. The Group does not recognize any revenues relating to minimum guarantee on any motion picture as well as amortization expense on that picture until United States theatrical release if it has agreed with the licensees that delivery or payment of minimum guarantee will be delayed for any material period of time to permit such a theatrical release.

Royalty revenue which equates to an agreed share of gross receipts of films is recognized as income as and when the Group is notified of the amounts by the customers through their royalty reports.

Fee-related Revenues

Many countries make tax credits available to encourage film production in their territory. Seven Arts benefits from tax credits in:

a) the UK and several other European territories for their European productions
b) Canada for their Canadian productions
c) Louisiana for their US productions
d) Tax preferred financing deals

F-32

In the majority of circumstances, these tax credits are treated as a reduction in the capitalized costs of the film assets they are financing. However, to the extent such tax benefit proceeds would:

a) exceed the capitalized cost of the film or
b) represent fee income not applied to production cost, such proceeds are accounted for as producers' fees income where relevant producer's contracts are in place.

In addition, to the extent that the Group was to receive benefits from tax advantaged investments relating to:

a) a picture that has not commenced production by the investment agreement closing date, that investment is forfeited such that the Group has no further obligations to the investor or
b) third party productions taken on by the Group as sales agent/distributor, then such benefits are also recorded as producer fees income

One of the risks for the investor associated with these tax advantaged investments is that a particular picture will not start production within the investment agreement period therefore giving no asset value to their slate of investments. The contract with the Group will generally state that there is no recourse to the Group and associated companies as this is one of the many risks of the film industry that the investors are made aware of on signing the investment agreements. Therefore, when a picture has not commenced production by the investment agreement closing date that investment is forfeited and the Group has no further obligations to the investors. These financing schemes are part of the general operations of the Group in its role as producer. Revenues in the year ended June 30, 2011 however did not include fee income derived from a structured film and distribution cost financing with UK investors. It did include additional producer fee of $570,029 associated with films produced in Louisiana. In 2010, the Group recognized $2,650,794 of fee income as described and, in addition, producer's fees of $1,792,125.

Investments

Investments are held at the lower of cost or net realizable value, and reviewed annually for any impairment charges. As of June 30, 2011 the Group has no outstanding investments.

Film Costs

Film costs include the unamortized costs of completed films which have been produced by the Group or for which the Group has acquired distribution rights, libraries acquired as part of acquisitions of companies and films in progress and in development. For films produced by the Group, capitalized costs include all direct production and financing costs, capitalized interest and production overhead.

Costs of acquiring and producing films are amortized using the individual-film-forecast method, whereby these costs are amortized and participations and residuals costs are accrued in the proportion that current year's revenue bears to management's estimate of ultimate revenue at the beginning of the current year expected to be recognized from the exploitation, exhibition or sale of the films. Generally, 80% or more of a film's costs are amortized within three years of the picture's initial release.

Ultimate revenue includes estimates of revenue to be earned over a period not to exceed ten years following the date of initial release. Film costs are stated at the lower of amortized cost or estimated fair value. Individual film costs are reviewed on a title-by-title basis, when an event or change in circumstances indicates that the fair value of a film is less than its unamortized cost. The fair value of the film is determined using management's future revenue and cost estimates and a discounted cash flow approach. Impairment is recorded in the amount by which the unamortized costs exceed the estimated fair value of the film. Estimates of future revenue involve measurement uncertainty and it is therefore possible that reductions in the carrying value of film costs may be required as a consequence of changes in management's future revenue estimates.

Films are included in the general “library” category when initial release dates are at least three years prior to the acquisition date.

Films in progress include the accumulated costs of productions which have not yet been completed. Films in development include costs of acquiring film rights to books, stage plays or original screenplays and costs to adapt such projects. Such costs are capitalized and, upon commencement of production, are transferred to production costs. Projects in development are written off at the earlier of the date they are determined not to be recoverable or when abandoned.

Property & Equipment

Equipment is carried at the cost of acquisition or construction and depreciated over the estimated useful lives of the assets. Costs associated with repair and maintenance are expensed as incurred. Costs associated with improvements which extend the life, increase the capacity or improve the efficiency of our property and equipment are capitalized and depreciated over the remaining life of the related asset. Gains and losses on dispositions of equipment are reflected in operations. Depreciation and amortization are provided using the straight-line method over the estimated useful lives of the assets, which are two to five years.

Income Taxes

The Company has adopted ASC 740-10 “Income Taxes”, which requires the use of the liability method in the computation of income tax expense and the current and deferred income taxes payable.

The Group is not part of any consolidated return filed in the United States.

Foreign Currency Transactions and Comprehensive Income

The accounts are presented in United States Dollars (“USD”), the functional currency of the main operating company, SAFE Ltd. The functional currency of the holding company SAP Plc. and other entities located in the UK is in Pounds Sterling (“GBP”). The books of the foreign entities are converted to USD at each reporting period date.

The Group translates the foreign currency transactions and balances into USD using the year or reporting period end or average exchange rates. Assets and liabilities of the foreign entities are translated at exchange rates as of the balance sheet date. Revenues and expenses are translated at average rates in effect for the periods presented. The cumulative translation adjustment is included in the translation reserve within shareholders’ equity (deficit). Foreign currency transaction gains and losses arising from exchange rate fluctuations on transactions denominated in a currency other than the functional currency are included in the consolidated results of operations.

Where possible, the Group seeks to match USD income with USD expenditures. To date the Group has not hedged any transactional currency exposure but will keep such exposures under review and where appropriate may enter into such transactions in future.

Relevant exchange rates used in the preparation of the financial statements are as follows for the years ended June 30, 2011 and 2010 (GBP per one USD):

	June 30, 2011	
Balance sheet period end exchange rate:	GBP	1.6056
Average exchange rate for the year ended:	GBP	1.5655
	June 30, 2010	
Balance sheet period end exchange rate:	GBP	1.4962
Average exchange rate for the year ended:	GBP	1,5721

Derivative Instruments and Hedging Activities

The Group's policy is not to use derivative or hedging financial instruments for trading or speculative purposes, except certain embedded derivatives derived from certain conversion features or reset provision attached to the convertible debentures as described in NOTE 12.

Earnings Per Share

Basic earnings (loss) per share are computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Diluted earnings (loss) per share include the effects of any outstanding options, warrants and other potentially dilutive securities. For the periods presented, there were no potentially dilutive securities outstanding, therefore basic earnings per share equals diluted earnings per share. Basic and diluted earnings per share ("EPS") are based on weighted-average common shares and exclude shares that would have an anti-dilutive effect. In accordance with ASC 260-10-45-19, the Company did not consider any potential common shares in the computation of diluted EPS as of June 30, 2011 and 2010, due to the loss from continuing operations, as they would have an anti-dilutive effect on EPS.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. The most significant estimates made by management in the preparation of the financial statements relate to ultimate revenue and costs of its films which are used in the amortization and impairment of film costs, estimates for allowances, option pricing for options and warrants issued and income taxes. Accordingly, actual results could differ from those estimates.

Recently Issued Accounting Pronouncements

The Company does not expect the adoption of recently issued accounting pronouncements to have a significant impact on the Company's results of operations, financial position or cash flow.

Accounts Receivable

Receivables are recognized at the initial amount of the invoice. As a result of the nature of the Group's activities, accounts receivables are generally of a short-term nature. However, any receivable whose recovery date was is beyond one year would be measured at its present value. The Group does not charge interest on late payment of trade receivables and loans.

Reserve for doubtful accounts represent a provision charged to reflect management's best estimate of the likelihood that certain of the Group's accounts receivable may not ultimately be collected. This provision is based on historical experience and relevant facts and information regarding collectability at the time and will be adjusted up or down over time with the benefit of actual results.

Any receivable outstanding is only written off after management has deemed the receivable to be uncollectible, under the terms of the agreement and/or based on the financial conditions of the customers at each reporting period. As of June 30, 2011 and 2010 the Group had an allowance for bad debts and doubtful accounts of $310,796 and $532,996, respectively, to cover any future uncollectible receivables. The Group determines its allowance by considering a number of factors, including the length of time receivables are past due, the Group's previous loss history, the customer's current ability to pay its obligation to the Group, and the condition of the general economy and the industry as a whole.

Substantially all of the trade receivables at face value as reflected in the consolidated financial statements are pledged as security for borrowings by the Group.

Accounts Payable

All operating trade payables (including notes payable and accrued supplier invoices) relate to the purchase of goods and services. These payables are due within and or less than one year. However any payable whose due date was more than one year would be measured at its present value. The Group did not have any such long-term accounts payable during the periods presented.

Fair Value of Financial Instruments

The carrying amount of cash, trade accounts receivable, other accounts receivable, receivables due from and payable to related parties, trade accounts payable, other accounts payable and accrued expenses, as well as short-term debt, approximate their corresponding estimated fair values due to the short-term maturity and revolving nature of these financial assets and liabilities. Cash and cash equivalents are recognized at fair value considering quoted market prices if available for the same or similar instruments. Long-term debt is based on estimated market prices for similar instruments, considering interest rates currently available in connection with bank loans with similar terms and due dates.

Share Based Payments

The Company accounts for share based payments using a fair value based method whereby compensation cost is measured at the grant date based on the value of the services received and is recognized over the service period. The Company uses the Black-Scholes pricing model to calculate the fair value of options and warrants issued. In calculating this fair value, there are certain assumptions used such as the expected life of the option, risk-free interest rate, dividend yield, volatility and forfeiture rate. The use of a different estimate for any one of these components could have a material impact on the amount of calculated compensation expense.

Cash and Cash Equivalents

The cash and cash equivalents of the Group consisted of cash balances held on deposit with banks, of which $8,767 is denominated in USD and $(968) denominated in GBP, as of June 30, 2011. These deposits earn interest at the relevant bank interest rates, which are all floating rates of interest. These annual interest rates ranged from 2.8% to 8.8% for the fiscal year ended June 30, 2011, and 3.1% to 8.8% for the fiscal year ended June 30, 2010.

NOTE 2 - REVENUE

Revenue earned by the Group can be classified into two categories: film revenues and fee-related revenues (see NOTE 1).

Film revenues consist of minimum guarantees from distributors, royalties earned either collected or receivable, and other fees or income associated with the sale of the Group's motion pictures.

Film revenue by geographical areas is as follows:

	June 30, 2011	June 30, 2010
Europe	$969,077	$110,285
North America	1,113,074	1,714,271
South America	378,763	24,000
Africa and Middle East	39,416	-
Asia	209,030	91,942
Australia	48,999	34,018
Total	$2,758,359	$1,974,516

All fee-related revenues for the years ended June 30, 2011 and 2010 were generated in North America, and through a related party (as described below).

Fee related revenues in the period ended June 30, 2011 consisted of:

a) Producer's fees of $70,097 resulting from excess tax credits received on Night of the Demons. This item was collected by Seven Arts Pictures Louisiana LLC who will pay it over to the Group under the agreement between the Group and SAPLA.

b) $500,000 of fees relating to Esplanade Pictures based in Louisiana.

Fee related revenues in the period ended June 30, 2010 consisted of:

a) $2,650,794 of fee income derived from the Equicap transactions, a structured finance transaction with UK investors who invested in certain third party motion pictures distributed by the Group. The fee items related to the Equicap transactions were contractually entered with Seven Arts Pictures Louisiana LLC ("SAPLA"), a related party who is acting on behalf of the Group but collected and recorded by the Group under the Group's agreement with SAPLA as fee income.

b) Producer's fees of $637,397 resulting from excess tax credits received on Night of the Demons. This item was collected by SAPLA and will be paid over to the Group under the agreement between the Group and SAPLA.

c) Producer’s fees income of $1,154,728 resulting from excess tax credits received on American Summer (Pool Boys) and Autopsy. This will be collected by SAPLA and will be paid over to the Group under the Group’s agreement with SAPLA.

All of the Group's revenues and profits before taxes in each year are derived from the financing, production and distribution of films.

NOTE 3 – NET INTEREST EXPENSE

The following presents the Group’s interest expense and interest income for the years ended June 30, 2011 and 2010:

	June 30, 2011	June 30, 2010
Interest expense		
Production loans interest paid	$(184,661)	$(1,490,924)
Corporate loans interest paid	(607,267)	(672,004)
Bank interest paid	(37,950)	(36,916)
Total interest paid	$(829,878)	$(2,199,844)
Interest income		
Interest received	$368	$110,365
Bank interest received	71,313	44
Total interest received	$71,681	$110,409
Net interest (expense)/income	$(758,197)	$(2,089,435)

NOTE 4 – OTHER INCOME RELATED TO CANCELATION OF INDEBTEDNESS

The Group recorded of $4,458,621 of other income for the year ended June 30, 2011 related to the cancellation of indebtedness arising from:

a) The release of a loan of $1,788,904 from Arrowhead (See NOTE 11) which is subordinated to the Cheyne debt of $6,500,000 which was assigned to Seven Arts in 2008. Management does not believe that forecast income will be sufficient to repay the primary loan; therefore the subordinated loan will also not be repaid.

b) Forgiveness of accrued interest of $2,669,717, which was accrued through June 30, 2010, on the Palm Finance loans.

During the year ended June 30, 2010, the Company recorded a $150,000 gain on the cancellation of indebtedness arising from a settlement with Kismet releasing a loan of $150,000. Also during 2010, 120dB agreed to a cash settlement of $323,000 in full and final settlement of the outstanding loan for Knife Edge. The Group recorded a $383,874 gain on the cancellation of indebtedness related to this settlement. Total other income related to cancellation of indebtedness was $533,874 for the year ended June 30, 2010.

NOTE 5 – INCOME TAXES

The Company has adopted ASC 740-10, "Income Taxes", which requires the use of the liability method in the computation of income tax expense and the current and deferred income taxes payable (deferred tax liability) or benefit (deferred tax asset). Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

During the year ended June 30, 2011 the Company had a net income of $1,461,554 decreasing the deferred tax asset approximately $496,928 at the statutory tax rate of 34%. Deferred tax assets at June 30, 2011 and 2010 consisted of the following:

	Year ended June 30, 2011	Year ended June 30, 2010
Net operating loss carry forwards	$ 10,422,664	$ 11,579,923
Capital loss carry forwards	5,398,529	5,398,529
Total carry forwards	15,821,193	16,978,452
Tax rate of 34%	34%	34%
Total long-term deferred tax assets	5,379,206	5,772,673
Less: valuation allowance	(5,379,206)	(5,772,673)
Net long-term deferred tax assets	$ -	$ -

The net deferred tax asset generated by the loss carry forward has been fully reserved and will expire in 2019 through 2030. The realization of deferred tax benefits is contingent upon future earnings and, therefore, is fully reserved at June 30, 2011 and 2010.

The following represents the effect of timing differences on the Group's tax expense or benefit for the years ended June 30, 2011 and 2010:

	Year ended June 30, 2011	Year ended June 30, 2010
Current tax charge/(benefit)	$ -	$ -
Factors affecting the tax charge for the year:		
Income/(loss) before taxes	1,461,554	(475,651)
Income/(loss) before taxes multiplied by the standard rate of UK corporation tax of June 30 2011 at 27.5% (June 2010 at 28%)	401,927	(133,182)
Effects of:		
Non deductible expenses	47,606	42,000
Excess of amortization over tax deductions	(14,158)	(14,416)
Non-qualifying depreciation	782,027	495,782
Excess of capital allowances over depreciation	(1,182)	(824)
Movement in tax losses	(714,322)	(727,311)
Film tax profit adjustment	(501,898)	337,951
Current tax expense/(benefit)	$ -	$ -

As of June 30, 2011, the Group had operating losses of approximately $10,422,664 to carry forward against future operating profits.

As of June 30, 2011, the Group had capital losses of approximately $5,398,529 to carry forward against future capital profits.

The net deferred tax asset generated by the loss carry forwards has been fully reserved and will expire in 2019 through 2030. The realization of deferred tax benefits is contingent upon future earnings and is fully reserved at June 30, 2011 and 2010.

NOTE 6 – EARNINGS PER SHARE

Basic net income/(loss) per share is based upon the weighted average number of common shares outstanding for the period presented and all shares amounts have been adjusted to reflect the Group's two separate 5:1 reverse stock splits. Diluted earnings per share is based on the assumption that all dilutive convertible shares and stock warrants were converted or exercised. Warrants are assumed to be exercised at the beginning of the period (or at the time of issuance, if later), and as if funds obtained thereby were used to purchase common stock at the average market price during the period. At June 30, 2011, the Company had a total of 2,217,872 common stock equivalents outstanding, including options, warrants and convertible debentures. All common stock equivalents for the year ended June 30, 2010 are anti-dilutive due to the net loss incurred.

Basic and diluted earnings per share ("EPS") are based on weighted-average common shares and generally exclude shares that would have an anti-dilutive effect. In accordance with ASC 260-10-45-19, the Group did not consider any potential common shares in the computation of diluted EPS as of June 30, 2011 or for June 30, 2010, due to the loss from continuing operations. For the year ended June 30, 2011, 329,160 anti-dilutive shares were excluded from the EPS calculation, which would have been considered dilutive if the Company did not have a loss from operations.

The following is a reconciliation of the number of shares (denominator) used in the basic and diluted earnings per share computations for the years ended June 30, 2011 and 2010:

	2011		2010	
	Weighted Average Shares Outstanding	Per Share Amount	Weighted Average Shares Outstanding	Per Share Amount
Basic earnings per share	1,888,712	$0.77	1,402,720	$(0.34)
Diluted earnings per share	1,888,712	$0.77	1,402,720	$(0.34)

Basic and diluted net income (loss) per share is calculated based on the weighted average common shares outstanding for the period presented and all have been adjusted to reflect the Group's 5:1 reverse stock splits which occurred on December 31, 2008 and May 12, 2011.

NOTE 7- EMPLOYEE BENEFIT TRUST

The Group established the Seven Arts Employee Benefit Trust ("EBT") for the purpose, among others, of acquiring 3,000,000 of the Group's preferred shares from Armadillo Investments Plc. ("Armadillo"). EBT is governed by a Trust Deed that the Group entered into with the trustees. Under the Trust Deed, the Trustees have absolute control over the Trust although the Group may recommend options to the trustees. The Group has the right after approval of the audit committee to restrict the Trust's right to vote its shares of the Group to prevent the Trust from taking control of the Group and the right to remove the Trustees under certain circumstances for the same purpose.

The Group has no interest in the profits or losses of the Trust on the Group's shares and does not control the actions of the Trustees in the sale or use of these shares. The Group has no control or significant influence on the EBT. All cash and ordinary shares owned by EBT are held by EBT for the benefit of the Group's United Kingdom employees.

On October 30, 2008, EBT reached an agreement to acquire these preference shares for £1,500,000 plus the return of 1,600,000 of Armadillo's ordinary shares. On that date the Group advanced £500,000 as the first of three equal installments together with 1,600,000 shares of Armadillo Investments Plc. The EBT acquired 3,000,000 of the Group's convertible preferred shares from Armadillo. Seven Arts has guaranteed the remaining two payments due to Armadillo aggregating £1,000,000, but has not yet advanced these payments to EBT, so EBT is in default on both payments due to Armadillo. On November 20, 2008, EBT converted 2,500,000 of these preferred shares into 2,000,000 of the Group's ordinary shares. On June 30, 2010, the EBT converted the remaining 500,000 preferred shares to 400,000 ordinary shares.

The EBT originally pledged 266,667 ordinary shares to Armadillo to secure the sum due to Armadillo, which the pledge will be terminated when the EBT pays the £1,000,000 to Armadillo. As of February 9, 2011, 150,000 shares of the Group were issued to New Moon Pictures LLC who then pledged the shares to Armadillo Investments Ltd who in turn have:

a) extended the terms of the repayment of the £1,000,000 due from the EBT to June 30, 2011; and
b) reduced their lien over the 266,667 shares currently held by the EBT to 200,000 shares.

At June 30, 2011, the loan receivable from EBT amounted to £643,084 ($1,107,134) and the EBT owned 200,000 shares (or approximately 7.6% of the Group's outstanding ordinary shares as at June 30, 2011) all of which are pledged to Armadillo Investments Ltd.

NOTE 8 - FILM COSTS

The following presents the Group's film costs as of June 30, 2011 and 2010:

	June 30, 2011	June 30, 2010
Film costs - beginning balance	$23,808,869	$22,902,513
Additional costs incurred	2,168,425	2,677,006
Third party investments/ tax credits	-	-
Amortization of film costs during period	(2,843,734)	(1,770,650)
Film costs as of June 30, 2011	$23,133,560	$23,808,869

The net book value of all films as of June 30, 2011 includes $17,917,287 relating to films released since April, 2007 and $5,216,272 relating to pictures in development.

Over 98% of the Group's pictures released before April 2007 have been fully amortized and therefore have a net book value of zero as of June 30, 2011.

Capitalized film costs are reviewed for impairment at least twice a year and whenever events or changes in circumstances indicate that the carrying amounts of such assets may not be recoverable. Determination of recoverability is based on an estimate of future cash flows resulting from the use of the asset, and its eventual disposition. Measurement of an impairment loss for the assets is based on the fair value of the asset as estimated using a discounted cash flow model. An impairment charge of $ 820,951 was recognized during the year ended June 30, 2011 and $195,557 for the year ended June 30, 2010.

NOTE 9 – PROPERTY AND EQUIPMENT

The Group's property and equipment as of June 30, 2011 and 2010:

Net book value as of June 30, 2009	$40,112
Additions	2,808
Depreciation charge for the period	(13,884)
Exchange differences	(2,647)
Net book value as of June 30, 2010	26,389
Additions	12,177
Depreciation charge for the period	(14,026)
Exchange differences	-
Net book value as of June 30, 2011	$24,540

NOTE 10 – FILM AND PRODUCTION AND CORPORATE LOANS

The following presents that Company's film and production and corporate loans as of June 30, 2011 and 2010:

Current	June 30, 2011 (USD)	June 30, 2010 (USD)
Film & production loans	$10,890,430	$16,766,689
Corporate loans	1,755,250	1,534,591
Current	$12,645,680	$18,301,280

F-43

Film and Production Loans

Film and production loans arose from the financing of motion pictures and are secured with an interest in the associated motion pictures.   Detail of these production loans is presented below.

A loan of $8,300,000 was advanced to Seven Arts Future Flows I LLC ("SFF"), a subsidiary of Seven Arts Pictures Inc., (“SAP, Inc.) a related party, on a non-recourse basis by Arrowhead Ltd. ("Arrowhead") and was secured by a pledge of Seven Arts Filmed Entertainment Limited’s distribution rights in twelve designated pictures owned by SFF for the period of the loan. During the period ended June 30, 2009, Arrowhead made the decision to take control over the distribution rights to these pictures. Since the Group no longer controls the licensing of these motion pictures, it has removed all investment in the cost of these pictures as well as receivables from its assets and has removed the non-recourse indebtedness and accrued interest from its liabilities as of June 30, 2009. This resulted in the recognition of $5,601,683 of “Other income” in the period ended June 30, 2009 relating to the cancellation of indebtedness.

Arrowhead filed an action on September 22, 2010, which seeks recovery from the Group of the monies which the Group has retained under its interpretation of the relevant agreements with Arrowhead. In addition, Arrowhead makes substantial additional claims against the Group, Mr. Hoffman and Seven Arts Pictures Inc. regarding claimed breaches of the terms of the operative agreements, including failure to properly account, failure to turn over materials, failure to remit monies collected, and similar matters. The claims against the Group for these breaches of warranties for damages are $8,300,000 although Arrowhead states no basis for this amount.

The Group had moved to dismiss the action against all defendants other than Seven Arts Future Flows I LLC, which is not part of the Group. On August 9, 2011, the New York Supreme Court granted the Group’s motion and dismissed all defendants except SAFE Ltd. in its capacity as a collateral agent, which is not a material element of Arrowhead claim. The Group continues to believe that Arrowhead’s claims against the Group are without substantial merit.

Management has accounted for the monies collected and not remitted from the Arrowhead titles as accrued liabilities in the Group’s books and records as of June 30, 2011.

An original loan of $7,500,000 was taken from Cheyne Specialty Finance Fund LLP ($6,500,000) senior debt and Arrowhead Consulting Group Limited ($1,000,000) -subordinated debt. The Cheyne portion of the loan was acquired by SAFE Ltd for payment of $6,500,000 in April 2008, leaving a balance owed by the Group of $1,000,000 due to Arrowhead Consulting Group Limited but subordinated to the collection of $6,500,000 plus interest from certain pictures after June 30, 2008. The $1,000,000 balance of the loan is secured with all of the income over and above the $6,500,000 plus interest from six films (Deal, Noise, Pool Hall Prophets, A Broken Life, Mirror Wars and Boo) as well as with a secondary security interest in certain film library assets (behind Arrowhead) and a first security interest in 321,400 shares of the Group owned by Seven Arts Pictures Inc. The Group is in litigation with the liquidator of Arrowhead Consulting Group regarding the $1,000,000 plus accrued interest and it believes this debt will never be paid due to its subordination to the senior loan.

A security interest in favor of Palm Finance Corporation ("Palm") was lodged at Companies House (the United Kingdom’s registrar of companies) in January 2008, by the Group to cover loans made by Palm to finance the films Nine Miles Down, The Pool Boys and Autopsy. The Group entered into two senior financing loan and security agreements with Palm Finance Corp (“Palm”) to finance the production costs of The Pool Boys, Autopsy and Nine Miles Down dated May 7, 2007 and December 17, 2007. These loans are secured by the revenues to be collected from these motion pictures. The revenues so far collected have been insufficient to repay the majority of these loans, primarily as result of management’s decision to delay the release of these films. The original principal amount of the Palm loan for The Pool Boys and Autopsy are $5,500,000 including $700,000 of accrued interest, and for Nine Miles Down was $4,000,000 including $750,000 of accrued interest. In November 2010, the Group entered into a new financing agreement with Palm extending the due date of these loans to December 31, 2011.

The lender agreed to write-off the accrued interest as of June 30, 2011, giving rise to forgiveness of debt income of $2,669,717. The outstanding balances on these loans as at June 30, 2011 were $4,910,052 (Pool Boys/Autopsy) and $ 3,176,018 (Nine Miles Down).

Subsequent to June 30, 2011, the lender sold $2,750,000 of its debt and converted 50% of the monies received to Series A preference shares in SAE Inc. (See NOTE 13 – Subsequent Events.)

On August 27, 2007, the Group borrowed $1,650,000 from Blue Rider Financial ("Blue Rider") to pay for the domestic prints and advertising costs for the motion picture "Deal" ("Blue Rider Loan") and arranged that the revenues due from Metro-Goldwyn-Mayer Studios Inc. ("MGM") to the Group for the distribution of that motion picture be assigned to Blue Rider Financial as partial security for that loan. To date the revenues paid to the Group from MGM have not yet been sufficient to repay the Blue Rider Loan. The Group has therefore entered into an accommodation agreement with Blue Rider to redeem the loan due for $2,200,000, less approximately $812,000 of collections that have been received by Blue Rider to date from MGM. We expect this indebtedness will be repaid from proceeds due from MGM on or before December 31, 2011.

Corporate loans

Trafalgar Loan

On October 15, 2008 the Group borrowed £1,000,000 from Trafalgar Capital Special Investment Fund ("Trafalgar"). A portion of this loan the Group advanced to the EBT for it to use as the first installment for the acquisition of all the Preferred Shares owned by Armadillo. On September 2, 2009 the Group repaid Trafalgar $1,000,000 (approximately £698,934) as a partial payment against this loan, with the remaining balance subject to repayment in cash or convertible to the ordinary shares of the Group at the conversion terms as agreed between Trafalgar and the Group. On June 22, 2010 an amended agreement was entered into with Trafalgar for an extension of the due date of the convertible debentures to December 31, 2010, and the Group agreed to issue 340,000 ordinary shares to settle a portion of the debt. Trafalgar agreed to reduce the loan amount from the proceeds it receives from selling the 340,000 ordinary shares. All of the 340,000 shares were sold in the market before December 31, 2010. A further amended agreement was entered into with Trafalgar for an extension of the due date of the convertible debentures to March 31, 2011, and the Group issued 425,000 ordinary shares to settle a portion of the debt. Trafalgar agreed to reduce the loan amount from the proceeds it receives from selling the 425,000 ordinary shares. The per-share value is determined as the amount recovered by Trafalgar on sale thereof in the market and Trafalgar may "put" these shares to the Group at £1.00 per share on April 30, 2011 if not previously sold. This put option was not exercised by Trafalgar.

Asher Loan

In May, June and September 2010, the Group issued an aggregate of $200,000 Convertible Promissory Notes to Asher Enterprises, Inc. ("Asher Notes") that were to mature on March 11, 2011, March 17, 2011 and June 24, 2011, respectively. The Asher Notes bore interest at a rate of 8% per annum and were convertible into the Group's ordinary shares beginning on the date which is one hundred twenty (120) days following the issuance of the Asher Notes, at the holder's option, at the conversion rate of 60% of the market price of the lowest three trading prices of the Group's ordinary shares during the ten-day period ending one trading day prior to the date of the conversion notice is sent by the note holders via facsimile.

The Group has identified the embedded derivatives related to the Asher Notes. These embedded derivatives included certain conversion features and reset provision. The accounting treatment of derivative financial instruments requires that the Group record fair value of the derivatives as of the inception date of Asher Notes and to fair value as of each subsequent reporting date. At the inception of the Asher Notes, the Group determined a fair value of $178,187 on the embedded derivative. The fair value of the embedded derivative was determined using the Black Scholes Option Pricing Model based on the following assumptions:

Assumption	Amount
Dividend yield:	0.0%
Volatility	133% ~ 142%
Risk free rate:	0.25% ~ 0.37%

During the year ended June 30, 2011, the Company issued an aggregate of 53,668 shares of common stock in full settlement of the $100,000 Convertible Promissory Note dated May 2010 and related interest. In addition, the Company paid remaining two Convertible Promissory Notes an aggregate of $120,000 in cash. As such, the Company recorded amortization of $178,187 as debt discount for the year ended June 30, 2011 and $32,530 loss on change in fair value of debt derivative.

Convertible Notes issued August 30, 2010

On August 30, 2010, the Group issued an aggregate of $470,000 Convertible Debt to qualified investors that matures on February 28, 2011. The Convertible Debts bear interest at a rate of 15.0% per annum and could be converted into the Group's ordinary shares beginning on the date which is one hundred twenty (120) days following the issuance of the Convertible Debt, at the conversion rate of $3.75 per share, subject to certain changes, and are convertible at the option of the Group.

a) On March 22, 2011 an additional $300,000 of convertible notes were issued to Runway Investments Ltd on the same terms as above. At the same time the original notes were extended to July 31, 2011.

b) All $770,000 of these notes were extended on May 24, 2011 to September 30, 2011, and the conversion terms were changed as follows:

The Scarborough note's principal and interest will convert into common stock at $0.50 per share.

For extending the maturity date until December 31, 2011, Sendero and Runway will reduce their conversion price to $0.60 per share.

For extending the maturity date until September 30, 2011, Agua Alta will reduce its conversion price to $0.75 per share.

The average conversion price of the three remaining notes is $0.64 per share.

c) $225,000 of the Scarborough notes were converted to 507,000 shares on July 29, 2011, subsequent to year-end.

d) $170,000 of the Agua Alta and $75,000 of the Sendero notes were converted into 1,786,374 shares on October 19, 2011.

Isaac Capital Group

On June 10, 2011, the Group borrowed $150,000 from Isaac Capital Group ("ICG") in the form of a convertible note. The loan is for 6 months with interest at 15% per annum. ICG will have the right to convert the Loan at any time into shares at a conversion price of 60% of the volume weighted average sale price on NASDAQ of the shares for the 10 trading days prior to the closing of the loan. There is also a closing fee of 15,000 shares on closing of the Loan. (These shares have not yet been issued).

The maturity dates and interest rates applicable to the Group's funded indebtedness and third party guarantees are as follows:

	Amount outstanding			
Lender	June 30, 2011	June 30, 2010	Applicable interest rate	Status
Film and Production Loans				
Arrowhead Consulting Group	$ -	$ 1,788,904	19-23% Variable	Subordinated
Palm Finance Corporation	4,910,052	6,575,881	18% Fixed	Forbearance agreement
Palm Finance Corporation	3,176,018	4,243,835	18% Fixed	Forbearance agreement
Blue Rider Finance Inc.	813,742	1,599,813	22.5% per annum plus 4% of outstanding indebtedness for each 30 days period the indebtedness remains outstanding after December 15, 2008	Due on demand
120dB Film Finance LLC	323,000	219,000	No stated interest rate	Due on demand
Cold Fusion Media Group LLC	582,510	920,410	10% Fixed	Due on demand
Parallel Media	1,469,108	1,418,846	No stated interest rate	Due on demand
Pledged Shares	(384,000)	-		
Film and Production Loans	$ 10,890,430	$ 16,766,689		
Corporate Loans				
Trafalgar Capital Specialized Investment Fund	$ 490,412	$ 1,176,608	9% Fixed	Forbearance agreement
Asher Enterprise, Inc.	-	150,000	8% Fixed	

						Due on March 11, 2011 and March 17, 2011
Lion House		263,234		207,983	30% Fixed	In default
Scarborough/Runway		853,384		-	15% fixed	Due September 30, 2011
Isaac Capital Group		148,220		-	15% fixed	Due December 10, 2011
Corporate Loans	$	1,755,250	$	1,534,591		
Total Loans	$	12,645,680	$	18,301,280		

The loan amounts as of June 30, 2011 and 2010, includes accrued interest of $2,233,994 and $5,238,407, respectively.

NOTE 11 - SHAREHOLDERS' EQUITY

The following presents the Company's authorized, issued and outstanding shares, by class as of June 30, 2011 and 2010:

	June 30, 2011	June 30, 2010
Authorized		
6,000,000, £1 convertible, redeemable preference shares for all periods.	11,337,600	11,337,600
20,527,360 ordinary shares at £ 0.25 par value each for all periods.	9,055,719	9,055,719
20,527,360 deferred shares at £1.00 par value each for all periods	36,222,876	36,222,876
13,184,000 deferred shares at £0.45 par value each for all periods	11,636,594	11,636,594
	68,252,789	68,252,789
Issued and outstanding		
£1.00 convertible, redeemable preference shares	-	-
2,643,131 ordinary shares at £.25 par value as of June 30, 2011, 1,495,460 as of June 30, 2010;	$1,121,208	$641,126
2,268,120 deferred shares of £1 as of June 30, 2011,	3,876,745	2,564,504
1,495,460 as of June 30, 2010;		
13,184,000 deferred shares of £0.45 each for all periods.	11,636,594	11,636,594
	$16,634,547	$14,842,224

Convertible Redeemable Preferred Shares

During the year ended March 31, 2005, Seven Arts issued approximately £3,000,000 of convertible redeemable preferred shares to Armadillo Investments Plc ("Armadillo") in return for 3,000,000 ordinary shares from Armadillo, valued at $5,668,800.

a) The convertible redeemable preferred shares held by Armadillo were acquired by the Seven Arts Employee Benefit Trust ('EBT") on October 30, 2008 and 2,500,000 of the preferred shares were converted into 2,000,000 of the Seven Arts Pictures Plc ordinary shares on November 20, 2008.

b) The remaining 500,000 convertible preferred shares owned by the EBT were converted into 400,000 ordinary shares of Seven Arts Pictures Plc on June 30, 2010. As of June 30, 2011 and 2010, there were no convertible redeemable preferred shares outstanding.

The terms attached to the convertible redeemable preferred shares include:

a. no dividends,
b. a liquidation preferred,
c. conversion rights into ordinary shares, and
d. redemption rights only in the event of certain defaults by Group

Ordinary Shares

On May 9, 2011, the shareholders approved a 5:1 reverse split and then the division of the new share into £0.25 ordinary share and £1.00 deferred share. All per share amounts in the financial statements have been retroactively adjusted to the earliest period presented for the effect of this reverse split.

In the year ended June 30, 2011, the Group issued an aggregate of 1,147,671 shares of ordinary stock comprised of:

a) 342,000 shares issued to consultants in exchange for services rendered
b) 153,000 shares issued to Trafalgar Capital Specialized Investment Fund pursuant to an amended loan agreement and 100,000 issued to Eden Corporate Finance in part payment of their debt
c) 53,668 shares issued to Asher Enterprises in exchange for conversion of notes payable in the aggregate amount of $200,000.
d) Pledges of stock issued to SAP Inc (23,800 shares) for an insurance policy, New Moon LLC (150,000 shares) pledged against Armadillo's debt, Palm Finance (150,000 shares) and TCA (175,000 shares) pledged against a loan of $125,000 given to the Company in March 2011 (See NOTE 12)

See NOTE 20 – Subsequent Events, for details of shares issued subsequent to June 30, 2011.

In the year ended June 30, 2010, the Group issued an aggregate of 110,000 shares of ordinary stock comprised of:

a) 80,000 shares issued to the EBT on conversion of 500,000 convertible preferred shares. The EBT conversion resulted in an addition of $149,620 to the share capital account and $1,390,180 to the additional paid in capital account and a reduction of $1,539,800 in the carrying value of the preferred shares in the capital account.
b) 2,000 share options were converted to 10,000 ordinary shares by a former employee. As the excess 8,000 ordinary shares were issued in error, a related party (SAP Inc.) has promised to advance and pledge 8,000 of its shares of Seven Arts Pictures Plc to the Group until it can arrange for the cancellation of these shares and replace with the correct shares to be issued and sent to the former employee. As of June 30, 2010, the Group had not received these cancelled shares.
c) 20,000 shares were issued to Eden Finance to cover loan, interest and fees in April 2010.

Deferred Shares

The Group's deferred shares issued prior to March 31, 2007 have essentially no rights for participation with income or assets of the Group other than their existing rights under ordinary share ownership. The Group has the right to purchase back and cancel the deferred shares. These shares were issued when the ordinary stock par value was reduced from £0.50 to £0.05 per share (i.e. for every £0.50 per share held the shareholder received one £0.05 ordinary share and one £0.45 deferred share.). The Group has no current plans to retire this deferred stock. The stock is treated as part of the nominal share capital valued at £0.45 per share.

The second category of deferred shares was issued on May 12, 2011 after the 5:1 reverse split when five ordinary shares with £0.25 par values were combined into one share of £1.25 par value share and then the resulting share subdivided into one ordinary share of £0.25 and one deferred share of £1.00. These shares have essentially no rights for participation with income or assets of the Group other than their existing rights under ordinary share ownership. The Group has the right to purchase back and cancel the deferred shares. The stock is treated as part of the nominal share capital valued at £1.00 per share.

NOTE 12 - CONVERTIBLE DEBENTURES WITH NO REDEMPTION DATE

	As of June 30, 2011	As of June 30, 2010
Convertible debentures	$3,432,450	$3,432,450

During the year ended March 31, 2005, Seven Arts issued £3,000,000, of convertible debt to Langley Park Investment Trust Plc ("Langley") in return for 3,000,000 ordinary shares in Langley valued at approximately $5,204,000. Langley converted £1,250,000 of its convertible debenture into 1,000,000 ordinary shares in Seven Arts Pictures Plc. on March 15, 2007. The remaining £1,750,000 ($3,432,450) of convertible debentures are convertible into a maximum of 1,400,000 ordinary shares at 4:1 conversion.

The original Langley agreement stated that the debentures were convertible at 2:1 when the original share price was £0.5 and above, increasing to 4:1 if the original share price was £0.25 or less. After the 5:1 reverse split the conversion parameters became 2:1 at £2.5 and above and 4:1 at £1.25 and below. The Group also agreed to grant Langley options to acquire the number of ordinary shares as is equal to the difference, if a positive amount, between (a) the number of ordinary shares into which the original amount of debt would have been convertible at a conversion price of £0.5, less (b) the aggregate number of the ordinary shares into which the original amount of debt has actually been converted at the date of conversion. The exercise price of the option shall be the fixed conversion price of £0.5. As of June 30, 2011, there were no such options granted.

The Convertible debentures bear no interest, are entitled to a liquidation preferred ahead of ordinary and preferred shareholders, are convertible into ordinary shares. There is no due date or required due date on the Group's Debentures. The Debentures rank junior to all the Group's indebtedness and senior only to its ordinary and preferred shares; accordingly these debentures have accounted for as equity transactions.

NOTE 13 - DERIVATIVES AND OTHER FINANCIAL INSTRUMENTS

Financial instruments

The Group's financial instruments comprise cash balances, items such as trade receivables and trade payables that arise directly from its operations, convertible loan notes, convertible redeemable preference shares and loans taken out from banks and other third parties. Financial instruments such as investments in, and advances to, subsidiary undertakings including short-term receivables and payables have been offset in the consolidation.

The Group relies on loans taken out from banks and other third parties to fund its investment in the production of motion pictures and to minimize the liquidity risk that it faces. The strategy in relation to these loans is to minimize the interest rate and to maximize the flexibility of repayment terms. The reliance on loans to provide finance is clear from the significant balances included within loans payables at the period end and the extent to which favorable terms have been achieved on these loans is indicated in the disclosures below.

The main risks arising from the Group's financial instruments are foreign currency risk, interest rate risk, liquidity risk, credit risk and price risk.

Foreign currency risk

The Group receives distribution income from overseas, normally in US Dollars. Consequently, its trade receivables are largely denominated in US Dollars. It also maintains a significant part of its cash in US Dollars. The Group's exposure to exchange rate fluctuations is currently deemed to be low, since the majority of its liabilities are also denominated in US Dollars. Therefore, the Group does not hedge against this risk.

Transactions in GB Pounds are in the opinion of Management either immaterial or outside the ordinary course of business and therefore there is no policy for mitigation of risks associated with conversion of GBP to USD.

An analysis of the monetary assets of the Group as of June 30, 2011, showing the amount denominated in each currency, is as follows:

	GBP	USD	Total
Trade receivables	$ -	$ 431,891	$ 431,891
Prepayments	1,369,399	231,843	1,601,242
Assets	$ 1,369,399	$ 663,734	$ 2,033,133
Trade payables	$ 1,964,776	$ 604,499	2,569,275
Accrued liabilities	371,051	2,011,865	2,382,916
Participation and residuals	-	503,187	503,187
Corporate loans	1,766,158	-	1,766,158
Film and production loans	-	10,949,675	10,949,675
Deferred income		311,880	311,880
Taxes payable	366,237	-	366,237
Liabilities	$ 4,468,222	$ 14,381,106	$ 18,849,328

Liquidity risk

Management monitors liquidity risk regularly by way of preparing cash flow forecasts and ensuring that adequate loan facilities are in place prior to the commencement of principle photography for any film.

Credit risk

The Group has a large number of customers, primarily sub-distributors who are located all over the world. Certain of these customers are large and well-known companies and these are not generally regarded as presenting a credit risk. However, certain of the smaller customers are considered to be a potential credit risk, and the Group manages such risk to the extent possible by maintaining regular contact with those customers who owe the Group money.

Economic dependence

During the year ended June 30, 2011, revenue from two major customers approximated $714,681 and $149,000, or 26% and 5%, respectively, of film revenues. Accounts receivable due from these two customers approximated $0 and $0, respectively, of the total accounts receivable at June 30, 2011.

During the year ended June 30, 2010, revenue from two major customers approximated $1,020,000 and $518,000, or 52% and 26%, respectively, of film revenues. Accounts receivable due from these two customers approximated $212,000 and $518,000, or 14% and 35%, respectively, of the total accounts receivable at June 30, 2010.

During the year ended June 30, 2011, 100% of fee related revenue in the amount of $570,029 was generated through SAPLA, all of which has been paid to the Group.

During the year ended June 30, 2010, 100% of fee related revenues in the amount of $4,442,919 was generated through SAPLA, $3,288,191 of which has been paid to the Group (see note 2). Overall receivable due from SAPLA (including SAPLOU Equicap) through the related parties accounts was approximately $2,473,000 at June 30, 2010, and reflected in Due From Related Parties.

There was no supplier in any of the periods reported who accounted for more than 10% of the Company's expenditures during the years ended June 30, 2011 and 2010.

Price risk

The Group manages the risk of goods and services being obtained at a higher than necessary price by ensuring that all purchases above a certain value are authorized by a Director prior to the purchase order being placed.

Production and corporate loans are included in the Group's balance sheet as financial liabilities. Production loans of $10,890,430 as of June 30, 2011 are all denominated in US Dollars; corporate loans of $1,755,250 are denominated in both USD and GBP. The bank overdraft in June 30, 2011 was denominated in Pounds Sterling.

The analysis of notes payable is as follows:

	Year ended June 30, 2011	Year ended June 30, 2010
Fixed and variable rate - production and corporate loans	$ 10,826,572	$ 16,663,434
No stated interest - production loans	1,819,108	1,637,846
Total financial liabilities	$ 12,645,680	$ 18,301,280

The fixed rate financial liabilities have fixed interest rates for the entire term of each loan. The weighted average interest rate of these fixed rate liabilities on the production loans was 11.0% for the year ended June 30, 2011 and 12.2% for the year ended June 30, 2010.

Those loans where no interest was payable were all loans made to fund the production of motion pictures that were repayable from the proceeds of each motion picture in accordance with a defined payment schedule. The period over which these loans are repayable, therefore, depends on the performance of each motion picture.

The financial assets of the Group are cash balances held on deposit with banks. As of June 30, 2011, the Group had only nominal cash balances. Such deposits earn interest at the relevant bank interest rates, which are generally fixed.

The fair value of all the financial assets and liabilities of the Group are considered to be equal to their stated value due to the short-term nature.

The Group has recorded the fair value of the derivative liabilities at fair value with changes in the value of the derivatives accounted for as gain or loss on derivative liabilities. As described in Note 12, as of June 30, 2011, the Group measured fair value of its derivative liabilities at approximately $0, using unobservable, Level 3 inputs.

NOTE 14 – SHARE BASED PAYMENTS

The Group accounts for share based payments in accordance with ASC 718 ("Accounting for Stock Compensation") using a fair value based method whereby compensation cost is measured at the grant date based on the value of the services received and is recognized over the service period. The Company uses the Black-Scholes pricing model to calculate the fair value of options and warrants issued. In calculating this fair value, there are certain assumptions used such as the expected life of the option, risk-free interest rate, dividend yield, volatility and forfeiture rate. The use of a different estimate for any one of these components could have a material impact on the amount of calculated compensation expense.

The numbers of stock options granted by the Group, by period, are as follows:

	Year Ended June 30, 2011	Year Ended June 30, 2010
Outstanding at beginning of period	43,500	51,500
Granted	120,000	-
Exercised		(2,000)
Cancelled or expired	(27,500)	(6,000)
Outstanding at end of period	136,000	43,500

120,000 and 0 options were issued during the years ended June 30, 2011 and 2010, respectively.

The following presents the inputs used by the Group in the Black Scholes valuation model for the new options issued in the periods presented:

	Year Ended June 30, 2011	Year Ended June 30, 2010
Risk-free interest rate	5 %	5 %
Expected option lives (in years)	3 years	3 years
Expected volatility for options	207%-238 %	207%-238 %
Expected dividend yield	0 %	0 %
Forfeiture rate	0 %	0 %

All shares are vested upon the grant date the Group recognized share-based compensation expense of $ 87,026 and $0 in the years ended June 30, 2011 and 2010. There was no income tax benefit recognized in the statements of operations for share-based compensation arrangements during any periods presented herein. Under standard applicable UK tax rules, the Group is not entitled to any tax benefit for such share-based compensation arrangements.

The weighted average exercise price of the share options outstanding at June 30, 2011 is $1.97 per share. The weighted average remaining exercise period of these options is approximately 12 months.

Employee options

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of Shares Outstanding	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price of Outstanding Options	Number of Shares Exercisable	Weighted Average Exercise Price of Exercisable Options
$7.30	4,000	0.17	7.30	4,000	7.30
$7.70	12,000	0.35	7.70	12,000	7.70

Non-employee options

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of Shares Outstanding	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price of Outstanding Options	Number of Shares Exercisable	Weighted Average Exercise Price of Exercisable Options
$2.00	20,000	1.6	$ 2.00	20,000	$ 2.00
$1.00	100,000	2.3	$ 1.00	100,000	$ 1.00

NOTE 15 – RELATED PARTY TRANSACTIONS

Employment Agreement

The Group engaged Kate Hoffman as an employee and director, who is the daughter of Peter Hoffman, the Chief Executive Officer. The Group has an employment agreement with Kate Hoffman pursuant to which she will act as Chief Operating Officer ad infinitum at a current salary of £52,000 ($85,000) per year plus bonuses and expenses. Ms. Hoffman’s contract contains a non-compete clause whereby she is excluded from competing against the Group for 6 months following the date of her termination. She currently does not have any share options or shares in the Group.

Affiliated and Related Party Agreements

Upon acquisition of control of the Group by Seven Arts Pictures Inc. ("SAP Inc.") in September 2004, Seven Arts Pictures Plc. entered into an agreement with Seven Arts Pictures Inc. under which Seven Arts Pictures Inc. provided the services of Peter Hoffman for the amount of his contracted salary as well as the direct costs of the Los Angeles office and staff of Seven Arts Pictures Inc. SAP Inc. is a related party by virtue of it being majority owned by Peter Hoffman, the Group's Chief Executive Officer and Director, and his wife, Susan Hoffman.

Certain affiliates controlled by Mr. Hoffman are entitled to be reimbursed by the Group for general overhead incurred by each to conduct business for the Group. Amounts are approved by the Group and then to be reimbursed for certain third party costs on motion pictures controlled by the Group and to be indemnified for loss costs or damages arising from the conduct of the Group's business if approved by the Group. The Group has the right to control through management all material decisions of all affiliates controlled by Mr. Hoffman to the extent such decisions have any material effect on the Group's business or results of operations.

Peter Hoffman controls several companies that are not part of the Group but from which it obtains or transfers distribution rights or other assets related to the business and which control production of the motion pictures. The agreements with Mr. Hoffman, and the companies controlled by him; provide that all revenues related to the Group's business payable to Mr. Hoffman or any of these related party companies is due to the Group, except Mr. Hoffman's salary, bonus and stock ownership.

Pursuant to an inter Group agreement, SAP Inc. also, from time to time, holds ownership of limited liability corporations in the United States, with all distribution rights and profits thereof being due to SAFE Ltd. In addition, they also provide other services for PLC and SAFE Ltd. At no fee other than Mr. Hoffman's salary and the direct third party costs of the Los Angeles office. These other services are any reasonable requests of the management of the Group including accounting services, audits of distribution statements, collection of accounts receivable, supervision of production of motion pictures and similar day-to-day aspects of the Group's business.

SAP Inc. has, from time to time, made non-interest bearing advances to the Group and SAFE Ltd, when the Group has not been able to collect amounts due from third party receivables in time to meet payments required to creditors. Any such advances that have been made by SAP. Inc. have been made solely for working capital purposes.

Pursuant to the inter Group agreements, the Group earned $551,672 from distribution of the Group's motion pictures during the year ended June 30, 2011. The Group is obligated to pay these funds to SAPLA which is a Louisiana limited liability company controlled by SAP Inc. SAP Inc. would then be obligated to return the funds to the Group. These obligations have been offset in the Group's books of account and the Group has recorded the amounts earned as described above.

The Group has from time to time made and received advances from and to Seven Arts Pictures Inc., Seven Arts Future Flow I LLC and various Louisiana limited liability companies referred to above, where the advances from and to these related parties do not bear interest. The balances of these combined accounts as of June 30, 2011 were $2,725,974 and $3,021,184 on June 30, 2010.

Apollo Media

Together with SAP Inc, the Group entered into a settlement agreement, dated September 30, 2006, with ApolloMedia GmbH & Co. Film produktion KG ("ApolloMedia") related to a dispute regarding amounts ultimately payable to ApolloMedia from distribution of the motion picture Stander and one of our subsidiaries' assumption of indebtedness of approximately $2,000,000 related to Stander. The Settlement Agreement fully releases the Group from any liability to ApolloMedia in exchange for a payment of $1,800,000 to be made by SAP Inc (of which $175,000 has been paid). In connection with the SAP Inc's payment obligation of the settlement amount to ApolloMedia, the Group issued 700,000 ordinary shares to SAP Inc. which SAP Inc immediately pledged to ApolloMedia to secure SAP Inc's obligations under the settlement agreement. SAP Inc has agreed that it will (1) return to the Group all ordinary shares in excess of 400,000 not necessary to satisfy SAP Inc's obligations to ApolloMedia and (2) deliver to the Group from SAP Inc's ordinary shares, any ordinary shares in excess of 400,000 in fact sold by SAP Inc to satisfy the indebtedness to ApolloMedia under the settlement agreement. The shares pledged to ApolloMedia will be sold by Apollo as necessary for ApolloMedia to derive net proceeds of $1,625,000, ($1,800,000 less $175,000) and any pledged shares remaining after such sale will be returned to the Group.

Relationship with Seven Arts Pictures Louisiana LLC ("SAPLA")

The Group license distribution rights to pictures controlled by them to its affiliate, SAPLA which perform distribution services for their motion pictures. All fees payable to SAPLA are subject to the agreements with Mr. Hoffman and his affiliates described above.

The Company entered into a distribution agreement with SAPLA (subsequently assigned by SAPLA to Seven Arts Pictures Louisiana (Equicap) LLC ("SAPLA Equicap")) pursuant to which the Group granted SAPLA the right to distribute motion pictures in return for a distribution fee of 20% of the revenues generated from these films, SAPLA and SAPLA Equicap are obligated under the related party agreements described above to pay and has permitted the Group to retain 100% of all such distribution fees.

SAPLA entered into a Credit Agreement with Advantage Capital Community Development Fund LLC dated October 11, 2007 for the acquisition and improvement of a production and post-production facility located at 807 Esplanade Avenue in New Orleans, Louisiana for aggregate principal advances of up to $3,700,000. This agreement was guaranteed by the Group. Approximately $3,700,000 has been drawn under the terms of this Credit Agreement, as of June 30, 2011 and 2010.

The Group has entered into a new financing agreement with Palm Finance in November 2010 to refinance the existing indebtedness secured by our production and post-production facility in New Orleans, Louisiana under which Palm has acquired the existing credit facility of $3,700,000 plus accrued interest of our affiliate SAPLA for $1,000,000 and agreed to advance an additional $1,800,000 to complete renovation and construction of this facility. Palm's advance and interest at the rate of 15% per annum are due and payable within five years and are secured by the property at 807 Esplanade Avenue in New Orleans ("Property") and Louisiana film infrastructure and historical rehabilitation credits, as well as Federal historical rehabilitation credits ("Credits") associated with the Property. As part of this agreement the Group has entered into an agreement with Palm extending the due date of the loans on American Summer, Autopsy and Nine Miles Down to December 31, 2011.

Upon commencement of business of SAPLA's production and post-production facility in New Orleans, Louisiana, SAPLA and an affiliate, Seven Arts Filmed Entertainment LLC ("SAFE LA") will be the lessee of those facilities and under the related party agreement all profits of SAFE LA if any will be returned to the Group under the agreements with Mr. Hoffman and his affiliates.

F-57

Investigation into Claim for Tax Credits (SAPLA)

The US Attorney in New Orleans is investigating claims for Louisiana film infrastructure tax credits including such tax credits to be claimed by an affiliate of the Group, Seven Arts Pictures Louisiana LLC. This investigation appears to include investigation as to whether certain expenses claimed by this affiliate were improper or fraudulent. All such claimed expenses were audited by independent auditors and reviewed by counsel. None of these expenses or credits have been included in the Group's financial statements for any period. Management believes that this investigation will have no material adverse effect on the Group's operations or the total tax credits to be received by the Group's affiliates, but could result in charges against current or former employees of this affiliate based on prior audits, including Mr. Hoffman.

Loan to Gone to Hell from Palm Finance

Together with SAP Inc, the Group guaranteed a $4,000,000 loan on December 17, 2007 between Palm Finance Corporation ("Palm") and Gone To Hell Ltd., a company controlled by the Chief Operating Officer and Director Kate Hoffman, in exchange for the distribution rights to the movie, Nine Miles Down. The loan was made exclusively to finance the motion picture Nine Miles Down and is secured by the distribution rights to that motion picture. The loan carries an annual rate of interest of 15% and became due on June 30, 2009. The Group has entered into a forbearance agreement with Palm in extending the due date of this loan to December 31, 2011.

Loan from Cold Fusion

The Group entered into a loan and security agreement dated January 15, 2009 for $750,000, together with SAP Inc. and certain limited liability companies controlled by SAP Inc. in connection with the production of the motion picture Night of the Demons ("NOTD"). The Group guaranteed the loan in exchange for the distribution rights to the picture. The loan was made to the Group to finance NOTD and is secured by the distribution rights to NOTD. The loan bears interest of ten percent (10%) per annum. The loan became due on March 31, 2010 and is being repaid from distribution revenues of NOTD. At June 30, 2011, the balance due to Cold Fusion amounted to $582,510 including unpaid accrued interest.

Employee Benefit Trust

The Group engaged Smith and Williams Trustees (Jersey) Limited to set up an Employee Benefit Trust ("EBT") in December, 2008. The Trust is a significant shareholder of the Group and controlled by the Trustees. The EBT entered into an agreement to purchase the 3,000,000 convertible preferred shares held by Armadillo Investment Trust ("Armadillo") for £1,500,000, to be paid in three equal installments of £500,000, and the return of the 1,600,000 ordinary shares in Armadillo owned by the Group, valued at £800,000 for an aggregate purchase price of £2,300,000. The agreed upon purchase price was to be loaned to the EBT by the Group at a nominal interest rate and, to date, the Group has advanced £500,000 as the first of three equal installments, together with the 1,600,000 ordinary shares of Armadillo, valued at £800,000 in the Group's books, to the EBT which has paid them over to Armadillo. The Group has guaranteed the EBT's remaining debt of £1,000,000 representing the second and third installments, but has not yet advanced these amounts. The EBT has repaid £582,604 ($1,039,946) of the £1,300,000 in the year ended June 30, 2011 by selling ordinary shares owned by the EBT to creditors of the Group. The Group charged interest of $44,822 to the EBT during the year ended June 30, 2011. The total balance due from the EBT to the Group as at June 30, 2011 was $1,237,417.

NOTE 16 – COMMITMENTS AND CONTINGENCIES

Acquisition of Big Jake Music

On September 29, 2011, the Company entered into a definitive agreement to acquire of all of the capital stock of Big Jake Music ("BJM"), a newly formed record and multi-media entertainment company, for $5,000,000 of convertible preferred stock, convertible into common stock at a premium to the market price at closing, and which is subject to restricted holding periods. BJM will also release soundtracks of Seven Arts films, including Night of the Demons (a film released in October 2010) and The Pool Boys (a film released in October 2011).

Creditors Liquidation of SAP Plc.

PLC was placed into compulsory liquidation on November 8, 2011 by the English Companies Court. The Company's CEO, Mr. Peter Hoffman, as a director of PLC had sought an administration order but this request was denied by the Courts as a result of inter alia the opposition of Parallel Pictures LLC ('Parallel'). The creditors are likely to be invited to appoint a licensed insolvency practitioner as liquidator. The role of a liquidator is to realize a company's assets for the benefit of the creditors and shareholders. Mr. Hoffman expects that the liquidator and PLC will pursue its substantial claims against Parallel and its defenses to Parallel's claims. Parallel has claimed in the proceedings in England and the United States that the Asset Transfer Agreement between the Company and PLC was 'fraudulent' and may seek additional compensation or guarantees from Company. Management believes that the Asset Transfer Agreement is a valid agreement for value and not subject to attack and that Parallel will not prevail in its claims. Management believes it has the support of its creditors to resist these claims by Parallel which are disputed by the Company and as a result Parallel will not obtain any relief from the courts on this issue.

807 Esplanade Guarantee

Seven Arts Pictures Louisiana LLC, a related party of the Company, entered into a Credit Agreement with Advantage Capital Community Development Fund LLC dated October 11, 2007, for the acquisition and improvement of a production and post-production facility located at 807 Esplanade Avenue in New Orleans, Louisiana for aggregate principal advances of up to $3,700,000. This agreement was guaranteed by the Company's predecessor. Approximately $3,700,000 has been drawn under the terms of this Credit Agreement, as of June 30, 2011. The Company has also guaranteed this amount.

There is a $1,000,000 guarantee of a note due to Armadillo by the Employee Benefit Trust resulting from the purchase back of the Seven Arts preferred shares from Armadillo.

Fireworks Litigation

The Group prevailed in a motion for summary adjudication on February 10, 2011 in an action against CanWest Entertainment and two of its affiliates ("CanWest") confirming the Group's ownership of five motion pictures "Rules of Engagement ", "An American Rhapsody," "Who Is Cletis Tout," "Onegin," and "The Believer", (the "Copywrights"). The Gr has filed an action in England against Content Media Corporation ("Content") and Paramount Picture Corp.("Paramount") to recover the Copyrights and substantial damages for the use of the copywrighted works after their purported acquisition from CanWest.The Group has also filed suits against Content and Paramount in the Unites States for collateral damage for copywright infringement against Paramount for use of copywright. The Group may incur up to $200,000 in legal expenses to pursue this claim but expects to recover those fees from Content.

Jones Film

The Group, its subsidiary Seven Arts Filmed Entertainment Limited, and a related party, SAP Inc, were the subject of an arbitration award of approximately $900,000 against them for legal fees and interest thereon relating to an ongoing dispute regarding a participation in the motion picture entitled 9 ½ Weeks II, even though the arbitration found no additional sums due to the complaining party, and potential loss of further distribution rights in this motion picture. The Federal District Court enforced this arbitration award, and the Group is seeking relief from that decision. The Group has accrued for the liability in the amount of $800,000 including approximately $100,000 of accrued interest as of June 30, 2011. The remaining interest, costs and fees have been guaranteed by SAP Inc., a related party.

Arrowhead Target Fund

Seven Arts Future Flow I ("SFF"), a limited liability Group owned by SAP Inc., one of the Group's controlling shareholders and a Group controlled by Mr. Hoffman, obtained financing from the Arrowhead Target Fund, Ltd. ("Arrowhead") of approximately $8,300,000 (the "Arrowhead Loan"). The Group secured the Arrowhead Loan with liens on 12 motion pictures that generated revenues of $820,026 in the year ended June 30, 2009, $2,739,800 in the year ended March 31, 2008. The Group's only liability is to repay the Arrowhead Loan from the proceeds of the film assets pledged against the Arrowhead Loan. The Group is not required to repay the Arrowhead Loan from any of its other assets or revenues.

The Arrowhead Loan became due in February 2009 and SFF has not paid the outstanding principle and interest due. Arrowhead has the right to foreclose on the pledged film assets, but has not done so at the present time. SFF has received a default notice to this effect and as a result Arrowhead is now collecting directly all sums receivable by the Group with respect to these motion pictures, and has appointed a new servicing agent for these motion pictures with the result that the Group no longer controls the licensing of these motion pictures. Failure to repay or refinance the Arrowhead Loan could result in a material disposition of assets through the loss of the Group's rights to the twelve motion pictures and related loss of revenues in amounts that are difficult to predict.

As a result of the foregoing, the Group has removed all assets accounts relating to the twelve motion pictures pledged to Arrowhead and has removed the corresponding limited recourse indebtedness from the Group's consolidated balance sheet at fiscal year ended June 30, 2009, due to the fact that the loan was a limited recourse loan and the Group had no further obligations to Arrowhead beyond the pledged film assets.

Arrowhead filed an action on September 22, 2010 which seeks recovery from the Group of the monies which the Group has retained under its interpretation of the relevant agreements with Arrowhead. In addition, Arrowhead makes substantial additional claims against the Group, Mr. Hoffman and Seven Arts Pictures Inc. regarding claimed breaches of the terms of the operative agreements, including failure to properly account, failure to turn over materials, failure to remit monies collected, and similar matters. The claims against the Group for these breaches of warranties for damages are $8,300,000 although Arrowhead states no basis for this amount.

The Group had moved to dismiss the action against all defendants other than Seven Arts Future Flows I LLC, which is not part of the Group. On August 9, 2011, the New York Supreme Court granted the Group's motion and dismissed all defendants except Seven Arts Filmed Entertainment Limited in its capacity as a collateral agent, which is not a material element of Arrowhead claim. The Group continues to believe that Arrowhead's claims against the Group are without substantial merit.

Arrowhead Capital Partners – AGC Loan

The Group and several affiliates were named as defendants in an action by Arrowhead Capital Partners Ltd filed in the Supreme Court of New York County of New York State purportedly served on May 24, 2010, seeking to collect $1,000,000 plus interest (the “ACG Loan”) due to Arrowhead Consulting group LLC (“ACG”) as well as foreclosure on the collateral granted as part of the Cheyne Loan described above in NOTE 12 under “Production Loans”. The ACG Loan is fully subordinated to repayment of the Cheyne Loan, which has not been repaid, and a subsidiary of the Group has been assigned all Cheyne’s rights under the subordination provision of the Cheyne Loan. As a result Management does not believe that ACG has the right to maintain this action to collect any monies or to foreclose on any collateral pursuant to the Cheyne Loan. The Group intends to vigorously defend against this action and has filed a motion for summary judgement to dismiss this action.

Silverback – Hungarian co-producer

The Group has obtained a final judgment from the Queen's Bench in England for approximately $300,000 erroneously converted to fees by a Hungarian co-producer on the motion picture Nine Miles Down. The Group is seeking to collect these fees back through enforcement by Hungarian courts and currently a bailiff has been appointed to collect the monies due in Hungary. The incorrectly appropriated fees have been included in the film asset in prior years. Capitalized film costs will be reduced upon collection of these fees.

Stonewood/Nine Miles Down

A settlement agreement for $250,000 has been reached with the liquidators of Gone to Hell ("GTH") the production company for Nine Miles Down. The main beneficiaries of the GTH liquidation are Stonewood; owned by the director of GTH and SAP INC for an action it took against the liquidator for interfering in the free distribution of the film. The debt to the liquidation is fully insured but only to the amount that is not payable back to SAP INC and Stonewood as they are the insured parties. The Group has guaranteed the legal costs of this action to make sure it releases the distribution rights to the movie. The Group has accounted for the legal expenses incurred related to this litigation by capitalizing them into film assets in the value of $200,000 as of June 30, 2011, due to the fact that these are direct expenditures to this particular film.

Zeus VAT

The Group believes that the accrual of the VAT input refund or output VAT tax with respect to the Zeus transaction is highly uncertain. Her Majesty's Customs and Revenue ("HMRC") raised issues regarding the Zeus transaction as early as May, 2008, and has made no determination regarding any of the inputs or outputs of VAT with respect to the Zeus transaction through today. The situation is still unresolved in that HMRC has not made a VAT refund to the 17 companies formed by investors in the Zeus transaction ("SAFCO's") of the output VAT tax charged by Seven Arts on the supplies made for the SAFCO's and declared on the Group's VAT return filed in 2008 and in that HMRC has taken no steps to enforce the collection of the output VAT tax as declared by the Group, as an internal "hold" has been placed on collection by HMRC. Until and unless this interest is lifted, HMRC will take no action to enforce the collection of the VAT output tax declared by the Group. The amount of VAT at issue is approximately £23,000,000 ($35,000,000) which would be both the amount owed by the Group to HMRC and the amount due to the Group from the SAFCO's as their refund from HMRC. The collection department of HMRC has stopped the collection of the VAT due from the Group, and to date no notices of interest have been received. The Group does not expect any penalties or fees will result from the VAT related to the Zeus transaction, accordingly no accrual of interest or penalties have been accrued as of June 30, 2011.

The Group acquired the SAFCO's as part of the Zeus transaction described above in May, 2009. The SAFCO's are not consolidated into the Group as the Group still does not have control of the bank accounts and the accounting records. The Group has instructed counsel to liquidate the SAFCO's under the applicable laws of the United Kingdom.

One of the Group's affiliates filed an action against Zeus Partners Limited and two of its executives for indemnity in relation to Value Added Tax due with respect to the Zeus Transaction. The purpose of this action is to protect the Group's rights with respect to any potential liability to the Group with respect to Value Added Tax arising out of the Zeus Transaction.

Investigation into Claim for Tax Credits (SAPLA)

The US Attorney in New Orleans is investigating claims for Louisiana film infrastructure tax credits including such tax credits to be claimed by an affiliate of the Group, Seven Arts Pictures Louisiana LLC. This investigation appears to include investigation as to whether certain expenses claimed by this affiliate were improper or fraudulent. All such claimed expenses were audited by independent auditors in Louisiana and reviewed by counsel. None of these expenses or credits have been included in the Group's financial statements for any period. Management believes that this investigation will have no material adverse effect on the Group's operations or the total tax credits to be received by the Group's affiliates, but could result in charges against current or former employees of this affiliate based on prior audits, including Mr. Hoffman.

Director’s Service Contracts

SAP Inc. has an employment agreement with Peter Hoffman pursuant to which he will act as the Group’s Chief Executive Officer (“CEO”) until December 31, 2013. Upon acquisition of control of Group, it entered into a contract with SAP Inc. to secure Mr. Hoffman's services solely to the Group as CEO. In connection with that employment agreement, Mr. Hoffman has been granted:

- the right to sole responsibility for creative and business decisions regarding motion pictures we develop and produce,
- a right of first refusal to produce remakes, sequels or prequels of motion pictures produced by Mr. Hoffman and acquired by the Group or any motion picture produced by the Group during his employment,
    - an annual salary of $500,000 per year plus bonuses, expenses and a signing option and
- a right upon termination without cause to a lump sum payment of approximately $1,500,000, an assignment of all projects in development during the term of his employment and any amounts due upon such compensation as an excise tax.

The Group has an employment agreement with Kate Hoffman pursuant to which she will act as Chief Operating Officer ad infinitum at a salary of $85,000 (£52,000) per year plus bonuses and expenses. Ms. Hoffman’s contract contains a “non-compete’ clause pursuant to which she will be excluded from competing against the Group for 6 months following the date of her termination.

The Group has an employment agreement with Elaine New pursuant to which she will act as an executive director and Chief Financial Officer ad infinitum at a salary of $225,000 (£150,000) per year plus bonuses and expenses. Ms. New’s contract contains a “non-compete’ clause pursuant to which she will be excluded from competing against the Group for 6 months following the date of her termination.

All of the employment agreements grant us a right to injunctive relief if the respective employee breaches the agreement. With the exception of Ms. Hoffman’s and Ms. New’s agreements, the employment agreements do not contain “non-compete” clauses.

Parallel Action

On June 28, 2011, PLC filed an action in the High Court of England against Parallel Media LLC (“Parallel”) to collect sums due to PLC with respect to acquisition of distribution rights in Russia to four motion pictures and to confirm Parallel’s obligations under both a signed and unsigned investment agreement with respect to the motion picture project Winter Queen. On the same day Parallel filed a petition to wind up and liquidate PLC in the Companies Courts of England based on its claim of repayment of $1,000,000 of investment made by Parallel in Winter Queen. On September 19, 2011, Parallel filed a new action against PLC and SAE in the Superior Court of California, asserting the same claims as in the winding up petition and seeking to enjoin the proposed administration proceedings in England. A request for a preliminary injunction was denied by the Superior Court.

HMRC Investigation

On July 19, 2011 Officers of Her Majesty's Revenue & Customs ("HMRC") attended the offices of PLC in London. Documents were retained appertaining to arrangements involving the subscription for shares in a number of companies which had lost value, resulting in subscribers making claims to tax relief.

PLC's participation in these transactions was limited to the transfer of rights to certain motion pictures to the investors in return for their investments in the production and release costs of those pictures and making available the provision of loans to fund a portion of those investments. PLC received no tax benefits from the transactions, which were made on arms-length terms. PLC believes that it is not a subject of the HMRC investigation.

In connection with the transactions, PLC did not make any representations or warranties to any party, including the investors, regarding any potential tax benefits related to the transactions. Prior to the closing of the transactions the investors obtained and made available to the Company, an opinion of prominent Queen's counsel, specializing in United Kingdom tax laws, that the transactions were permitted and acceptable under the terms of the applicable United Kingdom revenue laws. PLC remains confident that the transactions were permitted and acceptable under the terms of the applicable United Kingdom revenue laws.

Asset Transfer Agreement

On June 11, 2010, Seven Arts Entertainment, Inc. ("SAE"), a Nevada Corporation, was formed and became a 100% owned subsidiary of Seven Arts Pictures Plc. The Company entered into an Asset Transfer Agreement, as amended on January 27, 2011 and again on August 31, 2011, to transfer all of the assets with a cost basis from PLC to SAE, in exchange for assumption by SAE of certain indebtedness and for one share of common stock of SAE for each ordinary share of PLC which have been distributed to shareholders. Additionally, 2,000,000 shares of SAE were issued to PLC in order to satisfy any remaining obligations. This transfer was approved by the PLC shareholders at an Extraordinary General Meeting on June 11, 2010. The purpose of this transfer was to eliminate our status as a foreign private issuer and to assume compliance with all obligations of a domestic issuer under all applicable state and Federal securities laws. Management's intention in executing this transaction was to redomicile the business with no change in the economic interests of the shareholders.

Effective at the opening of trading on September 1, 2011, Seven Arts Entertainment Inc. ("Seven Arts" or "SAE") was substituted for the NASDAQ listing of Seven Arts Pictures PLC (the "Company"). On that date, each of the Company's ordinary shares was exchanged for one share of common stock of SAE, which commenced trading on NASDAQ as the successor to the Company's NASDAQ listing. SAE's new CUSIP number is 81783N102 and its trading symbol will remain SAPX.

Guarantees and Pledges

Guarantee of the Advantage Capital Loan

SAPLA, a related party of the Group, entered into a Credit Agreement with Advantage Capital Community Development Fund LLC dated October 11, 2007 for the acquisition and improvement of a production and post-production facility located at 807 Esplanade Avenue in New Orleans, Louisiana for aggregate principal advances of up to $3,700,000. This agreement was guaranteed by the Group. Approximately $3,700,000 has been drawn under the terms of this Credit Agreement, as of June 30, 2011. The Group has guaranteed this amount.

Guarantee of the £1,000,000 due to Armadillo by the EBT

As discussed in NOTE 1, PLC is a guarantor on the £1,000,000 due to Armadillo by the EBT.

NOTE 17 – OPERATING LEASE COMMITMENTS

During the years ended June 30, 2011 and 2010, the Group had no operating lease commitments. Both office facilities are operating under month to month agreements. Rent expense is approximately $4,500 a month for the Los Angeles office and $6,500 a month in London.

NOTE 18 – FAIR VALUE OF FINANCIAL INSTRUMENTS

Cash, accounts receivable, accounts payable and other accrued expenses and other current assets and liabilities are carried at amounts which reasonably approximate their fair values because of the relatively short maturity of those instruments.

ASC 820, "Fair Value Measurements and Disclosures", establishes a framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under ASC 820 are described as follows:

Leve l 1 - Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Company has the ability to access.

Leve l 2 - Inputs to the valuation methodology include:

- quoted prices for similar assets or liabilities in active markets;
- quoted prices for identical or similar assets or liabilities in inactive markets;
- inputs other than quoted prices that are observable for the asset or liability;
- inputs that are derived principally from or corroborated by observable market data by correlation or other means.

If the asset or liability has a specified (contractual) term, the Level 2 input must be observable for substantially the full term of the asset or liability.

Leve l 3 - Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The asset or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

The preceding method described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, although the Company believes its valuation method is appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date. As of June 30, 2011 and 2010, all of the Company’s assets and liabilities were considered current and due to the short maturity the carrying amounts are considered to approximate fair value.

NOTE 19 – RECENT ACCOUNTING PRONOUNCEMENTS

In May 2011, the FASB issued guidance intended to achieve common fair value measurements and related disclosures between U.S. GAAP and international accounting standards. The amendments primarily clarify existing fair value guidance and are not intended to change the application of existing fair value measurement guidance. However, the amendments include certain instances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has changed. This guidance is effective for the periods beginning after December 15, 2011, and early application is prohibited. The Company will adopt these amendments on January 1, 2012; however, the requirements are not expected to have a material effect.

NOTE 20 – SUBSEQUENT EVENTS

On June 11, 2010, Seven Arts Entertainment, Inc. (“SAE”), a Nevada Corporation, was formed and became a 100% owned subsidiary of Seven Arts Pictures Plc. The Company entered into an Asset Transfer Agreement, as amended on January 27, 2011 and again on August 31, 2011, to transfer all of the assets with a cost basis from PLC to SAE, in exchange for assumption by SAE of certain indebtedness and for one share of common stock of SAE for each ordinary share of PLC which have been distributed to shareholders. Additionally, 2,000,000 shares of SAE were issued to PLC in order to satisfy any remaining obligations. This transfer was approved by the PLC shareholders at an Extraordinary General Meeting on June 11, 2010. The purpose of this transfer was to eliminate our status as a foreign private issuer and to assume compliance with all obligations of a domestic issuer under all applicable state and Federal securities laws. Management’s intention in executing this transaction was to redomicile the business with no change in the economic interests of the shareholders.

As of January 27, 2011, net assets with a book value totaling approximately $7,200,000 plus convertible debentures with no redemption date, which are accounted for as equity, were transferred to SAE in accordance with the asset transfer agreement.

On August 31, 2011, NASDAQ approved the substitution of one share of SAE, Inc. stock for the Company's NASDAQ listing, effective at the opening of trading on September 1, 2011. On that date, each of the Company's ordinary shares were exchanged for one share of common stock of SAE, and commenced trading on NASDAQ as the successor to the Company's NASDAQ listing. This transaction was approved by the Company’s shareholders at the Company’s Extraordinary General Meeting on June 11, 2010.

SAE’s authorized capital consists of 50,000,000 shares of common stock, $.01 par value per share, of which the board of directors has allocated 25,000,000 shares as common stock. As of September 1, 2011, there were 6,476,344 shares of common stock outstanding. Each outstanding share of common stock entitles the holder thereof to one vote per share on matters submitted to a vote of stockholders.

SAE will be a United States issuer and commenced regular quarterly reporting for the first quarter ended September 30, 2011.

Issuance of New Shares or Options

Subsequent to June 30, 2011, an aggregate of 13,832,280 ordinary shares were issued, and accordingly there were 16,475,411 shares of the Group's issued and outstanding ordinary shares as of November 30, 2011.

The shares issued subsequent to June 30, 2011 include 10,000 shares issued to consultants in exchange for services rendered. $400,000 restricted shares were sold for cash.

Certain debt securities were partially converted into 11,422,000 ordinary shares at an average per-share price of $0.42.

The issuance of the converted debt was made pursuant to the exemption from registration provided pursuant to Section 4(2) of the Securities Act. Management believed that such exemption was available because (i) no advertising or general solicitation was employed in offering the debt securities, (ii) the offering and sale thereof were made solely to an accredited investor, and (iii) transfer of the debt securities was restricted in accordance with the requirements of such Act. More than one year passed between the issuance of the converted debt and its conversion into ordinary shares. In accordance therewith, the resale of such shares was exempt from the registration thereof pursuant to the exemption provided by Rule 144.

The debt that was converted to equity included $2,750,000 from Palm Finance, $350,000 from 120dB Film and $725,000 of convertible debt, including $500,000 from Whatley and $225,000 from Eden.

Palm Finance reinvested $1,250,000 back into SAE, Inc. (PLC’s successor entity) by acquiring 125,125 shares of Series A ($10 par) preferred stock in November 2011.

On October 14, 2011, the Board of Directors of SAE Inc. were each issued 50,000 options at the market price of $0.44 a share.

On November 21, 2011 SAE, Inc. issued 2,000,000 shares to PLC in accordance with the asset transfer agreement approved by shareholders on June 11, 2011.

Letter of Intent Regarding David Michery

On November 7, 2011, the Company signed a letter of intent to acquire the music assets of David Michery for 10,000,000 shares of preferred stock subject to due diligence and Board approval.

Creditors Liquidation of SAP Plc.

PLC was placed into compulsory liquidation on November 8, 2011, by the English Companies Court. PLC’s CEO, Mr. Peter Hoffman, as a director of PLC had sought an administration order but this request was denied by the Courts as a result of inter alia the opposition of Parallel Pictures LLC (‘Parallel’). The creditors are likely to be invited to appoint a licensed insolvency practitioner as liquidator. The role of a liquidator is to realize a company’s assets for the benefit of the creditors and shareholders. Mr. Hoffman expects that the liquidator and PLC will pursue its substantial claims against Parallel and its defenses to Parallel’s claims. Parallel has claimed in the proceedings in England and the United States that the Asset Transfer Agreement between SAE and PLC was ‘fraudulent’ and may seek additional compensation or guarantees SAE Inc. Management believes that the Asset Transfer Agreement is a valid agreement for value and not subject to attack and that Parallel will not prevail in its claims. Management believes it has the support of its creditors to resist these claims by Parallel which are disputed by SAE Inc. and PLC and as a result Parallel will not obtain any relief from the courts on this issue.

Certain indebtedness of PLC remained with PLC under the asset transfer agreement and will be subject to liquidation or payment in these liquidation proceedings. PLC has been issued 2,000,000 shares of common stock of the Company in order to satisfy these obligations.

Issue of Promissory Note to RBSM LLP

On September 4, 2011, SAE Inc. issued a promissory note to RBSM LLP ("RBSM"), the Group's prior registered accounting firm. The note guarantees that SAE Inc. will pay RBSM $150,000 on or before the six month anniversary of the note. The note bears interest of 7% per annum but this will be waived if the note is paid off within the six months. On maturity of the note if the principal and interest have not been paid in full then RBSM can convert the note into freely trading common shares with an issue price of 75% of the weighted average closing bid price per common share during the 10 days preceding the maturity date. In accordance therewith, the resale of such shares will be exempt from the registration thereof pursuant to the exemption provided by Rule 144.

Arrowhead Action

The Arrowhead Target Fund filed an action on September 22, 2010 which seeks recovery from the Group for amounts which the Group has retained under its interpretation of the relevant agreements with Arrowhead. In addition, Arrowhead makes substantial additional claims against the Group, Mr. Hoffman and Seven Arts Pictures Inc. regarding claimed breaches of the terms of the operative agreements, including failure to properly account, failure to turn over materials, failure to remit monies collected, and similar matters. The claims against the Group for these breaches of warranties for damages are $8,300,000 although Arrowhead states no basis for this amount.

The Group had moved to dismiss the action against all defendants other than Seven Arts Future Flows I LLC, which is not part of the Group. On August 9, 2011, the New York Supreme Court granted the Group's motion and dismissed all defendants except Seven Arts Filmed Entertainment Limited in its capacity as a collateral agent, which is not a material element of Arrowhead claim. The Group continues to believe that Arrowhead's claims against the Group are without substantial merit, and nothing has been accrued in the financial statements related to this claim.

HMRC Investigation

On July 19, 2011 Officers of Her Majesty's Revenue & Customs ("HMRC") attended the offices of Seven Arts Pictures plc (the "Company") in London. Documents were retained appertaining to arrangements involving the subscription for shares in a number of companies which had lost value, resulting in subscribers making claims to tax relief.

The Company's participation in these transactions was limited to the Company's transfer of rights to certain motion pictures to the investors in return for their investments in the production and release costs of those pictures and making available the provision of loans to fund a portion of those investments. The Company received no tax benefits from the transactions, which were made on arms-length terms. The Company believes that it is not a subject of the HMRC investigation.

In connection with the transactions, the Company did not make any representations or warranties to any party, including the investors, regarding any potential tax benefits related to the transactions. Prior to the closing of the transactions the investors obtained and made available to the Company, an opinion of prominent Queen's counsel, specializing in United Kingdom tax laws, that the transactions were permitted and acceptable under the terms of the applicable United Kingdom revenue laws. The Company remains confident that the transactions were permitted and acceptable under the terms of the applicable United Kingdom revenue laws.

HMRC has requested interviews with three officers of the Company to discuss whether those officers were involved in the arrangements for subscription of shares in the relevant companies. The Company is fully cooperating with the investigation. The Company believes there is no basis for any claim of responsibility of any of its officers or employees. Based on facts currently known by the Company, there is no need for it to record a contingent liability in its financial statements in connection with the investigation or the related transactions.

Board of Directors

The Board of Directors of SAE Inc. is the existing six members of the Board of Directors of the Company, plus the addition of Robert Kaiser as a Board Member and Chairman of SAE's Audit Committee. SAE will have four members of its Board who are independent as defined by NASDAQ.

Parallel Action

On June 28, 2011, Seven Arts Pictures plc ("PLC") filed an action in the High Court of England against Parallel Media LLC ("Parallel") to collect sums due to PLC with respect to acquisition of distribution rights in Russia to four motion pictures and to confirm Parallel's obligations under both a signed and unsigned investment agreement with respect to the motion picture project Winter Queen. On the same day Parallel filed a petition to wind up and liquidate PLC in the Companies Courts of England based on its claim of repayment of $1,000,000 of investment made by Parallel in Winter Queen. That winding up petition will not be heard until some unspecified date after October 10, 2011. PLC is no longer part of the Group and will file for administration under the laws of England, which management of PLC believes will be granted and which will result in the denial of Parallel's winding up petition. The disputes between PLC and Parallel will then be resolved in this administration under English law and should not affect the results of operations of the Group. On September 19, 2011, Parallel filed a new action against PLC and Seven Arts Entertainment Inc. ("SAE") in the Superior Court of California, asserting the same claims as in the winding up petition and seeking to enjoin the proposed administration proceedings in England. A request for a preliminary injunction was denied by the Superior Court. PLC will move to dismiss this action since all the operative agreements between PLC and Parallel include a clause requiring exclusive jurisdiction of all litigation in the courts of England. PLC expects this motion to dismiss will be granted.

Fletcher Joint Venture

The Group entered into an agreement with BRG Investments, LLC ("BRG"), an affiliate of Fletcher Asset Management ("Fletcher") for the investment by BRG of up to $30,000,000 in preferred stock of the Group and the formation of a joint venture to, among other things, produce and distribute motion pictures and make investments.

BRG purported to cancel the agreement in May 2011.

On October 5, 2011, the Company arranged a mutually acceptable settlement of its dispute with Fletcher arising out of an investment agreement purported terminated by Fletcher as was announced in a press release on June 7, 2011. In the settlement with Fletcher, the Company waived all claims against Fletcher. Fletcher agreed to acquire, and did acquire, 250,000 shares of the Company's common stock at a price of $1.00 per share. Fletcher received a warrant to buy an additional 100,000 shares at $1.00, Fletcher has the right within six months to buy an additional 250,000 shares of the Company's common stock based on a volume weighted average price but no less than $1.00 or more than $1.50, and if it buys these shares, Fletcher will receive an additional warrant to buy an additional 100,000 shares of our common stock on the same terms as the warrant we have issued. Seven Arts intends to use the proceeds of this transaction to partially fund its next motion picture production in Louisiana entitled Schism, written and to be directed by Adam Gierasch, the director of Autopsy and Night of the Demons, two recent releases by the Company.

Legal Action by Arrowhead Target Fund

The Arrowhead Target Fund has filed an action on September 22, 2010, which seeks recovery from the Group of the monies which the Group has retained under its interpretation of the relevant agreements with Arrowhead. In addition, Arrowhead makes substantial additional claims against the Group, Mr. Hoffman and Seven Arts Pictures Inc. regarding claimed breaches of the terms of the operative agreements, including failure to properly account, failure to turn over materials, failure to remit monies collected, and similar matters. The claims against the Group for these breaches of warranties for damages are $8,300,000 although Arrowhead states no basis for this amount. The Group does not believe there is any basis to the Arrowhead claims except with respect to the monies withheld by the Group based on its interpretation of the applicable agreements. The Group intends to aggressively defend these claims but is currently in settlement discussions with Arrowhead regarding the reacquisition of the 12 motion pictures subject to the Arrowhead transaction. However, the ultimate outcome of these claims cannot be determined at this time, and nothing has been accrued related to these claims.

New Office Lease in Los Angeles

On December 1, 2011, SAE Inc. entered into an agreement for office space in Los Angeles. The lease is for 60 months at a monthly rate of approximately $9,500. The office space and expense will be shared with related parties; however, SAE Inc. is joint and severally liable.