

Digitiliti Inc
Form 10-Q
November 15, 2011
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)

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

For the quarterly period ended September 30, 2011
OR

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

For the transition period from _____ to _____

Commission File No. 000-53235

DIGITILITI, INC.

(Exact name of Registrant as specified in its charter)

Delaware

26-1408538

(State or Other Jurisdiction of
incorporation or organization)

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

266 East 7th Street, 4th Floor
St. Paul, Minnesota 55101

(Address of Principal Executive Offices)

(651) 925-3200

(Registrant's telephone number, including area code)

N/A

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act (check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if smaller reporting company)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

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As of November 15, 2011, the Registrant had 69,376,179 shares of common stock issued and outstanding at \$.001 per share par value.

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PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

DIGITILITI, INC.
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

| | September 30, 2011 | December 31, 2010 |
|--|-----------------------|----------------------|
| ASSETS | | |
| CURRENT ASSETS | | |
| Cash | \$209,723 | \$27,557 |
| Accounts receivable | 541,941 | 333,687 |
| Prepaid and other current assets | 167,979 | 247,970 |
| Total current assets | 919,643 | 609,214 |
| Property and equipment, net | 68,570 | 158,105 |
| Software license, net | 236,187 | 436,608 |
| Deferred financing costs | 259,402 | 4,466 |
| Other assets | 6,322 | 6,322 |
| Total assets | \$1,490,124 | \$1,214,715 |
| LIABILITIES AND STOCKHOLDERS' DEFICIT | | |
| CURRENT LIABILITIES | | |
| Accounts payable | \$510,358 | \$692,923 |
| Accrued expenses | 670,674 | 554,978 |
| Deferred income | 9,989 | 9,989 |
| Notes payable | 50,000 | 231,540 |
| Note payable to related party | 66,000 | — |
| Current maturities of convertible debt, net of unamortized discounts of \$18,936 and \$7,059 | 471,064 | 782,941 |
| Current maturities of capital lease obligations | — | 23,308 |
| Total current liabilities | 1,778,085 | 2,295,679 |
| Convertible debt, non-current, net of unamortized discounts of \$489,612 and \$0 | 1,861,516 | 250,000 |
| Other liabilities | 3,607 | 3,607 |
| Total liabilities | 3,643,208 | 2,549,286 |
| STOCKHOLDERS' DEFICIT | | |
| Series A Convertible Preferred Stock, \$0.001 par value; 1,200,000 shares authorized for Series A, 668,720 and 724,187 shares issued and outstanding | 669 | 724 |
| Series B Convertible Preferred Stock, \$1.00 par value; 2,000,000 shares authorized for Series B, 420,000 shares issued and outstanding | 420,000 | 420,000 |
| Common stock, \$.001 par value; 125,000,000 shares authorized, 69,376,179 and 65,699,753 shares issued and outstanding | 69,376 | 65,700 |
| Additional paid-in capital | 25,880,222 | 24,409,477 |
| Accumulated deficit | (28,523,351) | (26,230,472) |
| Total stockholders' deficit | (2,153,084) | (1,334,571) |
| Total liabilities and stockholders' deficit | \$1,490,124 | \$1,214,715 |
| See accompanying notes to unaudited consolidated financial statements. | | |

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DIGITILITI, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|--------------|------------------------------------|----------------|
| | 2011 | 2010 | 2011 | 2010 |
| REVENUES | \$498,917 | \$555,386 | \$1,391,660 | \$1,719,520 |
| COST OF REVENUES | 347,205 | 418,141 | 1,227,536 | 1,098,509 |
| GROSS PROFIT | 151,712 | 137,245 | 164,124 | 621,011 |
| OPERATING EXPENSES | | | | |
| Selling and marketing | 52,962 | 239,490 | 292,008 | 616,068 |
| General and administrative | 307,042 | 362,733 | 1,211,085 | 1,978,671 |
| Research and development | 155,003 | 242,736 | 434,145 | 774,719 |
| Total Operating Expenses | 515,007 | 844,959 | 1,937,238 | 3,369,458 |
| LOSS FROM OPERATIONS | (363,295) | (707,714) | (1,773,114) | (2,748,447) |
| OTHER INCOME AND EXPENSES | | | | |
| Gain/Loss on extinguishment of debt | — | 2,866 | (71,634) | (315,428) |
| Interest expense | (200,909) | (90,790) | (448,131) | (2,198,769) |
| Total other expenses | (200,909) | (87,924) | (519,765) | (2,514,197) |
| NET LOSS | \$(564,204) | \$(795,638) | \$(2,292,879) | \$(5,262,644) |
| NET LOSS PER SHARE — BASIC AND DILUTED | \$(0.01) | \$(0.01) | \$(0.03) | \$(0.10) |
| WEIGHTED AVERAGE COMMON SHARES OUTSTANDING — BASIC AND DILUTED | 69,023,327 | 64,433,023 | 67,541,576 | 50,631,136 |

See accompanying notes to unaudited consolidated financial statements.

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DIGITILITI, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

| | Nine months ended September 30, | |
|---|------------------------------------|---------------|
| | 2011 | 2010 |
| OPERATING ACTIVITIES | | |
| Net loss | \$(2,292,879) | \$(5,262,644) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation expense | 95,398 | 252,497 |
| Amortization of software license | 200,421 | 222,619 |
| Beneficial conversion feature on converted notes | — | 1,522,950 |
| Amortization of deferred financing costs | 66,096 | 39,050 |
| Amortization of debt discounts | 189,011 | 324,173 |
| Loss on extinguishment of debt | 71,634 | 315,428 |
| Warrant expense | 49,548 | 387,067 |
| Common shares issued for services | 78,929 | 152,340 |
| Employee stock option expense | 253,696 | 214,742 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (208,254) | 45,685 |
| Prepaid and other current assets | 79,991 | 78,805 |
| Other assets | — | 1,000 |
| Accounts payable | (150,089) | 139,590 |
| Accounts payable — related parties | — | (7,861) |
| Accrued expenses | 195,937 | 203,060 |
| Deferred income | — | 14,486 |
| Deferred rent | (764) | (7,188) |
| Net cash used in operating activities | (1,371,325) | (1,364,201) |
| INVESTING ACTIVITIES | | |
| Purchase of property and equipment | (5,863) | (47,794) |
| Purchase of software license | — | (19,282) |
| Net cash used in investing activities | (5,863) | (67,076) |
| FINANCING ACTIVITIES | | |
| Proceeds from notes payable | 50,000 | — |
| Cash paid for debt issuance costs | (49,797) | — |
| Proceeds from sale of common stock, net of issuance costs | 63,000 | 1,199,050 |
| Proceeds from issuance of Series B convertible preferred stock | — | 300,000 |
| Proceeds from exercise of warrants | — | 509,900 |
| Payments on capital lease obligations | (23,308) | (35,537) |
| Proceeds from notes payable — related parties | 66,000 | — |
| Proceeds from convertible debt | 1,910,000 | — |
| Payments on notes payable | (231,540) | (364,572) |
| Payments on convertible debt | (225,001) | (95,000) |
| Net cash provided by financing activities | \$1,559,354 | \$1,513,841 |

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| | | |
|--|-----------|-----------|
| NET INCREASE IN CASH | 182,166 | 82,564 |
| Cash at beginning of year | 27,557 | 141,086 |
| Cash at end of year | \$209,723 | \$223,650 |
| SUPPLEMENTAL CASH FLOWS INFORMATION | | |
| Cash paid for interest | \$63,290 | \$75,094 |
| Cash paid for income taxes | — | — |
| NON-CASH INVESTING AND FINANCING ACTIVITIES: | | |
| Convertible debt issued for debt issuance costs | 64,000 | — |
| Warrants issued for debt issuance costs | 207,235 | — |
| Accrued interest converted to convertible debt | 8,844 | — |
| Debt discount due to warrants issued with debt | 427,580 | — |
| Common stock issued for the conversion of convertible debt | 75,000 | — |
| Debt discount due to beneficial conversion feature | 144,635 | — |
| Common stock issued for the conversion of Series A preferred stock | 277 | — |
| Common stock issued for debt and accrued interest | 103,109 | 3,265,973 |
| Preferred stock issued for accrued interest | — | 724,187 |
| Common stock issued for liabilities | — | 12,879 |
| Notes payable issued for maintenance fees | — | 56,634 |
| Accrued interest converted to debt principal | — | 21,107 |

See accompanying notes to unaudited consolidated financial statements.

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DIGITILITI, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. Basis of Presentation

The accompanying unaudited interim consolidated financial statements of Digitiliti, Inc. (the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) and with the instructions to Form 10-Q and Article 8 of Regulation S-X under the Securities Exchange Act of 1934, as amended. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. These consolidated financial statements and notes should be read in conjunction with the consolidated financial statements and notes included in the Company’s Form 10-K for the year ended December 31, 2010, filed with the Securities and Exchange Commission (“SEC”) on April 14, 2011. In the opinion of management, all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of financial position and the results of operations for the interim periods presented have been reflected herein. The results of operations for interim periods are not necessarily indicative of the results to be expected for the full year.

Software Revenue Recognition

The Company derives its revenue from sales of its products and services. Product revenue is derived from sales of the Company’s DigiBak and DigiLibe service.

The DigiBak service provides an offsite storage solution through a “utility based computing philosophy” where customers pay for the gigabytes of data they store in the DigiBak vault.

The DigiLibe service is a multiple element software sales arrangement that is comprised of three key components that act as one: Client Agent, Information Director, and Archive Information Store.

For multiple element software license sales arrangements that do not require significant modification or customization of the underlying software, we recognize revenue when: (1) we enter into a legally binding software arrangement with a customer for the license of software, (2) we deliver the software, (3) price is deemed fixed or determinable and free of contingencies of significant uncertainties and (4) collection is probable.

For sales arrangements with multiple elements, we defer revenue for any undelivered elements, and recognize revenue when the product is delivered or over the periods in which the service is performed. If we cannot objectively determine the fair value of any undelivered element included in bundled arrangements, we defer revenue until all elements are delivered and services have been performed, or until fair value can objectively be determined for any remaining undelivered elements.

New Accounting Pronouncements

The Company does not expect the adoption of recently issued or effective accounting pronouncements to have a material impact on the Company's consolidated financial statements.

2. Going Concern

As shown in the accompanying financial statements, the Company incurred a net loss of \$2,292,879 for the nine months ended September 30, 2011 and had a working capital deficit of \$858,442 as of September 30, 2011. These conditions raise substantial doubt as to the Company’s ability to continue as a going concern.

The Company continues to be dependent on its ability to generate future revenues, positive cash flows and additional financing. There can be no guarantee that the Company will be successful in generating future revenues, in obtaining additional debt or equity financing or that such additional debt or equity financing will be available on terms acceptable to the Company. The financial statements do not include any adjustments that might be necessary if the Company is unable to continue as a going concern.

3. Notes Payable

During the nine months ended September 30, 2011, the Company borrowed \$50,000 from a third party. This note is unsecured, bears interest at 12% per annum and matures on October 8, 2011. In connection with the loan, the lender received warrants to purchase an aggregate of 25,000 common shares at an exercise price of \$0.20 per share. The warrants vested immediately and have a term of five years. The relative fair value of the warrants was measured using the Black-Scholes option pricing model and

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determined to be \$1,923 and was recorded as a discount to the note. The entire discount was amortized to interest expense during the nine months ended September 30, 2011.

During the nine months ended September 30, 2011, the Company borrowed an aggregate of \$50,000 from a member of the Company's Board of Directors. The notes are secured against the Company's accounts receivable and bear interest at 12% per annum. The first note amounting to \$25,000 matured on July 29, 2011 and is currently past due. The remaining note for \$25,000 matured on September 1, 2011 and is currently past due.

During the nine months ended September 30, 2011, the Company borrowed \$16,000 from a member of the Company's Board of Directors. The note is secured against the Company's accounts receivable, bears interest at 12% per annum and matured on June 25, 2011. This note is currently past due.

During the nine months ended September 30, 2011, the Company repaid a previously issued note payable of \$231,540.

4. Convertible Debt

In June 2011, the Company initiated a Junior Secured Convertible Debt Offering that provides for the sale of up to an aggregate principal amount of \$1,500,000 Junior Secured Convertible Promissory Notes (the "Junior Notes") and Warrants. The investors in this Junior Secured Convertible Debt Offering receive five-year warrants to purchase that number of common shares equal to 10% of the principal amount of their Junior Note(s) divided by the exercise price of \$.06 per share. The Junior Notes bear interest at 8% per annum, have a 24-month maturity date and are secured by the assets of the Company with the repayment being subordinated to the repayment of all secured notes previously issued by the Company. The Junior Notes also contain a contingent conversion option wherein, at the option of 60% of the investors and twelve months following the closing of the first tranche, all or a portion of the principal amount and accrued interest may be converted into common shares at an exercise price of \$0.06 per share but only if at least \$1,000,000 in aggregate principal amount of the Junior Secured Convertible Debt Offering has been raised. However, the Junior Notes automatically convert into common shares upon a subsequent equity funding round of at least \$3 million of new equity capital ("Qualified Round") at a per share price equal to the per share price of the qualified round.

On June 28, 2011, the Company closed on the first \$500,000 tranche of the Junior Secured Convertible Debt Offering. In conjunction with the closing of the first tranche of the Junior Secured Convertible Debt Offering, the investors received warrants to purchase an aggregate of 833,333 common shares. The warrants vested immediately, have a five year term and an exercise price of \$0.06 per share. The relative fair value of the warrants was measured using the Black-Scholes option pricing model and determined to be \$52,239, which was recorded as a debt discount. The warrant discount is being amortized over the life of the notes using the effective interest method. The amortization expense recorded on the discount for the nine months ended September 30, 2011 totaled \$5,911.

In conjunction with the closing of the first tranche of the Junior Secured Convertible Debt Offering, the Company paid consultants fees totaling \$103,750 consisting of \$25,000 paid in cash and the issuance of 1,125,000 warrants valued at \$78,750 using the Black-Scholes pricing option model. The warrants vested immediately, have a five-year life and an exercise price of \$.06 per share. The total consulting fees of \$103,750 were recorded as deferred financing costs and are being amortized using the effective interest method over the term of the Notes. The amortization of these deferred financing costs during the nine months ended September 30, 2011 totaled \$6,701.

On September 15, 2011, the Company broke escrow on the remaining \$1,000,000 available under the second tranche of the \$1,500,000 Junior Secured Convertible Debt Offering by closing on \$550,000 of proceeds from the sale of the Junior Notes. In conjunction with the sale of \$550,000 of these Junior Notes, the investors received an aggregate of 916,667 common stock warrants. The warrants vested immediately, have a five year term and an exercise price of \$0.06 per share. The relative fair value of the warrants was measured using the Black-Scholes option pricing model and determined to be \$50,000, which was recorded as a debt discount. The warrant discount is being amortized over the life of the notes using the effective interest method. The amortization expense recorded on the discounts for the nine months ended September 30, 2011 totaled \$1,018.

In conjunction with the September 2011 sale of these \$550,000 of Junior Notes, the Company paid consultants fees totaling \$75,000 consisting of \$26,250 paid in cash and the issuance of 812,500 warrants valued at \$48,750 using the Black-Scholes pricing option model. The warrants vested immediately, have a five-year life and an exercise price of \$.06 per share. The total consulting fees of \$75,000 were recorded as deferred financing costs and are being amortized using the effective interest method over the term of the Notes. The amortization of these deferred financing costs during the nine months ended September 30, 2011 totaled \$5,634.

The Company analyzed the Junior Secured Convertible Debt Offering for derivative accounting under FASB ASC 815-15 and determined that derivative accounting does not apply to these instruments.

In addition, the Junior Secured Convertible Debt Offering was then evaluated for a beneficial conversion feature and it was determined that a beneficial conversion feature existed. The intrinsic value of the beneficial conversion feature associated with the closing of the first \$500,000 tranche was measured on the date of the agreement and determined to be \$135,572. And the intrinsic value of the beneficial conversion feature associated with the sale of the \$550,000 Junior Notes was measured on the date the proceeds were received and was determined to be \$50,000. However, due to the contingent nature of the conversion features, the beneficial conversion features associated with the tranches will be recognized when the contingency is lifted.

On February 28, 2011, the Company completed the placement of \$1,182,844 of Secured Convertible Promissory Note (the "Notes") and Warrants (collectively, the "First Secured Convertible Debt Offering"). The Lenders in the First Secured Convertible Debt Offering paid a 10% discount for their investment, resulting in a "stepped-up" basis in their individual Notes for a total principal amount of \$1,301,128. The Notes bear interest at the rate of 12% per annum, have an 18-month maturity date and are convertible to common shares at \$0.20 per share. The Notes are secured by a first lien on all assets of the Company; but are subordinate to the lien with respect to up to \$25,000 of original principal amount of other notes against the Company's vault.

In conjunction with the First Secured Convertible Debt Offering, the Lenders received warrants to purchase an aggregate of 3,252,821 common shares. The warrants vested immediately, have a five year term, a \$0.30 exercise price and are redeemable by the Company in the event of an acquisition. The Company valued the warrants using the Black-Scholes option pricing model. The warrants include standard antidilution provisions for stock splits, stock dividends and recapitalization.

During November and December of 2010, the Company received \$250,000 of the cash proceeds under the First Secured Convertible Debt Offering in the form of advanced convertible notes. These advanced convertible notes originally matured at the earlier of the closing of the First Secured Convertible Debt Offering or May and June of 2012, had an interest rate of 12% per annum and were convertible into common shares at \$0.20 per share. The principal and accrued interest amounting to \$250,000 and \$8,844, respectively, were converted into Notes under the First Secured Convertible Debt Offering upon closing.

In conjunction with the sale of the 12% First Secured Convertible Debt Offering, the Company paid consultants fees totaling \$64,000 and issued 170,000 five-year warrants with an exercise price of \$0.20 per share and 363,000 five-year warrants with an exercise price of \$0.30 per share. The fees were paid through the issuance of Notes in the

12% First Secured Convertible Debt Offering. The fees and the fair value of the warrants totaling \$143,735 were recorded as deferred financing costs and are being amortized using the effective interest method over the term of the Notes. The amortization of these deferred financing costs during the nine months ended September 30, 2011 totaled \$50,434.

The aggregate unamortized deferred financing costs on all notes amounted to \$259,402 as of September 30, 2011. The aggregate amortization of deferred financing costs during the nine months ended September 30, 2011 totaled \$66,096 including the above mentioned costs and \$3,327 of amortization of deferred financing costs incurred during fiscal 2010.

The Company analyzed the First Secured Convertible Debt Offering for derivative accounting under FASB ASC 815-15 and determined that derivative accounting does not apply to these instruments.

The First Secured Convertible Debt Offering was then evaluated for a beneficial conversion feature and it was determined that a beneficial conversion feature existed. The intrinsic value of the beneficial conversion feature was determined to be \$126,729. In addition, the relative fair value of the warrants was measured using the Black-Scholes option pricing model and determined to be \$316,226, which was recorded as a debt discount. The 10% face discount on the Notes was determined to be \$118,284 resulting in an aggregate discount of \$561,239 being recorded on the Notes. The aggregate discount is being amortized over the life of the Notes using the effective interest method. The amortization expense recorded on these discounts for the nine months ended September 30, 2011 totaled \$166,938 resulting in a total unamortized discount of \$394,302 as of September 30, 2011.

On February 28, 2011, the Company entered into an agreement to repay and modify three debt obligations owed to two stockholders. The debt obligations owed to these two stockholders were secured by a first lien on the Company's assets and consisted of the following: a \$250,000 12% secured convertible note issued in November 2008 with a \$0.35 per share conversion rate; a \$50,000 payable that was due on demand and bore interest at 10% per annum; and a \$231,540 6% promissory note that was due on demand. The terms of the agreement provided for the repayment of \$431,540 of principal on the combined debt and payable with the remaining principal balance owed of \$100,000 being converted into a Note under the Secured Convertible Debt Offering. In addition, the outstanding accrued interest owed to these two stockholders of \$103,109 was paid through the issuance 687,393 common shares. Under the agreement, the terms of 350,000 warrants previously granted to these stockholders were modified whereby the exercise price was reduced to \$0.15 and the term changed to 5 years. An additional 200,000 warrants with a 5-year term and a \$0.20 per share exercise price were also granted to these stockholders. Upon final payment of the loan on April 21, 2011, the stockholders released their first lien in the Company's assets in preference to those lenders associated with the First Secured Convertible Debt Offering.

The Company evaluated the modification of the \$100,000 owed to these two stockholders into the 12% First Secured Convertible Debt Offering under FASB ASC 470-50 and determined that the modification was substantial and qualified as a debt extinguishment. The incremental increase in the fair value of the 350,000 modified warrants of \$384, the fair value of the additional 200,000 warrants issued of \$30,000 and the fair value of the 275,000 warrants issued under the terms of the Secured Debt Offering of \$41,250 were recorded as a loss on the extinguishment of debt for the nine months ended September 30, 2011 resulting in an aggregate loss of \$71,634.

During the nine months ended September 30, 2011, the Company borrowed \$50,000 from a third party. This note is secured against the Company's accounts receivable, bears interest at 12% per annum and matures February 16, 2012. In connection with the loan, the lender received warrants to purchase an aggregate of 50,000 common shares at an exercise price of \$0.07 per share. The warrants vested immediately and have a term of five years. The note is convertible at \$0.07 per share. The relative fair value of the warrants was measured using the Black-Scholes option pricing model and determined to be \$3,704, which was recorded as a debt discount. The note was then evaluated for a beneficial conversion feature and it was determined that a beneficial conversion feature existed. The intrinsic value of the beneficial conversion feature was determined to be \$10,846 and was recorded as a debt discount. The debt

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discounts are being amortized over the life of the note using the effective interest method. The amortization expense recorded on the discounts for the nine months ended September 30, 2011 totaled \$3,627.

During the nine months ended September 30, 2011, the Company borrowed \$50,000 from a third party. This note is secured against the Company's accounts receivable, bears interest at 12% per annum and matures February 11, 2012. In connection with the loan, the lender received warrants to purchase an aggregate of 50,000 common shares at an exercise price of \$0.07 per share. The warrants vested immediately and have a term of five years. The note is convertible at \$0.07 per share. The relative fair value of the warrants was measured using the Black-Scholes option pricing model and determined to be \$3,488, which was recorded as a debt discount. The note was then evaluated for a beneficial conversion feature and it was determined that a beneficial conversion feature existed. The intrinsic value of the beneficial conversion feature was determined to be \$7,060 and was recorded as a debt discount. The debt discounts are being amortized over the life of the note using the effective interest method. The amortization expense recorded on the discounts for the nine months ended September 30, 2011 totaled \$2,535.

The Company analyzed the two \$50,000 convertible notes for derivative accounting under FASB ASC 815-15 and determined that derivative accounting does not apply to these instruments.

During the nine months ended September 30, 2011, the Company made an aggregate of \$225,001 of payments on convertible notes and a previously issued convertible note of \$75,000 was converted into 375,000 common shares. Amortization of the unamortized debt discounts totaled \$7,059 during the nine months ended September 30, 2011.

A summary of the changes in convertible debt for the nine months ended September 30, 2011, is as follows:

| | |
|---|-------------|
| Convertible debt, net at December 31, 2010 | \$1,032,941 |
| Add: Notes issued | 2,101,128 |
| Less: 10% discount on the Notes | (118,284) |
| Less: discount due to relative fair value of warrants | (427,580) |
| Less: discount due to beneficial conversion feature | (144,635) |
| Less: principal payments | (225,001) |
| Less: conversion to common stock | (75,000) |
| Add: amortization of debt discounts | 189,011 |
| Convertible debt, net at September 30, 2011 | \$2,332,580 |
| Less: current maturities, net | (471,064) |
| Long-term portion of convertible debt, net | \$1,861,516 |

5. Common Stock

During the nine months ended September 30, 2011, the Company:

- a) issued 936,698 common shares for services valued at \$78,929,
- b) issued 687,393 common shares to repay accrued interest of \$103,109 (see also Note 4),
- c) issued 277,335 common shares for the conversion of 55,467 Series A preferred shares,
- d) issued 1,400,000 common shares for total cash proceeds of \$63,000, net of issuance costs of \$7,000.
- e) issued 375,000 common shares for conversion of debt principal of \$75,000 (see also Note 4).

6. Stock Options

During the nine months ended September 30, 2011, options to purchase 225,000 common shares were granted by the Company to a member of the Board of Directors at exercise price of \$0.08 per share. These options have a contractual term of 5 years and vest over 3 years. The options have a fair value of \$17,997 which was calculated using the Black-Scholes option-pricing model. Variables used in the valuation include: (1) discount rate of 1.44%, (2) expected

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life of 4.0 years, (3) expected volatility of 377.58%, and (4) zero expected dividends.

During the nine months ended September 30, 2011, options to purchase 585,000 common shares were granted by the Company to executive management and a key employee at an exercise prices ranging from \$0.05 to \$0.07 per share. These options have a contractual term of 5 years and a vesting term of 3 years from the date of grant. The options have a fair value of \$39,437 which was calculated using the Black-Scholes option-pricing model. Variables used in the valuation include: (1) discount rate of 1.44%, (2) expected life of 4.0 years, (3) expected volatility ranging from 348.34% to 360.03%, and (4) zero expected dividends.

During the nine months ended September 30, 2011, options to purchase 1,050,000 common shares were granted by the Company to executive management and key employees at an exercise price of \$0.08 per share. These options have a contractual term of 5 years and a vesting term of 3 years. The options have a fair value of \$58,711 which was calculated using the Black-Scholes option-pricing model. Variables used in the valuation include: (1) discount rate of 1.44%, (2) expected life ranging between 3.0 to 4.0 years, (3) expected volatility ranging from 341.24% to 359.11%, and (4) zero expected dividends.

During the nine months ended September 30, 2011, options to purchase 235,000 common shares were granted by the Company to certain members of the Board of Directors at exercise prices ranging from \$0.06 to \$0.09 per share. These options have contractual terms ranging from 5 to 10 years and vesting terms ranging from 12 months to 3 years. The options have a fair value of \$19,675 which was calculated using the Black-Scholes option-pricing model. Variables used in the valuation include: (1) discount rate of 1.44%, (2) expected life ranging from 3.0 to 5.0 years, (3) expected volatility ranging from 359.11% to 372.09%, and (4) zero expected dividends.

During the nine months ended September 30, 2011, options to purchase 1,200,000 common shares were granted by the Company to certain employees at an exercise price of \$0.19 per share. These options have a contractual term of 5 years and a vesting term of 3 years with 154,566 of the options fully vested at grant date. The options have a fair value of \$227,872 which was calculated using the Black-Scholes option-pricing model. Variables used in the valuation include: (1) discount rate of 1.44%, (2) expected life of 4.0 years, (3) expected volatility of 344.12%, and (4) zero expected dividends.

During the nine months ended September 30, 2011, options to purchase 200,707 common shares were granted by the Company to certain officers, as payment of a portion of their salaries, at an exercise price of \$0.19 per share. These options have a contractual term of 5 years and vest monthly through June 30, 2011. The options have a fair value of \$38,014 which was calculated using the Black-Scholes option-pricing model. Variables used in the valuation include: (1) discount rate of 1.05%, (2) expected life ranging from 2.51 to 2.72 years, (3) expected volatility of 366.57%, and (4) zero expected dividends.

During the nine months ended September 30, 2011, options to purchase 250,000 common shares were granted by the Company to three employees at an exercise price of \$0.19 per share. These options have a contractual term of 5 years, and a vesting term of 3 years. The options have a fair value of \$47,473 which was calculated using the Black-Scholes option-pricing model. Variables used in the valuation include: (1) discount rate of 1.44%, (2) expected life of 4.0 years, (3) expected volatility of 344.12%, and (4) zero expected dividends.

A summary of option activities for the nine months ended September 30, 2011 is reflected below:

| | Options | Weighted-Average Exercise Price | Weighted Average Remaining Life (yrs) |
|----------------------------------|-----------|---------------------------------|---------------------------------------|
| Outstanding at December 31, 2010 | 2,990,000 | \$0.34 | |
| Granted | 3,735,707 | 0.13 | |

| | | | |
|-----------------------------------|--------------|-----------|------|
| Canceled | — | — | |
| Expired | (1,335,000) | \$(0.30) | |
| Outstanding at September 30,2011 | 5,390,707 | \$0.20 | 3.8 |
| Exercisable at September 30, 2011 | 2,306,263 | \$0.28 | 3.10 |

The weighted average grant date fair value of options granted in 2011 was \$0.12. The outstanding options at September 30, 2011 have an intrinsic value of \$215.

Stock option expense for the nine months ended September 30, 2011 and 2010 totaled \$253,696 and \$214,742 respectively. As of September 30, 2011, there was approximately \$604,630 of unrecognized cost which is expected to be recognized through August 2014.

7. Stock Warrants

During the nine months ended September 30, 2011, the Company issued 50,000 warrants with an exercise price of \$0.07 per share to a third party who provided a short term convertible loan to the Company (see Note 4). These warrants have a term of five years and vested immediately. The warrants have a fair value of \$4,000 which was calculated using the Black-Scholes option pricing model. Variables used in the valuation include: (1) discount rate of 1.02%, (2) a warrant life of five years, (3) expected volatility of 406.18%, and (4) zero expected dividends. The relative fair value of these warrants of \$3,704 was recorded as a discount to the short term loan provided by this third party.

During the nine months ended September 30, 2011, the Company issued 50,000 warrants with an exercise price of \$0.07 per share to a third party who provided a short term convertible loan to the Company (see Note 4). These warrants have a term of five years and vested immediately. The warrants have a fair value of \$3,750 which was calculated using the Black-Scholes option pricing model. Variables used in the valuation include: (1) discount rate of 0.95%, (2) a warrant life of five years, (3) expected volatility of 406.19%, and (4) zero expected dividends. The relative fair value of these warrants of \$3,488 was recorded as a discount to the short term loan provided by this third party.

During the nine months ended September 30, 2011, the Company issued of total of 1,937,500 warrants with an exercise price of \$0.06 per share to two individuals who provided services in connection with the Company's Junior Secured Convertible Debt Offering (see Note 4). These warrants have a term of five years and vested immediately. The warrants have a fair value of \$127,500 which was calculated using the Black-Scholes option pricing model. Variables used in the valuation include: (1) discount rate of 0.88% and 0.95%, (2) warrant life of five years, (3) expected volatility ranging from 407.04% to 407.11%, and (4) zero expected dividends. The fair value of these warrants was recorded as deferred financing costs during the nine months ended September 30, 2011.

During the nine months ended September 30, 2011, 25,000 warrants with an exercise price of \$0.20 per share were granted to a third party who provided a short term loan to the Company (see Note 3). These warrants have a term of five years and vested immediately. The warrants have a fair value of \$2,000 which was calculated using the Black-Scholes option pricing model. Variables used in the valuation include: (1) discount rate of 2.31%, (2) a warrant life of five years, (3) expected volatility of 401.22%, and (4) zero expected dividends. The relative fair value of these warrants of \$1,923 was recorded as a discount to the short term loan provided by this third party.

During the nine months ended September 30, 2011, a total of 500,000 warrants with an exercise price of \$0.08 were granted to a third party consulting firm that provided services in connection with the \$500,000 Equity Raise (see Note 4). These warrants have a term of five years and vested immediately. The warrants have a fair value of \$25,000 which was calculated using the Black-Scholes option pricing model. Variables used in the valuation include: (1) discount rate of 2.05%, (2) warrant life of five years, (3) expected volatility of 402.61%, and (4) zero expected dividends. The fair value of these warrants was recorded as stock issuance cost in additional paid in capital during the nine months

ended September 30, 2011.

During the nine months ended September 30, 2011, a total of 140,000 warrants with an exercise price of \$0.05 were granted to a third party consulting firm that provided services in connection with the \$500,000 Equity Raise (see Note 4). These warrants

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have a term of five years and vested immediately. The warrants have a fair value of \$10,500 which was calculated using the Black-Scholes option pricing model. Variables used in the valuation include: (1) discount rate of 1.81%, (2) warrant life of five years, (3) expected volatility of 403.02%, and (4) zero expected dividends. The fair value of these warrants was recorded as stock issuance costs in an entry to additional paid in capital during the nine months ended September 30, 2011.

In conjunction with the Company's Junior Secured Convertible Debt Offering (see Note 4), the Company issued an aggregate of 833,333 warrants with an exercise price of \$0.06 per share. These warrants have a term of 5 years, vested immediately and have a fair value of \$58,333 as calculated using the Black-Scholes option pricing model. Variables used in the valuation include: (1) discount rate of 1.62%, (2) warrant life of five years, (3) expected volatility of 405.90%, and (4) zero expected dividends. The relative fair value of these warrants of \$52,239 was recorded as a debt discount to the \$500,000 Junior Secured Convertible Debt Offering during the nine months ended September 30, 2011.

As a condition associated with the closing on the Company's Junior Secured Convertible Debt Offering (see Note 4), the Company granted 200,000 warrants to the Company's former President and Chief Executive Officer with an exercise price of \$0.06 per share. These warrants have a term of 5 years, vested immediately and have a fair value of \$17,000 as calculated using the Black-Scholes option pricing model. Variables used in the valuation include: (1) discount rate of 1.70%, (2) warrant life of five years, (3) expected volatility of 406.07%, and (4) zero expected dividends. The fair value of the warrants was recorded as stock based compensation for the nine months ended September 30, 2011.

As an additional condition associated with the closing on the Company's Junior Secured Convertible Debt Offering (see Note 4), the Company granted 150,000 warrants to the Company's Interim President and Chief Executive Officer with an exercise price of \$0.06 per share. These warrants have a term of five years, vested immediately and have a fair value of \$12,750, as calculated using the Black-Scholes option pricing model. Variables used in the valuation include: (1) discount rate of 1.70%, (2) warrant life of five years, (3) expected volatility of 406.07% and (4) zero expected dividends. The fair value of the warrants was recorded as stock based compensation for the nine months ended September 30, 2011.

In conjunction with the Company's First Secured Convertible Debt Offering (see Note 4), the Company issued an aggregate of 3,252,821 warrants with an exercise price of \$0.30 per share. These warrants have a term of five years, vested immediately and have a fair value of \$487,918 as calculated using the Black-Scholes option pricing model. Variables used in the valuation include: (1) discount rate of 2.13%, (2) warrant life of five years, (3) expected volatility of 400.26%, and (4) zero expected dividends. The relative fair value of the 2,977,821 warrants of \$316,226 was recorded as a debt discount and the fair value of the 275,000 warrants of \$41,250 was included in the calculation of the loss on the extinguishment of debt during the nine months ended September 30, 2011.

In conjunction with the sale of \$550,000 Junior Notes associated with the second tranche of the Company's Junior Secured Convertible Debt Offering, the Company issued an aggregate of 916,667 warrants with an exercise price of \$0.06 per share. The warrants have a term of five years, vested immediately and have a fair value of \$55,000 as calculated using the Black-Scholes option pricing model. Variables used in the valuation include: (1) discount rate of 0.95%, (2) warrant life of five years, (3) expected volatility of 408.42%, and (4) zero dividends. The relative fair value of the 916,667 warrants of \$50,000 was recorded as a debt discount during the nine months ended September 30, 2011.

In addition, the Company issued 200,000 warrants with an exercise price of \$0.20 per share to the two stockholders whose outstanding note of \$100,000 was converted into the Secured Convertible Debt Offering (see Note 4). These warrants have a term of five years, vested immediately and have a fair value of \$30,000 as calculated using the

Black-Scholes option pricing model. Variables used in the valuation include: (1) discount rate of 2.13%, (2) warrant life of five years, (3) expected volatility of 335.62%, and (4) zero expected dividends. The fair value of these warrants was included in the calculation of the loss on the extinguishment of debt during the nine months ended September 30, 2011.

During the nine months ended September 30, 2011, a total of 170,000 warrants with an exercise price of \$0.20 per share were granted to an individual who provided services in connection with the Company's Secured Convertible Debt Offering (see Note 4). These warrants have a term of five years and vested immediately. The warrants have a fair value of \$25,500 which was calculated using the Black-Scholes option pricing model. Variables used in the valuation include: (1) discount rate of 1.18%, (2) warrant life of five years, (3) expected volatility of 400.26%, and (4) zero expected dividends. The fair value of these warrants was recorded as deferred financing costs during the nine months ended September 30, 2011.

During the nine months ended September 30, 2011, 363,000 warrants with an exercise price of \$0.30 were granted to an individual who provided services in connection with the Company's Secured Convertible Debt Offering (see Note 4). These warrants have a term of five years and vested immediately. The warrants have a fair value of \$54,235 which was calculated using the Black-Scholes option pricing model. Variables used in the valuation include: (1) discount rate of 1.18%, (2) warrant life of five years,

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(3) expected volatility of 344.35%, and (4) zero expected dividends. The fair value of these warrants was recorded as deferred financing costs during the nine months ended September 30, 2011.

During the nine months ended September 30, 2011, a total of 60,000 warrants with an exercise price of \$0.20 per share were issued to an individual who provided consulting services to the Company ratably over a six month period. These warrants have a term of five years and vested immediately. The warrants have a fair value of \$3,059 as calculated using the Black-Scholes option-pricing model. Variables used in the valuation include: (1) discount rate of 1.18%, (2) warrant life of five years, (3) expected volatility ranging between 400.90% and 407.04%, and (4) zero expected dividends. The fair value of these warrants was recorded stock based compensation for the nine months ended September 30, 2011.

During the nine months ended September 30, 2011, the Company modified the terms of 350,000 previously granted warrants whereby the exercise price was reduced to \$0.15 per share and the term was changed to 5 years. The incremental increase in the fair value of the warrants was determined to be \$384 using the Black-Scholes option-pricing model. Variables used in the valuation include: (1) discount rate of 1.18%, (2) expected terms ranging from 2.7 to 5.0 years, (3) expected volatility of 344.22%, and (4) zero expected dividends. The incremental increase in the fair value of these warrants was included in the calculation of the loss on the extinguishment of debt during the nine months ended September 30, 2011.

A summary of warrant activities for the nine months ended September 30, 2011 is as follows:

| | Warrants | Weighted-Average Exercise Price | Weighted Average Remaining Life (yrs) |
|-----------------------------------|------------|---------------------------------|---------------------------------------|
| Outstanding at December 31, 2010 | 8,683,348 | \$0.64 | |
| Granted | 8,848,322 | 0.17 | |
| Expired | (15,824) | (0.35) | |
| Outstanding at September 30, 2011 | 17,515,846 | \$0.40 | 3.77 |
| Exercisable at September 30, 2011 | 17,515,846 | \$0.40 | 3.77 |

The weighted average grant date fair value of warrants granted during 2011 was \$0.10. The outstanding warrants at September 30, 2011 have an intrinsic value of \$292,425.

Warrants expense for the nine months ended September 30, 2011 and 2010 was \$49,548 and \$387,067, respectively.

8. Commitments and Contingencies

From time to time, Digitiliti may be subject to routine litigation, claims, or disputes in the ordinary course of business. In the opinion of management; no pending or known threatened claims, actions or proceedings against Digitiliti are expected to have a material adverse effect on Digitiliti's consolidated financial position, results of operations or cash flows, except for the matter discussed below. Digitiliti cannot predict with certainty, however, the outcome or effect of any litigation or investigatory matters specifically described or any other pending litigation or claims. There can be no assurance as to the ultimate outcome of these lawsuits and investigations.

In June 2011, the Company was made a party to a lawsuit initiated by one of its preferred stockholders seeking recovery of their investment in the Company based on, among other claims, an alleged breach of the state's securities regulations. The Company believes the preferred stockholder's claim lacks factual basis and is without merit. Accordingly, the Company has not accrued any manner of loss contingency related to this claim and litigation is

currently pending.

On May 6, 2011, the Company entered into a Confidential Settlement Agreement with one of its unsecured convertible note holders reflecting repayment of their convertible note totaling \$37,100, on a discounted basis, that involves an extended payment and the conversion of the outstanding principal balance based on an above-market conversion rate. Digitiliti evaluated the modification under FASB ASC 470-50 and determined that the modification was not substantial and did not qualify as a debt extinguishment. On September 6, 2011, the Company made the final payment and converted the outstanding principal balance based on the agreed to above market conversion rate.

Some of the Company's convertible note holders have not accepted offers to convert their notes under the terms of the Modification Proposal issued in 2009 and Incentive Offer from 2010, or otherwise. The Company is presently in arrears in principal and accrued

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interest payments in an aggregate total of \$216,839 as of September 30, 2011. Although the Company is continuing to discuss payment and/or conversion or extension of these notes with note holders, these outstanding obligations pose a risk to the Company's ongoing operations.

9. Subsequent Events

On October 14, 2011, the Company entered into a Confidential Settlement Agreement with one of its unsecured convertible note holders reflecting repayment of its convertible note that involves an extended payment plan.

On October 31, 2011, the Company entered into a Confidential Settlement Agreement with one of its secured convertible note holders reflecting repayment of its convertible note that involves an extended payment plan.

On October 25, 2011, the Company repaid a secured convertible note of \$63,981.

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

Forward-looking Statements

This quarterly report contains “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements concern goals, beliefs, plan objectives, intentions, expectations, financial condition, results of operations, future performance, business strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts. Such forward-looking statements are preceded by, followed by or include the words “may,” “would,” “could,” “should,” “expects,” “projects,” “anticipates,” “believes,” “estimates,” “plans,” “intends,” “targets” or similar expressions.

Forward-looking statements involve inherent risks and uncertainties, and important factors (many of which are beyond our control) that could cause actual results to differ materially from those set forth in the forward-looking statements, including the following: general economic or industry conditions, nationally and/or in the communities in which we may conduct business, changes in the interest rate environment, legislation or regulatory requirements, conditions of the securities markets, our ability to raise capital, changes in accounting principles, policies or guidelines, financial or political instability, acts of war or terrorism, other economic, competitive, governmental, regulatory and technical factors affecting our current or potential business and related matters. Accordingly, results actually achieved may differ materially from expected results in these statements.

The information in this quarterly report is as of September 30, 2011, or, where clearly indicated, as of the date of this filing. Forward-looking statements speak only as of the date they are made. We do not undertake, and specifically disclaim, any obligation to update any forward-looking statements to reflect events or circumstances occurring after the date of such statements. We also may make additional disclosures in our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K that we may file from time to time with the SEC. Please also note that we provide a cautionary discussion of risks and uncertainties under the section entitled “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2010. These are factors that could cause our actual results to differ materially from expected results. Other factors besides those listed could also adversely affect us.

Plan of Operation

The Business

Our business is developing and delivering superior information management technologies and methodologies enabling our customers to manage, control, protect and access their information and data simply and cost effectively. Our traditional business is providing a cost effective on-line data protection solution to the small to medium business (“SMB”) and small to medium enterprise (“SME”) markets through our DigiBAK service. This on-line cloud storage management solution helps organizations manage and protect their entire network from one centralized location.

Our emerging business product, released in the first quarter of 2010, is called DigiLIBE. We believe that DigiLIBE is a game-changing product that addresses the significant need for a fiscally responsible, integrated system to manage the increasing growth, volume, and diversity of unstructured data that now represents up to 85% of enterprise information and continues to grow rapidly. Content chaos is overwhelming many companies’ ability to meet compliance, utilize collaboration tools and optimize storage needs for their virtualized infrastructures.

DigiBAK and DigiLIBE are complementary products — DigiBAK provides cloud storage backup and recovery of structured data and operating system files and DigiLIBE offers information management and life-cycle control of unstructured data from end-user through archiving and back to the end user.

Growing Both Business Segments:

We believe the benefits of seeking to grow both the DigiBAK and DigiLIBE businesses are:

- (i) solving a major industry and customer problem of managing continually growing information volume and associated cost of storage and retrieval;
- (ii) being able to access a larger share of the opportunity in the information management storage business;
- (iii) offering significant technological advantages in corporate policy level control of information and ability to leverage knowledge from the information it creates; and
- (iv) optimizing how we synergistically allocate capital and resources between both business.

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DigiLIBE has received excellent feedback on the capability, performance, and function it delivers since its initial release. Our sales and prospecting efforts have also reaffirmed the potential of selling DigiBAK services as part of a DigiLIBE sale.

“The first company to demonstrate that it can genuinely bridge the gap between storage and information management will make existing products look archaic by comparison”

Joseph Martins, Managing Director, Data Mobility Group LLC

We believe DigiLIBE is a fiscally responsible solution at a price, performance, and ease of use level that alters the current competitors’ point solution landscape and positions while exceeding customers’ expectations and needs. We also believe this product represents a significant step toward our goal of becoming a technology leader in the information content and context management marketplace.

Liquidity and Capital Resources

Our liquidity is dependent, in the short term, on proceeds from newly issued debt and the sale of our securities for cash. In the long term, we may need to continue expanding our capacity of the Data Storage Center by investing in property and equipment and software licenses.

We have financed our operations, debt service and capital requirements through cash flows generated from operations, the issuance of secured and unsecured convertible debt financing, capital leases and issuance of equity securities. We had a working capital deficit of \$1,686,465 at December 31, 2010, and at September 30, 2011 we had a working capital deficit of \$858,442. We had cash of \$209,723 as of September 30, 2011, compared to cash of \$27,557 as of December 31, 2010.

On June 28, 2011, the Company initiated a placement of up to \$1,500,000 in a Junior Secured Convertible Promissory Note and Warrants Offering (the “Junior Secured Convertible Debt Offering”). On June 28, 2011, the Company closed on the first tranche of three potential closings of this Junior Secured Convertible Debt Offering resulting in the receipt of \$500,000 of proceeds. On September 15, 2011, the Company broke escrow on the second tranche of the Junior Secured Convertible Debt Offering resulting in the receipt of \$550,000 of proceeds.

The investors in the Junior Secured Convertible Debt Offering received five-year warrants to purchase that number of common shares equal to 10% of the principal amount of their Junior Note(s) divided by the exercise price of \$.06 per share. The Junior Notes bear interest at 8% per annum, have a 24-month maturity date and are secured by the assets of the Company with the repayment being subordinated to the repayment of all secured notes previously issued by the Company. The Junior Notes also contain a contingent conversion option wherein, at the option of 60% of the investors and twelve months following the closing of the first tranche, all or a portion of the principal amount and accrued interest may be converted into common shares at an exercise price of \$.06 per share but only if the Junior Secured Convertible Debt Offering has been raised. However, the Junior Notes automatically convert into common shares upon a subsequent equity funding round of at least \$3 million of new equity capital (“Qualified Round”) at a per share price equal to the per share price of the qualified round. All of the securities issued in conjunction with the Junior Secured Convertible Debt Offering were sold to “accredited investors” as those terms are defined on Rule 501 of Regulation D of the Securities and Exchange Commission, and each such person had prior access to all material information about the Company. The offer and a sale of these securities were exempt from the registration requirements of the Securities Act of 1933, as amended (the “Securities Act”), pursuant to, among other reasons, Section 4(2) and 4(6) thereof, and Rule 506 of Regulation D of the Securities and Exchange Commission. Registration of sales to “accredited investors” are preempted from state regulation.

On February 28, 2011, the Company completed the placement of \$1,182,844 First Secured Convertible Promissory Notes and Warrants (the “First Secured Convertible Debt Offering”). All of the securities issued in conjunction with the First Secured Convertible Debt Offering were sold to “accredited investors” as those terms are defined on Rule 501 of Regulation D of the Securities and Exchange Commission, and each such person had prior access to all material information about the Company. The offer and a sale of these securities were exempt from the registration requirements of the Securities Act of 1933, as amended (the “Securities Act”), pursuant to, among other reasons, Section 4(2) and 4(6) thereof, and Rule 506 of Regulation D of the Securities and Exchange Commission. Registration of sales to “accredited investors” are preempted from state regulation.

The Lenders in the First Secured Convertible Debt Offering paid 90% of the principal amount for their investment, resulting in a “stepped-up” basis in their individual First Secured Convertible Promissory Notes. The First Secured Convertible Promissory Notes bear interest at the rate of 12% per annum, have an 18-month maturity date and a \$.20 per share conversion rate in the Company’s common stock. The Secured Convertible Promissory Notes are secured by a first lien on all assets of the Company; provided, however, that the Lenders agreed to subordinate to a lien with respect to up to \$25,000 of original principal amount of

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other notes against the Company's vault.

On February 28, 2011, the Company entered into an agreement with two stockholders to repay and modify three debt obligations owed to the two stockholders, (the "Miner Debt"). The debt obligations owed to these two stockholders were secured by a first lien on the Company's assets and consisted of the following: a \$250,000 12% secured convertible note issued in November 2008 with a \$0.35 per share conversion rate; a \$50,000 note payable that was due on demand and bore interest at 10% per annum; and a \$231,540 6% promissory note that was due on demand. The terms of the agreement provided for the repayment of \$431,540 of principal on the combined debt and payable with the remaining principal balance owed of \$100,000 being converted into a secured promissory note under the First Secured Convertible Debt Offering. In addition, the outstanding accrued interest of \$103,109 owed to these two stockholders was paid through the issuance 687,393 common shares of the Company. Under the agreement, the terms of 350,000 common stock warrants previously granted to these stockholders were modified whereby their exercise price was reduced \$0.15 and their term was changed to five years. An additional 200,000 common stock warrants with a five year term and a \$0.30 per share exercise price were also granted to these stockholders. As of March 31, 2011, there remained an outstanding a balance of \$2,371 on the \$250,000 12% secured convertible note, which was satisfied in full on April 21, 2011. After this final payment of \$2,371 and completion of all documentation reflecting the repayment of the Miner Debt, the Miners released their first lien in the Company's assets in preference to those Lenders associated with the Secured Convertible Debt Offering.

The Company evaluated the modification of the \$100,000 owed to these two stockholders into the First Secured Convertible Debt Offering under FASB ASC 470-50 and determined that the modification was substantial and qualified as a debt extinguishment. The incremental increase in the fair value of the 350,000 modified warrants of \$384, the fair value of the additional 200,000 warrants issued of \$30,000 and the fair value of the 275,000 warrants issued under the terms of the Secured Debt Offering of \$41,250 were included in the calculation of the loss on extinguishment of debt resulting in a total loss on the extinguishment of debt of \$71,634 for the nine months ended September 30, 2011.

We used \$1,371,325 of net cash in operating activities for the nine months ended September 30, 2011, compared to using \$1,379,687 for the nine months ended September 30, 2010. Cash used in operating activities during the nine months ended September 30, 2011, funded a net loss of \$2,292,879. This net loss was offset by non-cash charges of \$295,819 for amortization and depreciation, \$253,696 associated with stock options expense, \$49,548 associated with warrant expense, \$71,634 related to a loss on the extinguishment of debt, \$255,107 related to amortization of the discount on our convertible debt and deferred financing costs and \$78,929 related to common stock issued for services. Cash used in operating activities during the nine months ended September 30, 2010, funded a net loss of \$5,262,644. This net loss was offset by non-cash charges of \$475,116 for amortization and depreciation, \$214,742 associated with stock options expense, \$363,223 related to amortization of discounts on our convertible debt and deferred financing costs, \$387,067 of warrant expense, \$1,522,950 of amortization pertaining to the beneficial conversion feature associated with the convertible notes that were converted, \$315,428 loss on extinguishment of debt and \$152,340 related to shares issued for services. In addition, the Company's operating activities during the nine months ended September 30, 2010, benefited from a \$45,685 decrease in accounts receivable and a \$342,650 increase in accounts payable and accrued expenses.

Net cash flows used in investing activities was \$5,863 for the nine months ended September 30, 2011, compared to net cash flows used in investing activities of \$67,076 for the nine months ended September 30, 2010. During 2011, the total consisted of \$5,863 paid for the purchase of property and equipment. During 2010, the total consisted of \$67,076 paid for the purchase of property and equipment and software licenses.

Net cash flow provided by financing activities was \$1,559,354 for the nine months ended September 30, 2011, compared to net cash provided by financing activities of \$1,213,841 for the nine months ended September 30, 2010.

During the nine months ended September 30, 2011, cash provided by financing activities is primarily due to proceeds of \$1,910,000 received from the sale of convertible notes. We used these proceeds to make \$23,308 in capital lease payments, \$231,540 in payments on notes payable and \$225,001 of payments on convertible debt. During the nine months ended September 30, 2010, cash provided by financing activities was primarily due to proceeds of \$1,199,050 received from issuance of our common stock for cash, net of issuance costs, proceeds of \$300,00 from the issuance of our Series B Convertible Preferred Stock and \$509,900 received from the exercise of warrants. We used these proceeds to make \$35,537 in capital lease payments \$364,572 in payments on notes payable and \$95,000 of payments on convertible debt.

As of September 30, 2011, the Company had \$171,555 of past due debt and accrued interest outstanding from the \$5.5 million offering and \$45,081 of past due debt and accrued interest outstanding from the \$750,000 secured offering. At present, the Company continues to negotiate the repayment of these past due notes.

Results of Operations

For the three month periods ended September 30, 2011 and 2010

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Gross sales were \$498,917 for the three months ended September 30, 2011, compared to \$555,386 for the three months ended September 30, 2010. This reflects a 10% decrease in DigiBAK revenues from sales between these two comparable periods. Beginning in 2008, the Company anticipated increasing competitive pricing pressures on its DigiBAK product as a result of an ever-expanding range of alternative archiving storage services and a struggling economy. In response to these challenges, we restructured our resources, strengthened our DigiBAK VAR and customer relationships to reposition and rebrand our DigiBAK offering, initiated targeted sales efforts, took pricing actions and refined other aspects of the DigiBAK business to sustain our margins and attract new customers. Despite the decrease in DigiBAK revenue, we increased our customer count from 857 as of September 30, 2010 to 915 as of September 30, 2011 and our current customer base remains highly satisfied with our DigiBAK service offering.

During the three months ended September 30, 2011, our gross margin was negatively impacted by modifications and repairs made to our vault facilities that could not be capitalized and charged over future periods. Our DigiLIBE product extends our capability from the price competitive storage management market to the value priced information market and serves to increase our overall gross margin of our combined product offerings.

Research and development expenses for the three months ended September 30, 2011 were \$155,003 compared to \$242,736 for the three months ended September 30, 2010. During the third quarter of 2010, we incurred significant expenditures to finalize our in-house product development efforts, which allowed us to bring our new DigiLIBE product to market during 2010. These efforts in 2010 allowed us to improve the installation process and broadening the scalability of the product. As a result of these actions, we were able to reduce our research and development overhead and personnel resources during the three months ended September 30, 2011, thus lowering our actual expenditures when compared to the three months ended September 30, 2010.

Given the release and roll-out of our new DigiLIBE product in the first quarter of 2010, we have incurred lower sales and marketing expenses for the three months ended September 30, 2011 of \$52,962 compared to \$239,490 incurred during the three months ended September 30, 2010. This decrease in sales and marketing expenditure directly relates to our DigiLIBE market launch actions during 2010, which included; establishment of regional and national reseller processes and agreements, and retaining a public relations and industry trade group to create market and industry awareness through product promotion within the industry analyst community, trade publications, and target market segments.

Our general and administrative expenses were reduced 15% from \$362,733 incurred during the three months ended September 30, 2010 to \$307,042 for the three months ending September 30, 2011. The improvement is attributable to our conscious efforts to reduce costs, streamline administration expenses and contain executive salaries. The business restructuring undertaken midway through 2010 resulted in targeted efforts to reduce general overhead expenses through personnel realignment to priorities and goals, vendor contract negotiations, stock based compensation alternatives, insurance costs and a daily/weekly focus on expenditures between the CEO and CFO.

The increase of \$110,119 in interest expense between the comparative three months ended September 30, 2011 and September 30, 2010 is attributed to the accrued interest associated with the First Secured Convertible Debt Offering and the Junior Secured Convertible Debt Offering.

For the nine month periods ended September 30, 2011 and 2010

Sales for the nine months ended September 30, 2011 decreased 19% to \$1,391,660 compared to \$1,719,520 for the nine months ended September 30, 2010 reflecting a \$327,860 decrease in revenue. This decrease in revenue is primarily a result of increasing competitive pricing pressure from an ever-expanding range of alternative archiving storage services impacting our DigiBAK product and a struggling economy. Our DigiLIBE product broadens our

product offerings into new markets with higher margins. Our actions to restructure resources, strengthen our VAR and customer relationships, reposition and rebrand our overall offerings, initiated stronger sales efforts and refined other aspects of the DigiBAK business are also intended to sustain and enhance our margins. Despite this decrease in revenue, we increased our DigiBAK customer count from 831 as of September 30, 2010 to 915 as of September 30, 2011 and we believe our current customer base remains highly satisfied with our DigiBAK service offering.

Gross margin for the nine months ended September 30, 2011 was \$164,124 compared to a gross margin of \$621,011 for the nine months ended September 30, 2010. This significant decrease in margin results from a one-time charge of approximately \$277,000 the Company incurred during the first quarter of 2011, along with continued modifications and repairs required to our vault facilities incurred during the third quarter of 2011 that could not be capitalized and charged over future periods. At present, we believe we will recover all or a portion of the approximate cost of these modification and repair costs under our property and casualty insurance.

Research and development expenses for the nine months ended September 30, 2011 were \$434,145 compared to \$774,719 for the

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nine months ended September 30, 2010. During the first quarter of 2010, we incurred significant expenditures to finalize our in-house product development efforts, which allowed us to bring our new DigiLIBE product to market during late 2010. These efforts in 2010 allowed us to improve the product by enhancing the installation process and broadening the scalability of the product. As a result of these actions, we were able to reduce our research and development overhead and personnel resources during the nine months ended September 30, 2011, thus lowering our actual expenditures when compared to the nine months ended September 30, 2010.

Given the release and roll-out of our new DigiLIBE product during late 2010, we have incurred lower sales and marketing expenses for the nine months ended September 30, 2011 of \$292,008 compared to \$616,068 incurred during the nine months ended September 30, 2010. This decrease in sales and marketing expenditures directly relates to our DigiLIBE market launch actions during 2010, which include; establishment of regional and national reseller processes and agreements and retaining a public relations and industry trade group to create market and industry awareness through product promotion within the industry analyst community, trade publications, and target market segments.

Our general and administrative expenses were reduced 39% from \$1,978,671 incurred during the nine months ended September 30, 2010 compared to \$1,211,085 for the nine months ending September 30, 2011. The improvement is attributable to our conscious effort to reduce costs, streamline administration and contain executive salaries. The business restructuring undertaken midway through 2010 resulted in targeted efforts to reduce general overhead expenses through personnel realignment to priorities and goals, vendor contract negotiations, stock based compensation alternatives, insurance costs and a daily/weekly focus on expenditures between the CEO and CFO.

The decrease of \$1,750,638 in interest expense between the comparative nine months ended September 30, 2011 and September 30, 2010 is attributed to the conversion of a substantial number of convertible notes under the terms of the 2010 Incentive Offer for which we are no longer required to accrue interest. The loss on extinguishment of debt results primarily from the conversion of secured convertible notes into the Company Series A Preferred Convertible Stock Company's incurred under the terms of the Company's Incentive Offer that closed on June 30, 2010.

Off-Balance Sheet Arrangements

We had no off-balance sheet arrangements during 2011 and 2010.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Securities and Exchange Commission reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Our disclosure controls and procedures are also designed to accumulate and communicate information to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, we recognize that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. Accordingly, management must apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

We conducted our evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure

controls and procedures pursuant to Rule 13a-15(b) under the Exchange Act as of the end of the period covered by this report. Based on their review of our disclosure controls and procedures, the Chief Executive Officer and the Chief Financial Officer have concluded that our disclosure controls and procedures are not effective in providing reasonable assurance that information required to be disclosed by us in the reports we file under the Exchange Act were recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules, regulations and forms. In particular, we have identified the following material weakness in our disclosure controls:

We did not maintain sufficient personnel with an appropriate level of technical accounting knowledge, experience, and training in the application of generally accepted accounting principles commensurate with our complexity and (a) our financial accounting and reporting requirements. We have limited experience in the areas of financial reporting and disclosure controls and procedures. As a result, there is a lack of monitoring of the reporting process and there is a reasonable possibility will not be detected or made known to permit us to report on a timely basis.

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Changes in internal control over financial reporting

Our management, with the participation of our chief executive officer and chief financial officer, has concluded there were no significant changes in our internal controls over financial reporting that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II — OTHER INFORMATION

Item 1. Legal Proceedings.

On June 10, 2011, the Company, its former President/CEO and one of the Company's financial agents, were made a party to a lawsuit initiated by one of its preferred stockholders, P&H Family Limited Partnership, seeking recovery of its investment in the Company based on, among other claims, an alleged breach of the state's securities regulations. The Company believes the preferred stockholder's claim lacks factual basis and is without merit. Accordingly, the Company has not accrued any manner of loss contingency related to this claim and litigation is currently pending.

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

None.

Item 3. Defaults Upon Senior Securities.

As of November 15, 2011, the Company had \$177,233 of debt and accrued interest outstanding from the \$5.5 million offering and \$31,475 of debt and accrued interest outstanding from the \$750,000 secured offering. This debt is presently due and payable.

Item 6. Exhibits

We have listed the exhibits by numbers corresponding to the Exhibit Table of Item 601 in Regulation S-K on the Exhibit list attached to this report.

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SIGNATURES

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

Digitiliti, Inc.

Date: November 15, 2011

By: /s/ Jack B. Scheetz
Jack B. Scheetz, Interim President, CEO
(Principal Executive Officer)

Date: November 15, 2011

By: /s/ William McDonald
William McDonald, CFO
(Principal Accounting Officer)

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INDEX TO EXHIBITS

| Exhibit No. | Description of Exhibit |
|-------------|---|
| 31.1 | 302 Certification of Interim CEO, Jack B. Scheetz |
| 31.2 | 302 Certification of CFO, William McDonald |
| 32.1 | 906 Certification |
| 10.1 | Form of Convertible Promissory Note and Warrant Purchase Agreement dated as of February 28, 2011 (Incorporated by reference to Exhibit 10.1 of the Form 8-K filed on September 22, 2011). |
| 10.2 | Form of Secured Convertible Promissory Note dated as of February 28, 2011 (Incorporated by reference to Exhibit 10.2 of the Form 8-K filed on September 22, 2011). |
| 10.3 | Form of Security Agreement (Incorporated by reference to Exhibit 10.3 of the Form 8-K filed on September 22, 2011). |
| 10.4 | Form of Warrant Agreement (Incorporated by reference to Exhibit 10.4 of the Form 8-K filed on September 22, 2011). |
| 10.5 | Form of Severance Agreement between Digitiliti and Ehssan Taghizadeh dated June 29, 2011 (Incorporated by reference to Exhibit 10.5 of the Form 8-K filed on September 22, 2011). |
| 10.6 | Form of Employment Agreement between Digitiliti and Jack B. Scheetz (Incorporated by reference to Exhibit 10.6 of the Form 8-K filed on September 22, 2011). |
| 101.0 | XBRL Disclosure |