PATRICK INDUSTRIES INC
Form 424B5
March 09, 2017
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Filed Pursuant to Rule 424(b)(5)
Registration No. 333-204777

1,350,000 Shares

Common Stock

We are offering 1,350,000 shares of our common stock, no par value. Our common stock is traded on the NASDAQ Global Select Market under the symbol PATK. On March 8, 2017 the closing sale price of our common stock on the NASDAQ Global Select Market was $75.20 per share.

Investing in our common stock involves certain risks. Before purchasing our common stock, please review the information included in, and incorporated by reference into, the Risk Factors section beginning on page S-10 of this prospectus supplement and page 2 of the accompanying prospectus.

	Per Share	Total
Public offering price	$ 73.00	$ 98,550,000
Underwriting discount	$ 3.65	$ 4,927,500
Proceeds, before expenses, to us	$ 69.35	$ 93,622,500

The underwriters may also purchase up to an additional 202,500 shares of our common stock from us, at the public offering price, less the underwriting discount, within 30 days from the date of this prospectus supplement.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus supplement or the accompanying prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The underwriters expect to deliver the shares to purchasers on or about March 14, 2017.

Joint Book-Running Managers

BofA Merrill Lynch **Wells Fargo Securities** **Baird**
KeyBanc Capital Markets

Co-Managers

CJS Securities **C.L. King & Associates** **Fifth Third Securities** **Sidoti & Company, LLC**

The date of this prospectus supplement is March 8, 2017

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Prospectus Supplement

Prospectus

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ABOUT THIS PROSPECTUS SUPPLEMENT

We are providing information to you about this offering of our common stock in two parts. The first part is this prospectus supplement, which provides the specific details regarding this offering. The second part is the accompanying prospectus, which provides general information, including information about the shares of our common stock. Unless the context indicates otherwise, when we refer to this prospectus, we are referring to both documents combined. Some of the information in the accompanying prospectus may not apply to this offering. If information in this prospectus supplement is inconsistent with the accompanying prospectus, you should rely on the information contained in this prospectus supplement. You should read and consider all information contained or incorporated by reference in this prospectus supplement and the accompanying prospectus before making your investment decision. See Where You Can Find More Information in the accompanying prospectus and Incorporation of Certain Documents by Reference in this prospectus supplement and the accompanying prospectus.

We have not, and the underwriters have not, authorized anyone to provide you with information that is in addition to or different from that contained or incorporated by reference in this prospectus supplement and the accompanying prospectus or in any free writing prospectus. We take no responsibility for, and can provide no assurances as to the reliability of, any other information that others may give you. We are not, and the underwriters are not, offering to sell these securities in any jurisdiction where the offer or sale is not permitted. You should not assume that the information contained or incorporated by reference in this prospectus supplement or the accompanying prospectus is accurate as of any date other than as of the date of this prospectus supplement or the accompanying prospectus, as the case may be, or in the case of the documents incorporated by reference, the date of such documents regardless of the time of delivery of this prospectus supplement and the accompanying prospectus or any sale of our common stock. Our business, financial condition, results of operations and prospects may have changed since those dates.

Unless the context otherwise requires, references to Patrick, we, us, our or the Company refer to Patrick Industri Inc. and our subsidiaries. The term you refers to a prospective investor.

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PROSPECTUS SUPPLEMENT SUMMARY

This summary highlights selected information contained or incorporated by reference in this prospectus supplement and the accompanying prospectus. This information is not complete and does not contain all of the information you should consider before investing in our common stock. You should read the entire prospectus supplement and the accompanying prospectus carefully, especially the matters discussed under Risk Factors beginning on page S-10 and the documents incorporated by reference in this prospectus supplement and the accompanying prospectus, including the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016. See Incorporation of Certain Documents by Reference below.

OUR COMPANY

We are a leading component manufacturer and supplier serving original equipment manufacturers (OEMs) primarily in the recreational vehicle (RV) and manufactured housing (MH) markets. We also supply certain products to adjacent industrial (Industrial) markets, including the commercial, institutional, and residential furniture and fixtures markets.

We play an important role in the value chain within each of the end markets in which we participate. We offer a broad product portfolio consisting of components that are integral to the overall aesthetics, quality, and function of the finished product sold to the consumer. To deliver a wide variety of components to our customers, we source raw materials and select products, innovate and collaborate on design, product and materials and manufacture or assemble components that are differentiated and aligned with consumer preferences in today s competitive market. Our success depends on our ability to provide quality products and service through our value added relationships to help our customers satisfy consumer preferences. Our goal is to present them with significant product line depth and breadth allowing them to focus on designing, assembling and marketing the end product.

We serve our customers in the estimated $4 billion currently addressable portion of the RV market, which includes both towable and motorized RVs, the $900 million currently addressable portion of the MH market, and the large and fragmented Industrial markets. Our customers include the largest manufacturers in each of the RV and MH segments as well as distributors, component suppliers, and manufacturers serving the Industrial markets.

We operate through a nationwide network of 56 manufacturing and 22 distribution facilities in 16 states, thereby allowing us to be responsive and close to our customers, while simultaneously reducing in-transit delivery time and cost to the regional manufacturing footprint of our customers. We believe that we are one of the few suppliers to the RV and MH markets that has such an extensive network.

Our strategic and capital allocation strategy is focused on optimally managing and utilizing our resources and leveraging our platform of operating brands to continue to grow our business. Through strategic acquisitions, expansion geographically and into new product lines, investment in infrastructure and capital expenditures, we seek to ensure that our operating network contains the capacity, technology, and innovative thought process necessary to proactively support anticipated growth needs. Additionally, we look to effectively and efficiently respond to changes in market conditions, successfully integrate manufacturing, distribution and administrative functions, and provide capital and operational resources to our acquired companies while still allowing them to maintain an entrepreneurial spirit and, in turn, enabling the continuation of their legacy value proposition to our customer base.

Over the last three years, we have executed on a number of new product initiatives and have invested approximately $351 million to complete 14 acquisitions involving 19 companies, which directly complement our

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core competencies and existing product lines. Additionally, we introduced over 300 new products and product line extensions through strategic acquisitions and organically in an ongoing effort to bring additional value to customers.

The combination of improving economic conditions and demographic trends benefitting the RV industry and the execution of the strategic initiatives identified above, among others, resulted in increases in our sales, operating income, net income and cash flows for each of the last four years ended December 31, 2016.

As of December 31, 2016, we employed approximately 4,800 employees. Our corporate headquarters are located in Elkhart, Indiana.

OUR VALUE PROPOSITION

We believe our customers value a partner who can deliver high quality products, service, design expertise and innovation, efficient operations and timely delivery of components to their assembly facilities, both regionally and nationwide. Our goal is to offer a broad and relevant range of products to our customers so they can focus on assembly, delivery of finished goods, brand awareness, product marketing, and dealer relationships. We supply critical and highly visible interior and exterior components that differentiate our customers products in the RV, MH, and Industrial markets.

As a result of our longstanding relationships with many of the largest players in our markets, our customers encourage us to supply new or extended categories of products in order to help them drive efficiencies with the same level of quality and service. We have provided these expanded offerings either by acquiring companies with strong product niches that we can leverage across our network or through new product development.

When we acquire companies to expand our geographic and product reach, we typically seek to integrate certain functions that are best managed centrally, such as administrative, finance, legal, information technology, and human resources while allowing our acquired businesses to retain significant autonomy which fosters entrepreneurial spirit and brand individuality, and in turn enables the continuation of legacy value propositions for customers.

OUR COMPETITIVE STRENGTHS

A Leading Provider of Components to RV, MH and Industrial End Markets

We are a leading provider of a range of core components that go into the RV, MH and Industrial end markets. The RV market has experienced several years of recovery and growth driven by increased consumer interest in spending quality time with family and the recreational lifestyle. This shift in consumer behavior is driven by favorable demographic trends, including a growing interest in experiences, especially active and outdoor activities, among the emerging millennial and minority demographic and the increasing population of aging, retiring baby boomers who have the disposal income and time to pursue RV ing. Additionally, all three of our segments have benefitted from increased consumer confidence, expanded credit availability, and lower unemployment, aiding our growth.

Robust Opportunities across Diverse Range of End Markets

We believe there are significant opportunities to grow within our established end markets while also expanding operations into new markets, such as marine. As a result of our presence across multiple recreational lifestyle categories, as well as MH and residential and commercial construction, our revenue is not solely dependent on a single end market. We believe each of these end markets has a favorable growth outlook.

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Ability to Steadily Increase Content Revenue per Unit in RV and MH Markets

We experienced RV unit content growth of 15% and MH unit content growth of 8% in 2016 compared to 2015. This growth was driven by new products, extension growth, acquisitions and market share gain. We estimate that our current revenue opportunity in existing products is $6,300 per RV unit and $6,900 per MH unit.

Leadership in New Product Introductions

New product introductions and product line extensions are key components of our strategy to grow our market share and revenue base, adapt to changing market conditions, and proactively address customer demand. We believe there are numerous opportunities to launch product line extensions in our RV and MH product lines. Our commitment to design and innovation allows us to increase our presence in the markets that we serve and gain entrance into other markets. Over the last three years, we have introduced over 300 new products and product lines extensions to the market through acquisitions and internal development.

Continued Expansion into Complementary End Markets to Core RV Sales

Over the last several years, we have targeted certain sales efforts towards market segments that are less directly tied to recreational vehicle and residential new home construction, including the retail fixture, furniture, and countertop markets. As a result, we have seen a shift in our product mix, which has had a positive impact on revenues from the Industrial markets. Additionally, we have gained market share and expanded into new geographic territories as a result of acquisitions and investment in new team members with significant product knowledge, relationships, and expertise in the commercial markets.

Proven and Active Industry Consolidator

We have a track record of successfully executing small- and mid-sized acquisitions. We are focused on driving growth in each of our primary markets through the opportunistic acquisition of companies with strong management teams having a strategic fit with Patrick s core values, business model, and customer presence, as well as additional product lines, facilities, or other assets to complement or expand our existing businesses. Since 2010, we have acquired 31 component manufacturers and distributors that have added breadth and depth to our product offering. The OEM supplier landscape includes numerous suppliers and remains highly fragmented, providing additional opportunity for growth through acquisitions. Our disciplined, focused acquisition strategy is to target acquisitions that can strengthen or broaden our product offering and achieve established payback hurdles. To facilitate ongoing acquisition activity, we plan to continue to utilize our methodical, strategic and value-driven approach to consolidating a highly fragmented industry with a long tail of attractive targets.

Proven Management Team that has Successfully Managed the Company Through Different Business Environments and Executed on a Successful Growth Strategy

Our experienced executive management team, including Todd Cleveland, Andy Nemeth, Jeff Rodino, Joshua Boone, and Kip Ellis, combines deep industry expertise and experience with mergers and acquisitions with more than 100 years of cumulative experience. The team demonstrated its knowledge and expertise by managing our business successfully through the last economic downturn.

OUR SEGMENTS

Manufacturing Our lamination operations utilize various materials, such as lauan, medium-density fiberboard (MDF), gypsum, and particleboard, which are bonded by adhesives or a heating process to a number of products, including vinyl, paper, foil, and high-pressure laminates. These products are utilized to produce

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furniture, shelving, wall, counter, and cabinet products with a wide variety of finishes and textures. This segment also includes the following divisions: cabinet doors, fiberglass bath fixtures, hardwood furniture, vinyl printing, solid surface, granite, and quartz countertop fabrication, RV painting, fabricated aluminum products, fiberglass and plastic components, softwoods lumber, custom cabinetry, polymer-based flooring, electrical systems components, and other products. Patrick s major manufactured products also include wrapped vinyl, paper and hardwood profile mouldings, interior passage doors, slide-out trim and fascia, and slotwall panels and components.

Distribution We distribute pre-finished wall and ceiling panels, drywall and drywall finishing products, electronics and audio systems components, wiring, electrical and plumbing products, fiber reinforced polyester products, cement siding, interior passage doors, roofing products, laminate and ceramic flooring, shower doors, furniture, fireplaces and surrounds, interior and exterior lighting products, and other miscellaneous products.

Net Sales by Segment, Product, and End Market:

Revenue By Segment (2016)

Net Sales By Product (2016)

Net Sales By End Market (2016)

MARKETS

We supply highly visible interior and exterior components that differentiate our customers products in the RV, MH, and Industrial markets. We have consistently captured market share through our new product initiatives and strategic acquisitions, resulting in sales levels growing at a rate in excess of the general industry over the last five years.

The RV industry has demonstrated continued growth in the past three years with broad-based demand strength across towable and motorized product categories. According to the Recreation Vehicle Industry

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Association (RVIA), as noted in its December 2016 Recreation Vehicle Market Report**,** RV shipments surpassed 430,000 units in 2016, representing a 15% increase over 2015. We believe factors that support RV demand include: consumer wealth, consumer confidence, availability of financing and levels of disposable income. We believe the current economic environment and these factors provide for a near-term positive RV outlook with favorable secular trends in RV ownership, outdoor lifestyle and demographics driving long-term industry growth. We believe society is increasingly participating in nature-based tourism activities, with millennials and minorities embracing the outdoor lifestyle and entering into the RV marketplace. According to the RVIA, RV sales will continue to benefit from ongoing aging of the baby boomers as more people enter the primary RV ownership age group of 55 to 70 years old.

RV Wholesale Unit Shipments

(shipments in thousands):

Source: Recreation Vehicle Industry Association, 1990-2017 RVIA

The marine industry has been improving over the past few years and we believe there is meaningful growth ahead in this industry. With similar demand factors as RVs, we believe a continued improvement in economic conditions will contribute to a marine market recovery. According to the National Marine Manufacturers Association, preliminary data indicates that 2016 new power boat registrations increased 6% year over year. In addition, current power boat sales levels still remain significantly below the 1984 to 2015 annual average of approximately 307,000 units, suggesting growth potential.

The MH industry has demonstrated steady growth in the last three years with increased levels of wholesale shipments. We continue to believe there is pent up demand and upside potential for this market based on improving residential housing market conditions, high consumer confidence levels, increased affordability and quality, and improving credit and financing considerations. The MH industry, however, continues to face some challenges presented by the lack of financing alternatives and credit availability.

MH Wholesale Unit Shipments in the U.S.

(shipments in thousands):

Source: Institute for Building Technology and Safety (IBTS) Report dated December 2016

Our MH end market is dependent upon wholesale shipments of units which are in turn historically closely related to housing starts. Meanwhile, approximately 50% of our Industrial revenue base in 2016 was

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associated with the U.S. residential housing market. Therefore, there is a correlation between the demand for our products in this market and new residential housing construction and remodeling activities. With housing starts projected to increase by 8% and 9% in 2017 and 2018, respectively, according to the National Association of Realtors U.S. Economic Outlook as of February 2017, we believe the positive momentum in both our MH and Industrial segments will continue to increase.

New Housing Starts in the U.S.

(housing starts in thousands):

Source: U.S. Census Bureau New Privately Owned Housing Units Started Annual Data through 2016

Corporate Information

Patrick Industries, Inc. was founded in 1959 and incorporated in the state of Indiana in 1961. Our executive offices are located at 107 West Franklin Street, Elkhart, Indiana 46515 and our telephone number is (574) 294-7511. Our website address is located at www.patrickind.com. The information contained in our website is not part of and shall not be deemed incorporated by reference in this prospectus supplement.

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The Offering

Issuer:	Patrick Industries, Inc.
Common stock offered by us:	1,350,000 shares of our common stock, or 1,552,500 shares of our common stock if the underwriters exercise their option to purchase additional shares of common stock in full.
Common stock outstanding after the offering:	16,759,386 shares of our common stock, or 16,961,886 shares of our common stock if the underwriters exercise their option to purchase additional shares of common stock in full.
NASDAQ Global Select Market symbol:	PATK
Use of proceeds:	We estimate that the net proceeds from the sale of shares of our common stock in this offering will be approximately $93.2 million (or approximately $107.3 million if the underwriters exercise their option to purchase additional shares in full), based on the public offering price of $73.00 per share, after deducting the underwriting discount and commissions and estimated offering expenses. We intend to use all of the net proceeds from the offering to pay down a portion of our indebtedness under our 2015 Credit Facility (defined below). See Use of Proceeds. Affiliates of certain of the underwriters are lenders under our 2015 Credit Facility and may receive a portion of the net proceeds of this offering. Because of the manner in which the proceeds will be used, this offering will be conducted in accordance with FINRA 5121. In accordance with that rule, no qualified independent underwriter is required because a bona fide public market exists in the shares, as that term is defined in the rule. See Underwriting (Conflicts of Interest) Conflicts of Interest.
Risk factors:	You should carefully consider the risk factors set forth in the section entitled Risk Factors beginning on page S-10 of this prospectus supplement, in the accompanying prospectus, in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016 and in our other reports that are filed with the SEC, which are incorporated by reference in this prospectus supplement, before making any decision to invest in our common stock.

The share information above is based on 15,409,386 shares of common stock outstanding as of March 3, 2017 and excludes:

419,107 shares of our common stock issuable upon exercise of options granted under our 2009 Omnibus Incentive Plan at a weighted average exercise price of $59.93 per share;

407,336 shares issuable under stockholder appreciation rights granted under our 2009 Omnibus Incentive Plan with strike prices ranging from $18.45 to $111.94 per share;

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- 55,000 shares issuable under restricted stock units granted to our management under our 2009 Omnibus Incentive Plan which have performance-based vesting criteria; and

- 750,000 shares of common stock to be reserved for future issuance under our 2009 Omnibus Incentive Plan. The availability of these shares under the 2009 Omnibus Incentive Plan is subject to stockholder approval of these shares at the Company s 2017 annual meeting of stockholders.

Unless we indicate otherwise, the information in this prospectus supplement assumes that the underwriters will not exercise their option to purchase up to 202,500 additional shares of our common stock.

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Summary Consolidated Financial and Operating Data

The following table shows our summary consolidated income statement, balance sheet, and other financial and operating data for the fiscal years ended December 31, 2012, December 31, 2013, December 31, 2014, December 31, 2015 and December 31, 2016. The summary consolidated income statement and other financial data for fiscal years 2014, 2015 and 2016 are derived from our audited consolidated financial statements prepared in accordance with U.S. generally accepted accounting principles, which are incorporated by reference in this prospectus supplement and accompanying prospectus. Our historical results are not necessarily indicative of our results for any future period.

This information should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2016, including the Management s Discussion and Analysis of Financial Condition and Results of Operations, and our audited consolidated financial statements and related notes which are incorporated by reference in this prospectus supplement and accompanying prospectus.

	As of or for the Year Ended December 31,				
	2012	2013	2014	2015	2016
	(thousands except per share amounts)				
Operating Data:					
Net sales	$ 437,367	$ 594,931	$ 735,717	$ 920,333	$ 1,221,887
Gross profit	65,744	91,023	118,503	152,279	202,469
Operating income	27,040	40,945	51,471	69,918	90,837
Net income	28,095	24,040	30,674	42,219	55,577
Basic net income per common share	$ 1.77	$ 1.49	$ 1.92	$ 2.76	$ 3.70
Diluted net income per common share	$ 1.76	$ 1.49	$ 1.91	$ 2.72	$ 3.64
Financial Data:					
Total assets (1)	$ 143,469	$ 174,187	$ 255,561	$ 381,584	$ 534,950
Total short-term and long-term debt (2)	49,716	55,000	101,054	204,484	273,153
Shareholders equity	61,408	82,310	102,768	128,597	185,448
Cash flows from operating activities (3)	20,997	22,431	46,318	66,856	97,147

(1) Total assets as of December 31, 2015 reflect the reclassification of assets related to deferred financing costs associated with the term loan outstanding under the Company s 2015 Credit Facility that were reclassified and presented net of long-term debt outstanding. For additional details see Deferred Financing Costs in Note 2 to our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2016, which are incorporated by reference in this prospectus supplement and accompanying prospectus. In addition, total assets as of December 31, 2015 were reduced by the reclassification of long-term deferred tax liabilities to long-term deferred tax assets to conform to the current year presentation. For additional details see Income Taxes in Note 3 to our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2016, which are incorporated by reference in this prospectus supplement and accompanying prospectus. Total assets as presented in the table above as of December 31, 2012, 2013 and 2014 are shown as originally reported.

(2) Total short-term and long-term debt for each of the periods presented in the table above do not reflect the reclassification of assets related to deferred financing costs to long-term debt outstanding as described in footnote (1) above.

(3) Cash flows from operating activities for the years ended December 31, 2015 and 2014 reflect the reclassification of payments related to vesting of share-based awards, net of shares tendered for tax, to cash flows from financing activities to conform to the current year presentation. Cash flows from operating activities as presented in the table above for the years ended December 31, 2013 and 2012 are shown as originally reported. See Stock Compensation in Note 3 to our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2016 and which are incorporated by reference in this prospectus supplement and accompanying prospectus for further details.

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RISK FACTORS

Investing in our common stock involves a high degree of risk. You should carefully consider the risks described below and the information set forth in the accompanying prospectus to this prospectus supplement and in our Annual Report on Form 10-K for the year ended December 31, 2016, together with all other information included or incorporated by reference into this prospectus supplement and the accompanying prospectus, before you decide to invest in our common stock. The risks and uncertainties described in such incorporated documents and described below are not the only risks and uncertainties we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also impair our business operations. If any of those risks actually occurs, our business, financial condition and results of operations would suffer. In that event, the trading price of our common stock could decline, and you may lose all or part of your investment. The risks discussed below also include forward-looking statements and our actual results may differ substantially from those discussed in these forward-looking statements. See Cautionary Note Regarding Forward-Looking Statements below.

Economic and business conditions beyond Patrick s control, including cyclicality and seasonality in the industries it sells products, could lead to fluctuations in and negatively impact operating results.

The RV, MH and Industrial markets in which we operate are subject to cycles of growth and contraction in consumer demand, and volatility in production levels, shipments, sales and operating results, due to external factors such as general economic conditions, consumer confidence, employment rates, financing availability, interest rates, inflation, fuel prices, and other economic conditions affecting consumer demand and discretionary spending. Periods of economic recession and downturns have adversely affected our business and operating results in the past, and have the potential to adversely impact our future results. Consequently, the results for any prior period may not be indicative of results for any future period. In addition, fluctuation in demand could adversely affect our management of inventory, which could lead to an inability to meet customer needs or a charge for obsolete inventory.

Sales in the RV and MH markets historically have been seasonal and are generally at the highest levels when the climate is moderate. However, seasonal industry trends in the past several years have differed from prior years, primarily due to volatile economic conditions, fluctuations in RV dealer inventories, changing dealer show schedules, interest rates, access to financing, the cost of fuel, and increased demand from RV dealers. Consequently, future seasonal trends may differ from prior years. In addition, unusually severe weather conditions may impact the timing of industry-wide shipments from one period to another and lead to unanticipated fluctuations in our operating results.

If the financial condition of our customers and suppliers deteriorates, our business and operating results could suffer.

The markets we serve have been highly sensitive to changes in the economic environment. Weakening conditions in the economy, or the lack of available financing in the credit market, could cause the financial condition of our customers and suppliers to deteriorate, which could negatively affect our business through the loss of sales or the inability to meet our commitments. Many of our customers participate in highly competitive markets and their financial condition may deteriorate as a result. In addition, a decline in the financial condition of our customers could hinder our ability to collect amounts owed by customers.

Although we have a large number of customers, our sales are significantly concentrated with two customers, the loss of either of which could have a material adverse impact on our operating results and financial condition.

Two customers in the RV market accounted for a combined 60% of our consolidated net sales in 2016. The loss of either of these customers could have a material adverse impact on our operating results and financial

condition. We do not have long-term agreements with our customers and cannot predict that we will maintain our current relationships with these customers or that we will continue to supply them at current levels.

Changes in consumer preferences relating to our products could adversely impact our sales levels and our operating results.

Changes in consumer preferences, or our inability to anticipate changes in consumer preferences for RVs or manufactured homes, or for the products we make could reduce demand for our products and adversely affect our operating results and financial condition.

A significant percentage of the Company s sales are concentrated in the RV market, and declines in the level of RV unit shipments or reductions in industry growth could reduce demand for our products and adversely impact our operating results and financial condition.

In both 2015 and 2016, the Company s net sales to the RV market were approximately 75% of consolidated net sales. While the Company measures its RV segment sales against industry-wide wholesale shipment statistics, the underlying health of the RV market is determined by retail demand. Retail sales of RVs historically have been closely tied to general economic conditions, as well as consumer confidence, which was above historical averages in 2016. Future declines in RV unit shipment levels or reductions in industry growth could significantly reduce the Company s revenue from the RV market and have a material adverse impact on its operating results in 2017 and other future periods.

The manufactured housing and recreational vehicle industries are highly competitive and some of our competitors may have greater resources than we do.

We operate in a highly competitive business environment and our sales could be negatively impacted by our inability to maintain or increase prices, changes in geographic or product mix, or the decision of our customers to purchase our competitors products or to produce in-house products that we currently produce. We compete not only with other suppliers to the RV and MH producers, but also with suppliers to traditional site-built homebuilders and suppliers of cabinetry and countertops. Sales could also be affected by pricing, purchasing, financing, advertising, operational, promotional, or other decisions made by purchasers of our products. Additionally, we cannot control the decisions made by suppliers of our distributed and manufactured products, and therefore, our ability to maintain our distribution arrangements may be adversely impacted.

The greater financial resources or the lower level of debt or financial leverage of certain of our competitors may enable them to commit larger amounts of capital in response to changing market conditions. Competitors may develop innovative new products that could put the Company at a competitive disadvantage. If we are unable to compete successfully against other manufacturers and suppliers to the RV and MH markets, we could lose customers and sales could decline, or we may not be able to improve or maintain profit margins on sales to customers or be able to continue to compete successfully in our core markets.

Conditions in the credit market could limit the ability of consumers to obtain retail financing for RVs and manufactured homes, resulting in reduced demand for our products.

Restrictions on the availability of consumer financing for RVs and manufactured homes and increases in the costs of such financing have in the past limited, and could again limit, the ability of consumers to purchase RVs and manufactured homes, which would result in reduced production of RVs and manufactured homes by our customers, and therefore reduce demand for our products.

Loans used to finance the purchase of manufactured homes usually have shorter terms and higher interest rates, and are more difficult to obtain than mortgages for site-built homes. Historically, lenders required a higher down payment, higher credit scores and other criteria for these loans. Current lending criteria are more stringent than historical criteria, and many potential buyers of manufactured homes may not qualify.

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The availability, cost, and terms of these manufactured housing loans are also dependent on economic conditions, lending practices of financial institutions, government policies, and other factors, all of which are beyond our control. Reductions in the availability of financing for manufactured homes and increases in the costs of financing have limited, and could continue to limit, the ability of consumers to purchase manufactured homes, resulting in reduced production of manufactured homes by our customers, and therefore reduced demand for our products. In addition, certain provisions of the Dodd-Frank Act, which regulate financial transactions, could make certain types of loans more difficult to obtain, including those historically used to finance the purchase of manufactured homes.

The manufactured housing industry has experienced a significant long-term decline in shipments, which has led to reduced demand for our products.

Our MH segment, which accounted for 13% of consolidated net sales for 2016, operates in an industry which has experienced a significant decline in production of new homes compared to the last peak production level in 1998. The downturn was caused, in part, by limited availability and high cost of financing for manufactured homes, and was exacerbated by economic and political conditions during the financial crisis. Although industry-wide wholesale production of manufactured homes has improved somewhat in recent years, a worsening of conditions in the MH market could have a material adverse impact on our operating results.

Fuel shortages or high prices for fuel could have an adverse impact on our operations.

The products produced by the RV market typically require gasoline or diesel fuel for their operation, or the use of a vehicle requiring gasoline or diesel fuel for their operation. There can be no assurance that the supply of gasoline and diesel fuel will continue uninterrupted or that the price or tax on fuel will not significantly increase in the future. Shortages of gasoline and diesel fuel, and substantial increases in the price of fuel, have had a material adverse effect on our business and the RV industry as a whole in the past and could have a material adverse effect on our business in the future.

We are dependent on third-party suppliers and manufacturers.

Generally, our raw materials, supplies and energy requirements are obtained from various sources and in the quantities desired. While alternative sources are available, our business is subject to the risk of price increases and periodic delays in delivery. Fluctuations in prices may be driven by the supply/demand relationship for that commodity, governmental regulation, tariffs or other cross-border taxes, economic conditions in other countries, religious holidays, natural disasters, and other events. In addition, if any of our suppliers seek bankruptcy relief or otherwise cannot continue their business as anticipated, the availability or price of these requirements could be adversely affected.

If we cannot effectively manage the challenges and risks associated with doing business internationally, our revenues and profitability may suffer.

We purchase a significant portion of our raw materials and other supplies from suppliers located in Indonesia, China and Malaysia. As a result, our ability to obtain raw materials and supplies on favorable terms and in a timely fashion are subject to a variety of risks, including fluctuations in foreign currencies, changes in the economic strength of the foreign countries in which we do business, difficulties in enforcing contractual obligations and intellectual property rights, compliance burdens associated with a wide variety of international and United States import laws, and social, political, and economic instability. Our business with our international suppliers could be adversely affected by restrictions on travel to and from any of the countries in which we do business due to a health epidemic or outbreak or other event. Additional risks associated with our foreign business include restrictive trade policies, imposition of duties, taxes, or government royalties by foreign governments, and compliance with the Foreign Corrupt Practices Act and local anti-bribery laws. Recently, the new White House administration, certain members of Congress and key policy makers have suggested the renegotiation of the North American Free Trade Agreement. In addition, the new administration has suggested the adoption of other laws to implement tariffs, border taxes, or other measures that could impact the level of trade between the U.S., Mexico and China. Any such proposals or measures could negatively impact our relations with our international suppliers and the volume of shipments to the U.S. from these countries, which could have a material adverse effect on our business and operating results.

Any increased cost and limited availability of certain raw materials may have a material adverse effect on our business and results of operations.

Prices of certain materials, including gypsum, lauan, particleboard, MDF, aluminum and other commodity products, can be volatile and change dramatically with changes in supply and demand. Certain products are purchased from overseas and their availability is dependent upon weather conditions, seasonal and religious holidays, political unrest, economic conditions overseas, natural disasters, vessel shipping schedules and port availability. Further, our commodity product suppliers sometimes operate at or near capacity, resulting in some products having the potential of being put on allocation. We generally have been able to maintain adequate supplies of materials and pass higher material costs on to our customers in the form of surcharges and base price increases where needed. However, it is not certain future price increases can be passed on to our customers without affecting demand or that limited availability of materials will not impact our production capabilities. Our sales levels and operating results could be negatively impacted by changes in any of these items.

Increases in demand for our products could make it more difficult for us to obtain additional skilled labor, which may adversely impact our operating efficiencies.

In certain geographic regions in which we have manufacturing facilities, we are experiencing shortages of qualified employees, which negatively impacted our cost of goods sold in 2016. Labor shortages and continued competition for qualified employees may increase the cost of our labor and create employee retention and recruitment challenges, especially during improving economic times as employees with knowledge and experience have the ability to change employers more easily.

If demand continues to increase, we may not be able to increase production to satisfy demand in a timely fashion, and may initially incur higher labor and production costs, which could adversely impact our financial condition and operating results.

We may incur significant charges or be adversely impacted by the consolidation and/or closure of all or part of a manufacturing or distribution facility.

We periodically assess the cost structure of our operating facilities to distribute and/or manufacture products in the most efficient manner. We may make capital investments to move, discontinue manufacturing and/or distribution capabilities, or products and product lines, sell or close all or part of additional manufacturing and/or distribution facilities in the future. These changes could result in significant future charges or disruptions in our operations, and we may not achieve the expected benefits from these changes, which could result in an adverse impact on our operating results, cash flows, and financial condition.

We are subject to governmental and environmental laws and regulations, and failure in our compliance efforts, changes to such laws and regulations or events beyond our control could result in damages, expenses or liabilities that individually, or in the aggregate, would have a material adverse effect on our financial condition and results of operations.

Some of our manufacturing processes involve the use, handling, storage and contracting for recycling or disposal of hazardous or toxic substances or wastes. Accordingly, we are subject to various governmental and environmental laws and regulations regarding these substances, as well as environmental requirements relating to air, water and noise pollution. The implementation of new laws and regulations or amendments to existing laws and regulations could significantly increase the cost of the Company s products. We cannot presently determine what, if any, legislation may be adopted by federal, state or local governing bodies, or the effect any such legislation may have on our customers or us. Failure to comply with present or future laws and regulations could result in fines or potential civil or criminal liability. Both scenarios could negatively impact our results of operations or financial condition.

The inability to attract and retain qualified executive officers and key personnel may adversely affect our operations.

While we include succession planning as part of our ongoing talent development and management process to help ensure the continuity of our business model, the loss of any of our executive officers or other key personnel could reduce our ability to manage our business and strategic plan in the short-term and could cause our sales and operating results to decline. In addition, our future success will depend on, among other factors, our ability to attract and retain executive management, key employees, and other qualified personnel.

Our ability to integrate acquired businesses may adversely affect operations.

As part of our business and strategic plan, we look for strategic acquisitions to provide shareholder value. Any acquisition will require the effective integration of an existing business and its administrative, financial, sales and marketing, manufacturing, and other functions to maximize synergies. Acquired businesses involve a number of risks that may affect our financial performance, including increased leverage, diversion of management resources, assumption of liabilities of the acquired businesses, and possible corporate culture conflicts. If we are unable to successfully integrate these acquisitions, we may not realize the benefits identified in our due diligence process, and our financial results may be negatively impacted. Additionally, significant unexpected liabilities could arise from these acquisitions.

Our level of indebtedness could limit our operational flexibility and harm our financial condition and results of operations.

As of December 31, 2016, we had $273.0 million of total long-term debt outstanding under our $360.0 million revolving credit facility (the 2015 Credit Facility) that was established pursuant to our current credit agreement, as amended (the 2015 Credit Agreement). Our level of indebtedness could have adverse consequences on our future operations, including making it more difficult for us to meet our payments on outstanding debt, and we may not be able to find alternative financing sources to replace our indebtedness in such an event. Our level of indebtedness could: (i) reduce the availability of our cash flow to fund working capital, capital expenditures, acquisitions and other general corporate purposes, and limit our ability to obtain additional financing for these purposes; (ii) limit our flexibility in planning for, or reacting to, and increasing our vulnerability to, changes in our business and the industry in which we operate; (iii) place us at a competitive disadvantage compared to our competitors that have less debt or are less leveraged; and (iv) create concerns about our credit quality which could result in the loss of supplier contracts and/or customers. Our ability to satisfy our debt obligations will depend on our future operating performance which may be affected by factors beyond our control.

Our 2015 Credit Agreement contains various financial performance and other covenants. If we do not remain in compliance with these covenants, our 2015 Credit Agreement could be terminated and the amounts outstanding thereunder could become immediately due and payable.

We have debt outstanding that contains financial and non-financial covenants with which we must comply that place restrictions on us. There can be no assurance that we will maintain compliance with the financial covenants under our

2015 Credit Agreement. These covenants require that we comply with a maximum level of a consolidated total leverage ratio and a minimum level of a consolidated fixed charge coverage ratio. If we fail to comply with the covenants contained in our 2015 Credit Agreement, the lenders could cause our debt to become due and payable prior to maturity or it could result in our having to refinance the indebtedness under unfavorable terms. If our debt were accelerated, our assets might not be sufficient to repay our debt in full and there can be no assurance that we would be able to refinance any or all of our indebtedness.

Due to industry conditions and our operating results, there have been times in the past when we have had limited access to sources of capital. If we are unable to locate suitable sources of capital when needed, we may be unable to maintain or expand our business.

We depend on our cash balances, our cash flows from operations, and our 2015 Credit Facility to finance our operating requirements, capital expenditures and other needs. If a significant economic recession occurred, such as the recession that impacted the economy from 2007 to 2010, production of RVs and manufactured homes could decline, resulting in reduced demand for our products. A decline in our operating results could negatively impact our liquidity. If our cash balances, cash flows from operations, and availability under our 2015 Credit Facility are insufficient to finance our operations and alternative capital is not available, we may not be able to expand our business and make acquisitions, or we may need to curtail or limit our existing operations.

We have letters of credit representing collateral for our casualty insurance programs and for general operating purposes that have been issued under our 2015 Credit Facility. The inability to retain our current letters of credit, to obtain alternative letter of credit sources, or to retain our 2015 Credit Facility to support these programs could require us to post cash collateral, reduce the amount of cash available for our operations, or cause us to curtail or limit existing operations.

If we are unable to manage our inventory, our operating results could be materially and adversely affected.

Our customers generally do not maintain long-term supply contracts and, therefore, we must bear the risk of advanced estimation of customer orders. We maintain inventory to support these customers needs. Changes in demand, market conditions and/or product specifications could result in material obsolescence and a lack of alternative markets for certain of our customer specific products and could negatively impact operating results.

We could incur charges for impairment of assets, including goodwill and other long-lived assets, due to potential declines in the fair value of those assets or a decline in expected profitability of the Company or individual reporting units of the Company.

Approximately 67% of our total assets as of December 31, 2016 was comprised of goodwill, other intangible assets, and property, plant and equipment. Under generally accepted accounting principles, each of these assets is subject to periodic review and testing to determine whether the asset is recoverable or realizable. The events or changes that could require us to test our goodwill and intangible assets for impairment include changes in our estimated future cash flows, changes in rates of growth in our industry or in any of our reporting units, and decreases in our stock price and market capitalization.

In the future, if sales demand or market conditions change from those projected by management, asset write-downs may be required. Significant impairment charges, although not always affecting current cash flow, could have a material effect on our operating results and financial position.

A variety of factors, many of which are beyond our control, could influence fluctuations in the market price for our common stock.

The stock market, in general, experiences volatility that has often been unrelated to the underlying operating performance of companies. If this volatility continues, the trading price of our common stock could decline significantly, independent of our actual operating performance. The market price of our common stock could fluctuate significantly in response to a number of factors, many of which are beyond our control, including the following:

- variations in our and our competitors operating results;
- high concentration of shares held by institutional investors;
- announcements by us or our competitors of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;
- announcements by us or our competitors of technological improvements or new products;
- the gain or loss of significant customers;
- additions or departures of key personnel;
- events affecting other companies that the market deems comparable to us;
- changes in investor perception of our business and/or management;
- changes in global economic conditions or general market conditions in the industries in which we operate;
- sales of our common stock held by certain equity investors or members of management;
- issuance of our common stock or debt securities by the Company; and
- the occurrence of other events that are described in these risk factors.

If our information technology systems fail to perform adequately, our operations could be disrupted and could adversely affect our business, reputation and results of operation.

We are increasingly dependent on digital technology, including information systems and related infrastructure, to process and record financial and operating data, manage inventory and communicate with our employees and business partners. We rely on our information technology systems to effectively manage our business data, inventory, supply chain, order entry and fulfillment, manufacturing, distribution, warranty administration, invoicing, collection of payments, and other business processes. Our systems are subject to damage or interruption from power outages, telecommunications or internet failures, computer viruses and malicious attacks, security breaches and catastrophic events. If our systems are damaged or fail to function properly or reliably, we may incur substantial repair or replacement costs, experience data loss or theft and impediments to our ability to manage our business, which could adversely affect our results of operations. Any such events could result in legal claims or proceedings, liability or penalties under privacy laws, disruption in operations, and damage to our reputation, which could adversely affect our business.

In addition, we may be required to make significant technology investments to maintain and update our existing computer systems. Implementing significant system changes increases the risk of computer system disruption. The potential problems and interruptions associated with implementing technology initiatives could disrupt or reduce our operational efficiency.

A cyber incident or data breach could result in information theft, data corruption, operational disruption, and/or financial loss.

Our technologies, systems, networks, and those of our business partners have in the past and may in the future become the target of cyber-attacks or information security breaches that could result in the unauthorized

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release, gathering, monitoring, misuse, loss, or destruction of proprietary and other information, or other disruption of our business operations. A cyber-attack could include gaining unauthorized access to digital systems for purposes of misappropriating assets or sensitive information, corrupting data, or causing operational disruption or result in denial of service on websites. We have programs in place to detect, contain and respond to data security incidents. However, because the techniques used to obtain unauthorized access, disable or degrade service, or sabotage systems change frequently and may be difficult to detect for long periods of time, we may be unable to anticipate these techniques or implement adequate preventive measures. Unauthorized parties may also attempt to gain access to our systems or facilities, or those of third parties with whom we do business, through fraud, trickery, or other forms of deceiving our team members, contractors, vendors, and temporary staff. In addition, hardware, software, or applications we develop or procure from third parties may contain defects in design or manufacture or other problems that could unexpectedly compromise information security. Any cyber-attack on our bancing activities

2,021,651 462,360

Net Increase (Decrease) in Cash and Cash Equivalents

(4,505,185) 451,818

Cash and Cash Equivalents at Beginning of Period

4,841,871 9,211

Cash and Cash Equivalents at End of Period

$336,686 $461,029

Cash paid during the period for:

Interest

$125,386 $150,608

Income taxes

$1,677 $

During the six months ended June 30, 2007, the Company entered into capitalized lease obligations for the purchase of $218,542 in fixed assets.

In April 2007, the shares issued in conjunction with the purchase AgaveOne were reduced by 66,667 shares or $250,000 as a result of indemnification claims.

In May 2007, the Company issued 100,000 warrants in conjunction with a loan agreement with a bank. See Note 4.

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

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St. Bernard Software, Inc.

Notes to Consolidated Financial Statements

(Unaudited)

1. Summary of Significant Accounting Policies

St. Bernard Software, Inc., a Delaware corporation (the Company or St. Bernard), formerly known as Old St. Bernard Software, Inc. is a software development firm specializing in the design and production of innovative network systems management security software. The Company sells its products through distributors, dealers and original equipment manufacturers (OEM), and directly to network managers and administrators worldwide.

Merger and accounting treatment

On October 26, 2005 the Company entered into an Agreement and Plan of Merger (Merger Agreement), as amended, with Sand Hill IT Security Acquisition Corp. (Sand Hill or Parent), a publicly held Delaware corporation. On July 27, 2006 stockholders of Sand Hill voted to approve the Merger Agreement and the transactions set forth therein (the Merger) in which St. Bernard Software, Inc. became the Parent s wholly-owned subsidiary. Sand Hill then changed its name to St. Bernard Software, Inc.

The shares of common stock held by the former stockholders of Old St. Bernard, Inc. were converted into a total of 9,733,771 shares of Sand Hill common stock, or approximately 69.2% of the subsequently outstanding common stock of the combined company.

Upon consummation of the Merger, approximately $22.3 million was released from trust to be used by the combined company. With respect to the business combination, any public stockholder who voted against the Merger could demand that the Company redeem their shares. The per share redemption price was equal to $5.40 per share. After payments of redeemed shares of approximately $4.2 million and costs related to the Merger of approximately $1.3 million, the net proceeds received by the Company was approximately $16.8 million. The costs incurred in connection with the Merger were reflected as a reduction to the proceeds as of the effective date of the Merger.

For accounting purposes the Merger was accounted for as a reverse acquisition. Under this method of accounting, Sand Hill was treated as the acquired company. Accordingly, for accounting purposes, the Merger was treated as the equivalent of St. Bernard issuing stock for the net monetary assets of Sand Hill. The historical financial statements prior to July 27, 2006, are those of St. Bernard Software. All historical share and per share amounts have been retroactively adjusted, using a conversion factor of 0.419612277 to give effect to the reverse acquisition of Sand Hill.

These consolidated financial statements are issued under the name of the Parent, but are a continuation of the financial statements of the Company and the comparative information presented is that of the Company. The assets and liabilities of the Company are recognized and measured in these consolidated financial statements at their pre-combination carrying amounts. The retained earnings and other equity balances recognized are the retained earnings and other equity balances of the Company immediately before the business combination. The amount recognized as issued equity instruments in these consolidated financial statements was determined by adding to the issued equity of the Company immediately before the business combination. However, the equity structure appearing in these consolidated financial statements reflects the equity structure of the Parent, including the equity instruments issued by the legal Parent to affect the combination

Effective October 17, 2006, we acquired AgaveOne, Inc., a Nevada corporation doing business as Singlefin. Singlefin provided on-demand security and business services to small and medium sized companies, including email filtering, web filtering and instant messaging management as a hosted or on demand service. In connection with the Singlefin acquisition, we paid Singlefin stockholders and option holders $0.47 million in cash, issued 471,288 shares of common stock and assumed certain stock options granted by Singlefin and converted them into options to acquire 47,423 shares of our common stock.

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St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

During the quarter ended June 30, 2007, the shares issued in conjunction with the purchase were reduced by 66,667 as a result of indemnification claims. We also satisfied $5.5 million in Singlefin indebtedness and certain Singlefin employees received bonuses totaling $0.25 million. The aggregate value of the transaction was approximately $8.0 million.

The following pro forma consolidated information is presented as if the October 2006 acquisition of AgaveOne, Inc. occurred on January 1, 2006. The unaudited pro forma consolidated results have been prepared for comparative purposes only and do not purport to be indicative of the results of operations that would have actually resulted had the acquisition been in effect in the periods indicated above, or of the future results of operations. The unaudited pro forma consolidated results for the quarter ended June 30, 2006, are as follows (in thousands):

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Net sales	$ 5,706	$ 11,069
Net loss	$ (1,599)	$ (3,264)
Basic and Diluted Loss per Common Share	(0.16)	(0.32)
Weighted Average Shares Outstanding	10,228	10,223

Basis of presentation

The accompanying consolidated financial statements have been prepared by us without audit and reflect all adjustments (consisting of normal and recurring adjustments and accruals) which are, in our opinion, necessary to present a fair statement of the results for the interim periods presented. The consolidated financial statements include our accounts and those of our subsidiaries. All inter-company balances and transactions have been eliminated in consolidation. The statements have been prepared in accordance with the regulations of the Securities and Exchange Commission, but omit certain information and footnote disclosures necessary to present the statements in accordance with U.S. generally accepted accounting principles. The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the full fiscal year. The information included in this form 10-QSB should be read in conjunction with the Company s financial statements and footnotes that are included in the most recent 10-KSB.

Use of estimates

The preparation of the consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates. Significant estimates used in preparing the consolidated financial statements include those assumed in computing the allowance for uncollectible accounts receivable, the valuation allowance on deferred tax assets, in testing goodwill for impairment, and assumptions used to determine the fair value of stock options under SFAS 123R.

Liquidity

As of June 30, 2007, we had $0.3 million of cash and a working capital deficit of $13.6 million. As of June 30, 2007, we did not expect sufficient cash flows from operations during the next twelve months, along with our available line of credit financing and cash on hand, to cover our anticipated operating expenses plus continued development of our on-demand software as a service solution package. Billings from our on demand service have been lower than expected due to a several month delay in developing the new product line to effectively compete in the

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St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

medium and large customer market space. In addition, we continue to invest in our on-demand service which includes the staffing of technical support personnel, as well as advertising expenses. Lastly, the increased costs associated with being a public company has caused an increase in the use of cash, which includes accounting, legal, and insurance fees; and a combination of SOX 404 , Board of Director, and IT consulting fees. These circumstances raised substantial doubt about our ability to continue as a going concern as of June 30, 2007. Consequently, we were actively seeking additional debt, and/or equity financing, and management was actively marketing for sale certain non-core assets.

On August 14, 2007 the assets of Open File Manager were sold and the cash proceeds from the transaction were $6.4 million. There will be additional cash received by the company for transition services provided to the acquirer and the release of $0.5 million from an indemnification escrow.

If the on-demand business continues to require cash investment and does not begin to meet sales expectations, we may need to raise additional funds on acceptable terms. If we cannot do so, we will not be able to develop or enhance our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements. To the extent we raise additional capital by issuing equity securities, our stockholders may experience substantial dilution. A material shortage of capital will require us to take drastic steps such as reducing our level of operations, disposing of selected assets or seeking an acquisition partner.

At June 30, 2007, our current liabilities exceeded our current assets by approximately $13.6 million and we had a stockholders deficit of approximately $6.4 million. Our expenses consist primarily of variable costs such as payroll and related expenses that can be modified to meet our operating needs. In addition, approximately $10.9 million of the current liability balance at June 30, 2007 consists of deferred revenues, which represents amounts that will be amortized into revenue over time, as they are earned. While there are costs that will be incurred as these revenues are earned, management believes these costs are significantly less than the approximately $10.9 million recorded as a current liability or the approximately $16.5 million recorded as a liability in total.

The accompanying financial statements have been prepared assuming the Company will continue as a going concern.

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

Cash and cash equivalents

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

Research and development and capitalized software costs

The Company s research and development expenses include payroll, employee benefits, stock-based compensation, offshore development and other head-count related costs associated with product development and are expensed as incurred. In accordance with *Statement of Financial Accounting Standards (SFAS) No. 86, Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed,* capitalization of costs begins when technological feasibility has been established and ends when the product is available for general release to customers. The Company has determined that technological feasibility for its products is reached after beta testing which is shortly before the products are released to manufacturing/operations. Costs incurred after technological feasibility is established are not material, and accordingly, the Company expenses all research and development costs when incurred. The technological feasibility of significant intellectual property that is purchased has been established prior to the acquisition and therefore the cost is capitalized.

Goodwill

The Company accounts for goodwill in accordance with the provisions of *Statement of Financial Accounting Standards (SFAS) No. 142*. The Company subjects the goodwill to an annual impairment test or when events indicate that an impairment has occurred. The impairment test consists of a comparison of the estimated fair value of the reporting unit to which the goodwill has been assigned to the sum of the carrying value of the assets and liabilities of that reporting unit. The fair value used in this evaluation is based upon discounted future cash flow projections for the reporting unit. As a result of our significant underperformance relative to the expected operating results, we tested our goodwill for impairment as of June 30, 2007. Based upon the results of the impairment test, management of the Company has concluded there was no impairment of goodwill at June 30, 2007. The Company is one reporting unit for purposes of testing goodwill.

Goodwill totaled $7.5 million and $7.7 million at June 30, 2007 and December 31, 2006, respectively that arose through business acquisitions made in 2000 and 2006. During the quarter ended June 30, 2007, goodwill was reduced by $0.2 million, or the fair value of 66,667 shares withheld from a stockholder as a result of indemnification claims in relation to the acquisition of AgaveOne.

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St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

Intangible assets

The Company accounts for intangible assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets , management reviews our long-lived asset groups, including property and equipment and other intangibles, for impairment and whenever events indicate that their carrying amount may not be recoverable. When management determines that one or more impairment indicators are present for an asset group, we compare the carrying amount of the asset group to net future undiscounted cash flows that the asset group is expected to generate. If the carrying amount of the asset group is greater than the net future undiscounted cash flows that the asset group is expected to generate, we compare the fair value to the book value of the asset group. If the fair value is less than the book value, we would recognize an impairment loss. The impairment loss would be the excess of the carrying amount of the asset group over its fair value. As a result of our significant underperformance relative to the expected operating results, we tested our intangible assets for impairment as of June 30, 2007. Based upon the results of the impairment test, management of the Company has concluded that there was no impairment of intangible assets at June 30, 2007. It is possible that the Company will have an impairment of intangible assets in the future if the on-demand service billings do not meet our expectations.

Stock options

Effective January 1, 2006, the Company adopted the fair value recognition provisions of Statement of *Financial Accounting Standards (SFAS) No. 123R (revised 2004), Share-based Payment* , using the modified prospective method and therefore has not restated results for prior periods. Under this transition method, stock-based compensation expense for fiscal year 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based upon the grant date fair value estimated in accordance with *SFAS No. 123*, *Accounting for Stock-Based Compensation*. Stock-based compensation expense for all stock-based compensation awards granted after January 1, 2006 is based upon the grant date fair value estimated in accordance with SFAS 123R. Prior to the adoption of SFAS 123R on January 1, 2006, the Company recognized stock-based compensation expense in accordance with Accounting Principles Board (APB) *Opinion No. 25, Accounting for Stock Issued to Employees* , and provided pro forma disclosure amounts in accordance with SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure* , as if the fair value method defined by SFAS 123 had been applied to its stock-based compensation.

The Company has non-qualified and incentive stock option plans (together, the Plans) providing for the issuance of options to employees, directors, and consultants as deemed appropriate by the Board of Directors. Terms of options issued under the Plans include an exercise price equal to the fair market value at the date of grant, vesting periods generally between three to five years, and expiration dates not to exceed ten years from date of grant. The determination of the fair market value of the Company s stock is derived using the closing sale price on the grant date.

The Company granted options during the six months ended June 30, 2007, therefore all fair value calculations were done using the Black-Sholes model under the guidance of SFAS 123R. The weighted average fair value of options granted during the six months ended June 30, 2007, was calculated using the Black-Scholes option pricing model with the following valuation assumptions: expected volatility 74%; dividend yield 0%; risk free interest rates ranging from 4.54% to 5.14%; expected life 6.5 years. There were no options granted in the six months ended June 30, 2006.

Total stock-based compensation expense was approximately $321,000 and $0 for the three months ended June 30, 2007 and 2006, respectively, and $581,000 and $0 for the six months ended June 30, 2007 and 2006, respectively. The stock-based compensation expenses were charged to general and administrative expenses. The earnings per share effect as a result of the stock based compensation expense was approximately $0.02 and $0.04 for the three months and six months ended June 30, 2007, respectively. The tax effect was immaterial.

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St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

The following is a summary of stock option activity under the Plans as of June 30, 2007, and changes during the six months ended June 30, 2007:

	Number of Shares Outstanding	Weighted Average Exercise Price
Options outstanding at December 31, 2006	2,260,643	$ 3.12
Granted	1,149,364	$ 1.95
Exercised	(44,950)	$ 0.67
Forfeited/Expired	(1,311,767)	$ 3.79
Options outstanding at June 30, 2007	2,053,290	$ 2.08

Additional information regarding options outstanding as of June 30, 2007, is as follows:

Range of Exercise Prices		Number of Shares Outstanding	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$0.59	to $1.15	149,552	7.03	$ 0.74	134,552	$ 0.69
$1.19	to $1.19	166,988	0.90	$ 1.19	166,988	$ 1.19
$1.79	to $1.79	3,000	9.71	$ 1.79		$ 0.00
$1.80	to $1.80	70,000	8.15	$ 1.80		$ 0.00
$1.90	to $1.90	400,000	9.47	$ 1.90		$ 0.00
$1.95	to $1.95	934,865	8.89	$ 1.95	77,447	$ 1.95
$2.30	to $2.30	50,000	9.51	$ 2.30		$ 0.00
$3.71	to $3.71	200,000	9.19	$ 3.71		$ 0.00
$4.75	to $4.75	60,000	2.54	$ 4.75	60,000	$ 4.75
$5.20	to $5.20	18,885	8.04	$ 5.20	18,885	$ 5.20
$0.59	to $5.20	2,053,290	8.04	$ 2.08	457,872	$ 1.80

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

Consistent with the adoption of the fair value recognition provisions of SFAS 123R and based upon the Company s historical experience, the Company has estimated that 200,000 outstanding options under the Plans that are currently unvested will be forfeited.

The aggregate intrinsic value of options outstanding and exercisable at June 30, 2007 was approximately $39,000. The aggregate intrinsic value represents the total intrinsic value, based upon the stock price of $0.98 at June 29, 2007. The intrinsic value of option exercises for the three and six months ended June 30, 2007 was approximately $0 and $69,000, respectively.

As of June 30, 2007, there was approximately $4.4 million of total unrecognized compensation expense related to unvested share-based compensation arrangements granted under the Plans. The cost is expected to be recognized over a weighted average period of 2.28 years.

Amendment to recent stock option grants

On January 3, 2007, the Board of Directors of St. Bernard approved an amendment to certain stock option grants made by St. Bernard to certain St. Bernard employees and directors between July 14, 2006 and December 4, 2006, reducing the exercise price of the amended option grants to the closing fair market price of St. Bernard common stock on January 11, 2007. The intention of St. Bernard s Board of Directors in approving the amendment is to reestablish the incentive and retentive value of the amended stock options for the affected employees and directors, as the relevant options had been left significantly out-of-the-money due to recent declines in the price of St. Bernard common stock. A substantial majority of the options that were amended were granted to new executives and employees that joined St. Bernard after the merger with Sand Hill IT Security Acquisition Corp. in July 2006. The reason for delaying the determination of the new grant date for the amended option grants until January 11, 2007 was to enable the market to absorb the information before setting the new exercise price. The amendment affects options to purchase a total of up to 1,055,064 shares of the Company s common stock, including options granted to the executive officers and directors of the Company. The Company expects incremental compensation expenses in relation to the amended stock option grants to total approximately $283,000.

The following table represents the St. Bernard Software employees and directors whose option grants were amended:

Name	Position	Original Option Grant Date	Shares Underlying the Option
Vincent Rossi	Chief Executive Officer	July 28, 2006	480,000
Al Riedler	Chief Financial Officer	July 14, 2006	20,980
Bradford Weller	Chief Legal Officer	July 28, 2006	50,000
Louis Ryan	Director	September 7, 2006	50,000
Richard Arnold	Director	September 7, 2006	50,000
Troy Sexton-Getty	General Manager	November 15, 2006	150,000
			800,980

Stock purchase plan

The Company s Employee Stock Purchase Plan, or ESPP, was adopted by our board of directors in December 2006, and approved by our shareholders in June 2007. The ESPP purchase period commenced on March 1, 2007, subject to the approval by the stockholders at the 2007 annual meeting and ended on the last business day in the period ending on June 30, 2007. The ESPP provides a means by which employees of the Company (and any parent or subsidiary of the Company designated by the Board of Directors to participate in the Purchase Plan) may be given an opportunity to purchase Common Stock of the Company

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

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at semi-annual intervals through payroll deductions, to assist the Company in retaining the services of its employees, to secure and retain the services of new employees, and to provide incentives for such persons to exert maximum efforts for the success of the Company. 400,000 shares have been initially reserved for issuance pursuant to purchase rights under the ESPP. A participant may contribute up to 15% of his or her compensation through payroll deductions, and the accumulated deductions will be applied to the purchase of shares on the purchase date, which is the last trading day of the offering period. The purchase price per share will be equal to 85% of the fair market value per share on the start date of the offering period in which the participant is enrolled or, if lower, 85% of the fair market value per share on the purchase date. In addition, the number of shares available for issuance under the Purchase Plan may be increased annually on the first day of each Company fiscal year, beginning in 2008 and ending in (and including) 2016, by an amount equal to the least of: (i) the difference between four hundred thousand (400,000) and the number of shares remaining authorized for issuance after the last purchase of shares, (ii) four hundred thousand (400,000) shares of Common Stock, or (iii) an amount determined by the Board of Directors or a committee of the Board of Directors appointed to administer the Purchase Plan. If rights granted under the Purchase Plan expire, lapse or otherwise terminate without being exercised, the shares of Common Stock not purchased under such rights again become available for issuance under the Purchase Plan. At June 30, 2007, $14,540 has been withheld from employee earnings for stock purchases under the ESPP.

Loss per share

Basic loss per share is calculated by dividing net loss by the weighted-average number of shares of common stock outstanding. Diluted loss per share includes the components of basic loss per share and also gives effect to dilutive common stock equivalents. Potentially dilutive common stock equivalents include stock options and warrants. No dilutive effect was calculated for the six months ended June 30, 2007 and June 30, 2006, respectively, as the Company reported a net loss in each period.

Income taxes

Deferred income taxes are recognized for the tax consequences in future years of differences between the tax basis of assets and liabilities and their financial reporting amounts at each year end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. Income tax expense is the combination of the tax payable for the period and the change during the period in deferred tax assets and liabilities.

New accounting standards

On February 15, 2007 the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (*SFAS) No. 159*, *The Fair Value Option for Financial Assets and Financial Liabilities* . SFAS No. 159 permits all entities to choose, at specified election dates, to measure eligible items at fair value (the fair value option). A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings (or another performance indicator if the business entity does not report earnings) at each subsequent reporting date. Upfront costs and fees related to items for which the fair value option is elected shall be recognized in earnings as incurred and not deferred. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted. The Company is currently evaluating whether SFAS No. 159 will have a material effect on its financial position, results of operations or cash flows.

In September 2006, the Financial Accounting Standards Board (FASB) issued *Statement of Financial Accounting Standards (SFAS) No. 157*, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This statement applies in those instances where other accounting pronouncements require or permit fair value measurements, the board of directors

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. The Company is required to adopt SFAS 157 no later than the fiscal year beginning after November 15, 2007. The Company is currently evaluating the impact, if any, this pronouncement will have on its financial statements.

On July 13, 2006, the Financial Accounting Standards Board (FASB) issued *FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*. Interpretation 48 clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with Statement 109 and prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Additionally, Interpretation 48 provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. Interpretation 48 is effective for fiscal years beginning after December 15, 2006, with early adoption permitted. The Company adopted Interpretation 48 during fiscal year 2007. The Company did not record, and does not anticipate any adjustments resulting from the adoption of Interpretation 48.

In June 2006, the Financial Accounting Standards Board (FASB) ratified *Emerging Issues Task Force (EITF) No. 06-2, Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, Accounting for Compensated Absences (SFAS No. 43).* EITF 06-2 provides guidelines under which sabbatical leave or other similar benefits provided to an employee are considered to accumulate, as defined in SFAS 43. If such benefits are deemed to accumulate, then the compensation cost associated with a sabbatical or other similar benefit arrangement should be accrued over the requisite service period. The provisions of the EITF are effective for fiscal years beginning after December 15, 2006 and allow for either retrospective application or a cumulative effect adjustment approach upon adoption. The Company adopted EITF 06-2 during fiscal year 2007. The Company did not record, and does not anticipate any adjustments resulting from the adoption of EITF 06-2.

Reclassifications

Certain amounts in the 2006 financial statements have been reclassified to conform with the 2007 classifications. These reclassifications have no effect on reported net income.

2. Assets Held for Sale

In July 2007, our Board of Directors approved a plan to actively pursue potential purchasers of the Open File Manager product line. The Company has determined that the active pursuit of the sale of the product line meets the criteria that cause the related assets and liabilities to be classified as a disposal group, pursuant to SFAS No. 144. On August 14, 2007, the product line was sold. The sale is expected to result in a gain due to cash received and the immediate recognition of previously unrecognized deferred revenue.

In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets , the Company has classified the identifiable assets and liabilities of the disposal group as held for sale subsequent to June 30, 2007.

The carrying amounts of the major classes of assets and liabilities included as part of the disposal group are summarized below as follows:

	June 30, 2007	December 31, 2006
Assets	**$**	$
Current portion of deferred revenue	**(1,627,819)**	(1,915,611)
Long term portion of deferred revenue	**(274,681)**	(347,947)
Total carrying amount of the disposal group	**$ (1,902,500)**	$ (2,263,558)

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St. Bernard Software, Inc.

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3. Other Assets

Other assets consisted of the following:

	June 30, 2007	December 31, 2006
Capitalized software costs, net of amortization	**$ 2,217,248**	$ 2,500,496
Customer-related intangible, net of amortization	**1,115,833**	1,245,833
Security deposits	**207,529**	191,519
	$ 3,540,610	$ 3,937,848

Amortization for the customer related intangible is computed using the straight-line method over a useful life of five years. Amortization expense for the customer related intangible was approximately $65,000 and $0 for the three months ended June 30, 2007 and 2006, respectively, and $130,000 and $0 for the six months ended June 30, 2007 and 2006, respectively.

Amortization for the capitalized software costs are computed on an individual-product basis using the straight-line method over a useful life ranging from three to six years. Amortization expense related to capitalized software was approximately $142,000 and $22,000 for the three months ended June 30, 2007 and 2006, respectively, and $283,000 and $53,000 for six months ended June 30, 2007 and 2006, respectively. See Note 1 Intangible assets.

4. Debt

Line of Credit

The Company had a $1,250,000 line of credit with a finance company that automatically renewed every six months. The line of credit provided for advances of up to 80% of eligible accounts receivable. Interest was payable monthly at 1.5% per month (18% per annum). The agreement included a provision for a 1% annual renewal fee and a 1% per annum charge for the average daily unused portion of the line. The agreement allowed for termination without penalty but required thirty days notice. The line of credit was secured by all of the assets of the Company and all assets acquired by the Company during the term of the agreement. The Company was required to deliver all accounts receivable proceeds to the finance company upon receipt by the Company. In May 2007, the Company terminated the above detailed agreement. At June 30, 2007, the balance was zero on the line of credit with this finance company.

On May 15, 2007, St. Bernard Software, Inc., a Delaware corporation (***St. Bernard***), entered into a Loan and Security Agreement (the ***Loan Agreement***) with Silicon Valley Bank, a California corporation (***SVB***). Pursuant to the terms of the Loan Agreement, SVB has agreed to provide St. Bernard with a two year revolving line of credit equal to the lesser of (i) $4,000,000 or (ii) the amount of the Borrowing Base , or eligible accounts receivable, as described in the Loan Agreement. The Loan Agreement also provides for term loans up to $2,000,000 pursuant to which St. Bernard may request up to a maximum of six term loan advances, the first of which was made available after May 15, 2007, in the amount of $1,000,000. The Loan Agreement further provides for letters of credit, advances in connection with SVB cash management services and a special reserve for foreign currency exchange contracts with SVB which in the aggregate may not exceed $250,000. The borrowing availability on the revolving line of credit is reduced by the amount of outstanding principal of any term loans, any outstanding letters of credit, any

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St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

advances in connection with SVB cash management services and the amount of the reserve for foreign currency exchange contracts with SVB and is subject to the other terms and conditions described in the Loan Agreement. Advances under the revolving line of credit and the term loans shall accrue interest at a per annum rate equal to 2% above the greater of (i) SVB s announced prime rate or (ii) 7.50%.

The obligations under the Loan Agreement are secured by substantially all of St. Bernard s assets other than certain stock of St. Bernard s foreign subsidiary and certain intellectual property rights.

The Loan Agreement contains customary affirmative and negative covenants and other restrictions. The affirmative covenants include, among others, the delivery of financial statements and accounts receivables schedules to SVB, the maintenance of insurance and the maintenance of a minimum level of tangible net worth. St. Bernard has also agreed that without the consent of SVB, it shall refrain from activities such as engaging in a merger or acquisition, incurring indebtedness, paying dividends or making distributions to its stockholders, repurchasing capital stock or making payments on subordinated debt. At June 30, 2007 we were in compliance with the above stated covenants and restrictions.

The Loan Agreement states that the Company will pay interest only for the first six months on Term Loan Advances outstanding. Thereafter, each Term Loan Advance will be payable in equal monthly installments of principal, plus interest, based on a 36 month amortization schedule, commencing in November 2007 and continuing on the same date of each month thereafter until the Term Loan Maturity Date of May 2009, on which date all remaining principal and accrued interest shall be paid in full.

Additionally, the Loan Agreement contains customary events of default including the following: nonpayment of principle or interest; the violation of a Loan Agreement covenant; the occurrence of a material adverse change; the attachment of a material portion of St. Bernard s assets; insolvency; default by St. Bernard of any third party agreement pursuant to which the acceleration of $50,000 in principal may result; entry of a judgment equal or greater than $50,000 against St. Bernard; material misrepresentations by St. Bernard; and the default by St. Bernard under any subordinated debt. Upon the occurrence of an event of default by St. Bernard, the applicable interest rate shall become 5% above the rate that would otherwise be applicable.

In connection with the execution of the Loan Agreement, St. Bernard issued warrants to SVB on May 16, 2007, which allows SVB to purchase up to 100,000 shares of St. Bernard common stock at an exercise price of $1.60 per share. The warrants expire on the fifth anniversary of the warrant s issue date. Accordingly, the Company recorded prepaid interest expense in the amount of $91,000, based on the estimated fair value allocated to the warrants using the following assumptions; 73.56% volatility, risk free interest rate of 4.71%, an expected life of five years and no dividends. Amortization of the interest expense for the six months ended June 30, 2007 was immaterial. Furthermore, St. Bernard has agreed to grant SVB certain piggyback registration rights with respect to the shares of common stock underlying the warrants. As of June 30, 2007, the balance on the line of credit with SVB was approximately $2.3 million.

5. Stockholders Deficit

Warrants

As of June 30, 2007 and 2006, a total of 8,750,104 and 8,719,341 shares of common stock, respectively, were reserved for issuance for the exercise of warrants at an exercise price of $1.60, $1.85, $2.98 and $5.00 per share.

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St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

6. Related Party Transactions

A stockholder and former member of the Board of Directors provides legal services to the Company in the ordinary course of business. Therefore, amounts due to this related party s firm exist throughout the year. Billings from the firm totaled $14,000 and $430,000 for the three months ended June 30, 2007 and 2006, respectively, and $636,000 and $568,000 for the six months ended June 30, 2007 and 2006. Amounts due at June 30, 2007 and 2006 were $424,000 and $642,000, respectively.

The Company presently occupies office space provided by an affiliate of certain officers and directors of the Company. Such affiliate has agreed that it will make such office space, as well as certain office and secretarial services, available to the Company, as may be required by the Company from time to time. The Company has agreed to pay such affiliate $7,500 per month for such services.

7. Commitment and Contingencies

Litigation

In the normal course of business, the Company is occasionally named as a defendant in various lawsuits. On April 13, 2006, eSoft, Inc. filed Civil Action No. 00697-EWN-MJW in the U.S. District Court in Denver, Colorado alleging infringement of U.S. Patent No. 6,961,773 by St. Bernard Software, Inc. In connection with this proceeding, the Company filed a counter claim against the plaintiff alleging infringement of U.S. Patent No. 5,557,747. In February 2007, the Company paid a settlement for an undisclosed amount in the lawsuit with eSoft, Inc. In addition, the Company has agreed to a cross license of patent rights.

In March 2007, Arthur Budman, a stockholder of the Company, filed a lawsuit against the Company and the Chief Financial Officer (CFO) in the Superior Court of the State of California, San Diego County, seeking monetary damages arising from the alleged negligence of the CFO in connection with communications regarding the terms of the merger of Old St. Bernard Software, Inc. and Sand Hill. It is the opinion of management that the outcome of this pending lawsuit will not materially affect the operations, the financial position, or cash flows of the Company.

Miscellaneous contingency

In January of 2006, an enterprise wide review of job descriptions and employee classifications was conducted by the Company. Based upon current responsibilities, certain exempt /non exempt classifications were updated. Any changes in classifications will be implemented going forward.

As a result of the update in employee classifications, there could be potential assertions from current and former employees that they were entitled to certain benefits under a non exempt classification pursuant to the Fair Labor Standards Act and state law.

In accordance with SFAS No. 5, Accounting for Contingencies , the Company has not recorded a provision since there are no pending claims and it is not probable that a claim will be asserted. The amount of any potential loss cannot be reasonably estimated.

8. Concentrations

Sales and revenue

The Company considers itself to operate within one business segment, Secure Content Management (SCM). For the six months ended June 30, 2007 and 2006, approximately 92% and 95% of the Company s revenue was in North America, the remaining 8% and 5%, respectively, were disbursed over the rest of the world.

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St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

9. Asset Sale and License Agreement

On January 29, 2007, pursuant to the terms of an Asset Sale and License Agreement signed and effective as of January 4, 2007 (the ***Agreement***), by and between the Company and Shavlik Technologies, LLC (***Shavlik***), St. Bernard assigned and sold to Shavlik St. Bernard s UpdateEXPERT and UpdateEXPERT Premium software applications and related customer and end user license agreements, software, programming interfaces and other intellectual property rights and contracts for an aggregate purchase price of $1.2 million plus 45% of any maintenance renewal fees collected by Shavlik in excess of $1.2 million for renewals invoiced by Shavlik between February 1, 2007 and January 31, 2008 (the ***Asset Sale***). As a result of the sale, the Company realized a gain of $3.7 million primarily due to the immediate recognition of deferred revenue offset by a loss of $0.3 million during the three months ended June 30, 2007 due to uncollectible accounts receivable amounts.

10. Subsequent Events

Asset Purchase Agreement

On August 14, 2007, pursuant to the terms of a Purchase Agreement signed and effective as of August 13, 2007 (the ***Agreement***), by and between the Company and EVault, Inc., a wholly owned subsidiary of Seagate Technology, Inc., (***EVault***), St. Bernard assigned and sold to EVault St. Bernard s Open File Manager (the ***Product***) software applications, which include all of the rights, title, and interest worldwide of St. Bernard in and to (i) the Product, (ii) the Assumed Contracts, (iii) the St. Bernard Materials, (iv) all St. Bernard Intellectual Property Rights, (v) all claims of St. Bernard against third parties relating to the Purchased Assets, whether choate or inchoate, known or unknown, contingent or noncontingent, (vi) all data and information that is collected from, or on behalf of, customers of St. Bernard who are party to the Assumed Contracts (the ***Customer Base)***, the OEM Partners and any Lead, including to the extent that receipt of such information would not violate any applicable Law, (vii) all routing and billing information and components used in connection with the Assumed Contracts, and (viii) all other tangible or intangible asset of St. Bernard used in the Business and necessary for the operation or use of the Product for an aggregate purchase price of $6.9 million. As a result of the sale, the Company realized a gain of approximately $8.6 million in August 2007, primarily due to cash received and the immediate recognition of previously unrecognized deferred revenue. See Note 2.

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

This Form 10-QSB contains forward-looking statements concerning our anticipated future revenues and earnings, adequacy of future cash flow, and related matters. These forward-looking statements include, but are not limited to, statements or phrases such as believe, will, expect, anticipate, estimate, intend, plan, and would and similar expressions, and the negative thereof. Forward-looking statements are not guarantee performance. We assume no obligation to update any such forward-looking statements, and these statements involve risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements. For a summary of such risks and uncertainties, please see Risk Factors located in our Annual Report on Form 10-KSB for the year ended December 31, 2006 filed with the Securities and Exchange Commission on April 2, 2007.

OVERVIEW

Our Business

We design, develop, and market secure content management (SCM) solutions that enable our customers to efficiently filter email, instant messaging (IM) and web usage. Our solutions block spam and viruses, and enforce acceptable use policies with respect to web access and email and IM usage. We provide additional capabilities in business continuity and compliance via hosted archiving of email and IM messages. We also provide customers with a hosted, on-demand email system that includes calendaring, a Web 2.0 interface and mobile user support. Our solutions are delivered as appliances and as on-demand software as a service (SaaS).

Our customers include more than 5,000 business, education, and government institutions. Our customers purchase our solutions directly from us, through our 1-tier and 2-tier reseller network, and through, original equipment manufacturers, (OEMs). Appliance purchases consist of an initial hardware purchase and software subscription, with recurring fees for data and maintenance. SaaS purchases consist of a single or multi-year subscription to the hosted services. Our primary customers are IT managers, directors, and administrators.

We invested significantly in research and development activities and for the six months ended June 30, 2007 and 2006 we spent $3.7 million and $3.0 million, respectively, on research and development. Our research and development efforts have been focused on network based secure content management solutions and expanding our product portfolio into new delivery models, such as SaaS, and additional secure content management markets, such as messaging security, business continuity and email systems, and consolidating these products under a common console.

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Our Strategy

During 2005, we undertook an evaluation of the appropriate long-term strategy for our business. As a result of that process, we determined that we should continue to build on our existing small and medium enterprise security business by increasing our penetration of the secure content management market, and also seek to expand into broader security segments, such as messaging security. We also believed that the software industry was undergoing a trend towards consolidation, and that the areas of security, content management and compliance were beginning to converge. Commencing in the first half of 2005 and continuing through the third quarter of 2006, we investigated business combinations and other strategic transactions that would allow us to expand our security products and service offerings into one or more other key areas of the small and medium size enterprise secure content management market. We focused on acquiring anti-phishing, instant messaging management, anti-spyware and email filtering technologies in our initial pursuit of the expansion of our security business with our adjacent secure content management software products.

Our Business Growth

We have historically grown internally and through acquisitions. On October 26, 2005 we entered into a merger agreement with Sand Hill IT Security Acquisition Corp., Sand Hill or Parent, a publicly held Delaware corporation. On July 27, 2006 stockholders of Sand Hill voted to approve the merger agreement and the transactions set forth therein in which we became the Parent s wholly-owned subsidiary. Sand Hill then changed its name to St. Bernard Software, Inc.

The shares of common stock held by the former stockholders of the private company in the merger were converted into a total of 9,733,771 shares of our stock, or approximately 69.2% of our outstanding common stock following the merger.

Upon consummation of the merger, approximately $22.3 million was released from trust to be used by the combined company. With respect to the business combination, any public stockholder who voted against the merger could demand that we redeem their shares. The per share redemption price was equal to $5.40 per share. After payments of redeemed shares of approximately $4.2 million and costs related to the merger of approximately $1.3 million the net proceeds received by us were approximately $16.8 million. The costs incurred in connection with the merger were reflected as a reduction to the proceeds as of the effective date of the merger.

For accounting purposes the merger was accounted for as a reverse acquisition. Under this method of accounting, Sand Hill was treated as the acquired company. Accordingly, for accounting purposes, the merger was treated as the equivalent of the private company in the merger issuing stock for the net monetary assets of Sand Hill. Our historical financial statements prior to July 27, 2006, are those of the private company in the merger. All historical share and per share amounts have been retroactively adjusted, using a conversion factor of 0.419612277 to give effect to the reverse acquisition of Sand Hill.

Effective October 17, 2006, we acquired AgaveOne, Inc., a Nevada corporation doing business as Singlefin. Singlefin provided on-demand security and business services to small and medium sized companies, including email filtering, web filtering and instant messaging management as a hosted or on demand service. In connection with the Singlefin acquisition, we paid Singlefin stockholders and option holders $0.47 million in cash, issued 471,288 shares of common stock and assumed certain stock options

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granted by Singlefin and converted them into options to acquire 47,423 shares of our common stock. During the quarter ended June 30, 2007, the shares issued in conjunction with the purchase were reduced by 66,667 as a result of indemnification claims. We also satisfied $5.5 million in Singlefin indebtedness and certain Singlefin employees received bonuses totaling $0.25 million. The aggregate value of the transaction was approximately $8.0 million.

Our Financial Results

For the quarter ended June 30, 2007, net revenue was $5.0 million, a decrease of 10.7% over the same period in 2006. The net loss for the quarter ended June 30, 2007 was $4.7 million, an increase from the second quarter of 2006 of 291.7%. Basic and diluted net loss per share was $0.32 for the three months ended June 30, 2007, an increase from a net loss per share of $0.12 reported in the same period in 2006, primarily the result of an increase in our operating expenses. The increase in operating expenses was mainly attributable to an increase of $0.7 million, or 25.9%, for sales and marketing expenses due to additional channel sales staff, which lead to an increase in base wages and commissions, and an increase in advertising expenses related to additional marketing for LivePrism on-demand service. In addition, an increase of $1.4 million or 140.0% for general and administrative expenses for the three months ended June 30, 2007 over the same period in 2006 was largely due to the costs associated with being a public company, which included an increase in compensation expenses and bonuses, an increase in legal costs, an increase in accounting costs, an increase in contract labor and consulting services, and an increase in insurance expenses.

We reported revenues of $10.4 million for the first six months of 2007 compared to $10.9 million in the same period last year, a decrease of 4.6%; a net loss for the first six months of 2007 of $5.7 million, compared to a net loss of $2.4 million in the same period last year; net basic loss per share for the first six months of 2007 was $0.38, compared to $0.25 reported in the same period last year.

Cash used by operations for the six months ended June 30, 2007 was $7.4 million compared to cash provided during the six months ended June 30, 2006 of $0.02 million. The increased use of cash was due primarily to an increased investment in general and administrative expenses due to being a public company of $3.0 million, an increased investment in sales and marketing of $2.2 million, a reduction in gross profit of $1.0 million, an increased investment in research and development of $0.7 million, a reduction of accounts payable of $0.6 million, and an increase in accrued expenses and other current liabilities of $0.1 million. Research, development, software license, and technical support costs for the on-demand service product group totaled $1.8 million for the six months ended June 30, 2007. These costs did not exist during the six months ended June 30, 2006.

We utilize cash in ways that management believes provide an optimal return on investment. Principal uses of our cash for investing and financing activities include new product development, acquisition of technologies, and purchases of property and equipment.

On May 15, 2007, we established a line of credit with Silicon Valley Bank, terminating our line of credit with Camel Financial. See section titled, Credit Facility for the terms of the agreement with Silicon Valley Bank. The balance on the line of credit with SVB was approximately $2.3 million as of June 30, 2007.

During the six months ended June 30, 2007, we continued to invest in product development. Two product extension efforts were underway during the quarter to enhance the features of iPrism version 4.0 and LivePrism.

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Critical Accounting Policies and Estimates

There are several accounting policies that are critical to understanding our historical and future performance, because these policies affect the reported amounts of revenue and other significant areas in our reported financial statements and involve management s judgments and estimates. These critical accounting policies and estimates include:

- revenue recognition;
- allowance for doubtful accounts;
- impairment of goodwill and long-lived assets;
- accounting for income taxes; and
- accounting for stock options.

These policies and estimates and our procedures related to these policies and estimates are described in detail below and under specific areas within the discussion and analysis of our financial condition and results of operations. Please refer to Note 1, Summary of Significant Accounting Policies in the Notes to Consolidated Financial Statements of St. Bernard for the six months ended June 30, 2007 included herein for further discussion of our accounting policies and estimates. There have been no material changes to these accounting policies during the six months ended June 30, 2007.

Revenue Recognition

We make significant judgments related to revenue recognition. For each arrangement, we make significant judgments regarding the fair value of multiple elements contained in our arrangements, judgments regarding whether our fees are fixed or determinable and judgments regarding whether collection is probable. We also make significant judgments when accounting for potential product returns. These judgments, and their effect on revenue recognition, are discussed below.

Multiple Element Arrangements

We typically enter into arrangements with customers that include perpetual software licenses, database subscriptions, hardware appliances, maintenance and technical support. Software licenses are on a per copy basis. Per copy licenses give customers the right to use a single copy of licensed software. We make judgments regarding the fair value of each element in the arrangement and generally account for each element separately.

Assuming all other revenue recognition criteria are met, license and appliance and product revenue is recognized upon delivery in accordance with Statement of Position, or SOP, 97-2 *Software Revenue Recognition*. Under 97-2, we have established vendor specific objective evidence, or VSOE, on each element of multiple element arrangements using the price charged when the same element is sold separately. Undelivered elements typically include subscription, maintenance and technical support and are recognized ratably over the term.

If we cannot establish fair value for any undelivered element, we would be required to recognize revenue for the whole arrangement at the time revenue recognition criteria for the undelivered element is met using *Statement of Position (SOP) No. 98-9, Modification of SOP No. 97-2 Software Revenue Recognition*, with respect to Certain Transactions.

The Fee is Fixed or Determinable

Management makes judgments, at the outset of an arrangement, regarding whether the fees are fixed or determinable. Our customary payment terms generally require payment within 30 days after the invoice date. Arrangements with payment terms extending beyond 120 days after the effective date of the license agreement are not considered to be fixed or determinable, in which case revenue is recognized as the fees become due and payable.

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Collection is Probable

Management also makes judgments at the outset of an arrangement regarding whether collection is probable. Probability of collection is assessed on a customer-by-customer basis. We typically sell to customers with whom we have a history of successful collections. New customers can be subjected to a credit review process to evaluate the customer s financial position and ability to pay. If it is determined at the outset of an arrangement that collection is not probable, then revenue is recognized upon receipt of payment.

Indirect Channel Sales

We generally recognize revenue from licensing of software products through our indirect sales channel upon sell-through or when evidence of an end-user exists. For certain types of customers, such as distributors, we recognize revenue upon receipt of a point of sales report, which is our evidence that the products have been sold through to an end-user. For resellers, we recognize revenue when we obtain evidence that an end-user exists, which is usually when the software is delivered. For licensing of our software to original equipment manufacturers, or OEMs, royalty revenue is recognized when the OEM reports the sale of software to an end-user customer, in some instances, on a quarterly basis.

Delivery of Software Products

Our software may be physically delivered to our customers with title transferred upon shipment to the customer. We primarily deliver our software electronically, by making it available for download by our customers or by installation at the customer site. Delivery is considered complete when the software products have been shipped and the customer has access to license keys. If an arrangement includes an acceptance provision, we generally defer the revenue and recognize it upon the earlier of receipt of written customer acceptance or expiration of the acceptance period.

Product Returns and Exchanges

Our license arrangements do not typically provide customers a contractual right of return. Some of our sales programs allow customers limited product exchange rights. Management estimates potential future product returns and exchanges and reduces current period product revenue in accordance with *Statement of Financial Accounting Standards (SFAS) No. 48, Revenue Recognition When Right of Return Exists* . The estimate is based on an analysis of historical returns and exchanges. Actual returns may vary from estimates if we experience a change in actual sales, returns or exchange patterns due to unanticipated changes in products, competitive or economic conditions.

Allowance for Doubtful Accounts

Management estimates potential future uncollectible accounts and recognizes expense as appropriate. The estimate is based on an analysis of historical uncollectible accounts and on a review of all significant outstanding invoices. Actual bad debts may vary from estimates if we experience a change in actual sales, returns or exchange patterns due to unanticipated changes in products, competitive or economic conditions.

Impairment of Goodwill and Long-Lived Assets

In accordance with the *Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets* , management tests our goodwill for impairment annually and whenever events or changes in circumstances suggest that the carrying amount may not be recoverable.

We compare the implied fair value of our reporting unit s goodwill to its carrying amount. If the carrying amount of our reporting unit s goodwill exceeds its fair value, an impairment loss will be recognized in an amount equal to that excess.

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Goodwill arose through business acquisitions made in 2000 and 2006. We completed the test for the goodwill that arose in 2000 during the fourth quarter of 2006, and we were not required to record an impairment loss on that goodwill. As a result of our significant underperformance relative to the expected operating results, we tested our goodwill that arose in 2006 for impairment as of June 30, 2007 in accordance with SFAS No. 142. We were not required to record an impairment loss on that goodwill. The Company is one reporting unit for purposes of testing goodwill.

In accordance with *Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets* , management reviews our long-lived asset groups, including property and equipment and other intangibles, for impairment and whenever events indicate that their carrying amount may not be recoverable. When management determines that one or more impairment indicators are present for an asset group, we compare the carrying amount of the asset group to net future undiscounted cash flows that the asset group is expected to generate. If the carrying amount of the asset group is greater than the net future undiscounted cash flows that the asset group is expected to generate, we compare the fair value to the book value of the asset group. If the fair value is less than the book value, we would recognize an impairment loss. The impairment loss would be the excess of the carrying amount of the asset group over its fair value. As a result of our significant underperformance relative to the expected operating results, we tested our intangible assets for impairment as of June 30, 2007. Based upon the results of the impairment test, management of the Company has concluded that there was no impairment of intangible assets at June 30, 2007. It is possible that we will have an impairment of intangible assets in the future if our on-demand service billings do not meet our expectations.

Some of the events that we consider as impairment indicators for our long-lived assets, including goodwill, are:

- our significant underperformance relative to expected operating results;
- significant adverse change in legal factors or in the business climate;
- an adverse action or assessment by a regulator;
- unanticipated competition;
- a loss of key personnel;
- significant decrease in the market value of a long-lived asset; and
- significant adverse change in the extent or manner in which a long-lived asset is being used or its physical condition.

Significant assumptions and estimates are made when determining if our goodwill or other long-lived assets have been impaired or if there are indicators of impairment. Management bases its estimates on assumptions that it believes to be reasonable, but actual future results may differ from those estimates as our assumptions are inherently unpredictable and uncertain. Management s estimates include estimates of future market growth and trends, forecasted revenue and costs, expected periods of asset utilization, appropriate discount rates and other variables.

In July 2007, our Board of Directors approved a plan to actively pursue potential purchasers of our Open File Manager product line. The Company has determined that the active pursuit of the sale of the product line meets the criteria that cause the related assets and liabilities to be classified as a disposal group, pursuant to SFAS No. 144. On August 14, 2007, the product line was sold. The sale is expected to result in a gain due to cash received and the immediate recognition of previously unrecognized deferred revenue.

In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets , the Company has classified the identifiable assets and liabilities of the Open File Manager product group as held for sale subsequent to June 30, 2007. See Note 2 in the Notes to the Consolidated Financial Statements.

Accounting for Income Taxes

We are required to estimate our income taxes in each federal, state and international jurisdiction in which we operate. This process requires that management estimate the current tax exposure as well as assess temporary differences between the accounting and tax treatment of assets and liabilities, including items such as accruals and allowances not currently deductible for tax purposes. The income tax effects of the differences identified are classified as current or long-term deferred tax assets and liabilities in our consolidated balance sheets. Management s judgments, assumptions and estimates relative to the current provision for income tax take into account current tax laws, our interpretation of current tax laws and possible outcomes of current and future audits conducted by foreign and domestic tax authorities. Changes in tax laws or management s interpretation of tax laws, including the provisions of the American Jobs Creation Act of 2004, and the resolution of current and future tax audits could significantly impact the amounts provided for income taxes in our balance sheet and results of operations. We must also assess the likelihood that deferred tax assets will be realized from future taxable income and, based on this assessment, establish a valuation allowance if required. As of June 30, 2007, the deferred tax assets were fully reserved. The deferred tax assets include net operating losses and may be subject to significant annual limitation under certain provisions of the Internal Revenue Code of 1986, as amended. Management s determination of valuation allowance is based upon a number of assumptions, judgments and estimates, including forecasted earnings, future taxable income and the relative proportions of revenue and income before taxes in the various domestic and international jurisdictions in which we operate.

Commitments and Contingencies

Effective October 1, 2006, we adopted the provisions of FASB Staff Position (FSP) *Emerging Issue Task Force (EITF) 00-19-2, Accounting for Registration Payment Arrangements* . As a result we changed the manner in which we account for the warrants that were issued subject to a registration payment arrangement by Sand Hill during 2004. Pursuant to the FSP which was posted December 21, 2006, we now account for the registration rights contained in the warrants separately and measures the liability under *FASB SFAS No. 5, Accounting for Contingencies* and FASB *Interpretation (FIN) No. 14, Reasonable Estimation of the Amount of a Loss* . As a result of the application of transition guidance in the FSP, we reported a change in accounting principle through a cumulative-effect adjustment. The warrant liability originally recorded of approximately $8.1 million was transferred to additional paid in capital and retained earnings was adjusted for approximately $2.6 million, which is the difference in the carrying amount of the instrument recorded as a liability immediately prior to the adoption of the FSP and the amount reclassified to equity. We have chosen early adoption of this FSP. Pursuant to FASB SFAS No. 5, a loss contingency is to be accrued only if it is probable and can be reasonably estimated. We have determined that a loss contingency related to the registration requirements in the warrants is not probable.

In January 2006, we conducted an enterprise wide review of job descriptions and employee classifications. Based upon current responsibilities, certain exempt/nonexempt classifications were updated. Changes in classifications were implemented going forward.

As a result of the update in employee classifications, there could be potential assertions from current and former employees that they were entitled to certain benefits under a non exempt classification pursuant to the Fair Labor Standards Act and state law.

In accordance with *SFAS No. 5, Accounting for Contingencies* , we have not recorded a provision since there are no pending claims and it is not probable that a claim will be asserted. The amount of any potential loss cannot be reasonably estimated.

In the normal course of business, we are occasionally named as a defendant in various lawsuits. On April 13, 2006, eSoft, Inc. filed Civil Action No. 00697-EWN-MJW in the U.S. District Court in Denver,

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Colorado alleging infringement of U.S. Patent No. 6,961,773 by our Company. In connection with this proceeding, we filed a counter claim against the plaintiff alleging infringement of U.S. Patent No. 5,557,747. In February 2007, we paid a settlement for an undisclosed amount in the lawsuit with eSoft, Inc. In addition, we agreed to a cross license of patent rights.

In March 2007, Arthur Budman, a stockholder of the Company, filed a lawsuit against the Company and the Chief Financial Officer, CFO, in the Superior Court of the State of California, San Diego County, seeking monetary damages arising from the alleged negligence of the CFO in connection with communications regarding the terms of the merger of Old St. Bernard Software, Inc. and Sand Hill. It is the opinion of management that the outcome of this litigation will not materially affect the operations, the financial position, or cash flows of the Company.

Results of Operations of St. Bernard Software, Inc.

Comparison of the Three Months Ended June 30, 2007 and 2006

Net Revenues

	For the Three Months Ended June 30, 2007	For the Three Months Ended June 30, 2006	% Change
	(In millions, except percentages)		
Total net revenue	$ 5.0	$ 5.6	(10.7)%

Net revenues decreased $0.6 million for the three months ended June 30, 2007 compared to the same period in the prior year due primarily to a decrease in license revenue of $0.4 million and a decrease in subscription revenue of $0.2 million. See discussion of changes in net license revenue and net subscription revenue below.

Net License Revenues

	For the Three Months Ended June 30, 2007	For the Three Months Ended June 30, 2006	% Change
	(In millions, except percentages)		
Net license revenue	$ 0.6	$ 1.0	(40.0)%
As a percentage of net revenue	12.0%	17.9%	

For the three months ended June 30, 2007, our net license revenue decreased $0.4 million as compared to the same period in 2006 due primarily to a decrease in UpdateEXPERT license revenue. We sold the UpdateEXPERT product line to Shavlik Technologies in January 2007.

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Net Appliance Revenues

	For the Three Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Net appliance revenue	$ 0.9	$ 0.8	12.5%
As a percentage of net revenue	18.0%	14.3%	

For the three months ended June 30, 2007, appliance hardware sales increased by $0.1 million due primarily to a reduction in discounts applied to sales of the model 500 iPrism appliance and two sales which included a large number of appliances. Total units sold for the three months ended June 30, 2007 and 2006 were 525 and 514, respectively.

Net Subscription Revenues

	For the Three Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Net subscription revenue	$ 3.6	$ 3.8	(5.3)%
As a percentage of net revenue	72.0%	67.9%	

For the three months ended June 30, 2007, our subscription revenue decreased $0.2 million over the same period in 2006 due primarily to the sale of UpdateEXPERT to Shavlik Technologies in January 2007. In addition, as of January 2007, we no longer marketed our Open File Manager product line, causing the subscription revenue for that product to decline in the three months ended June 30, 2007, as compared to the same period on 2006. More marketing efforts were concentrated towards the iPrism product line and the LivePrism product line. Renewal rates for our products range from 75% to 95%.

Cost of Revenue

	For the Three Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Total cost of revenue	$ 1.8	$ 1.6	12.5%
Gross margin percent	64.0%	71.4%	

Cost of revenue consists primarily of the cost of contract manufactured hardware, royalties paid to third parties under technology licensing agreements, packaging costs, fee-based technical support costs and freight. Cost of revenue increased $0.2 million for the three months ended June 30, 2007, compared to the same period in 2006. Gross margin decreased 7.4% for the three months ended June 30, 2007, as compared to the same period in 2006 primarily due to an increase in appliance hardware costs and the addition of LivePrism costs, which include direct subscription costs and payroll related costs for our LivePrism technical support staff. The LivePrism product line has not gained adequate revenue traction to support its costs of revenue.

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Cost of Appliance Revenue

	For the Three Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Total cost of appliance revenue	$ 0.8	$ 0.6	33.3%
Gross margin percent	11.1%	25.0%	

The cost of appliance revenue includes contract manufactured equipment, packaging and freight. The cost of hardware for the three months ended June 30, 2007 increased $0.2 million from the same period in 2006. The increase was due primarily to an increase of the amount of units shipped from the same period in 2006. The 13.9% decrease in gross margin percentage for the three months ended June 30, 2007 compared to the same period in 2006 can be attributed to the 12.5% increase in appliance revenue compared to a 33.3% increase in the costs of appliance revenue. The increase in costs of appliance revenue was primarily due to increased costs of freight, as well as an increase in the net number of outstanding customer-service replacement units at June 30, 2007 compared to June 30, 2006

Cost of Subscription Revenue

	For the Three Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Total cost of subscription revenue	$ 1.0	$ 1.0	0.0%
Gross margin percent	72.2%	73.7%	

The cost of subscription revenue includes the technical operation group that maintains the various databases and the technical support group. The cost of subscription revenue remained unchanged for the three months ended June 30, 2007 compared to the same period in 2006.

Sales and Marketing

	For the Three Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Total sales and marketing	$ 3.4	$ 2.7	25.9%
As a percentage of net revenue	68.0%	48.2%	

Sales and marketing expenses consist primarily of salaries, related benefits, commissions, consultant fees, advertising, lead generation and other costs associated with our sales and marketing efforts. For the three months ended June 30, 2007, the sales and marketing expenses increased 25.9%, or $0.7 million, over the same period in 2006. The increase was primarily due to the hiring of additional channel sales staff as part of the expansion of the channel sales program in order to reach a broader customer base. This decision resulted in increased compensation expenses and commissions of $0.5 million, attributed to higher base salaries. In addition, there was an increase in advertising expenses related to the on-demand product line of $0.2 million in the three months ended June 30, 2007. Sales and marketing expenses are incurred to generate billings, which are deferred and recognized according to Generally Accepted Accounting Principles (GAAP).

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Research and Development

	For the Three Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Total research and development	$ 1.8	$ 1.4	28.6%%
As a percentage of net revenue	36.0%	25.0%	

Research and development expense consists primarily of salaries, related benefits, third-party consultant fees and other engineering related costs. The increase of $0.4 million for the three months ended June 30, 2007 compared to the same period in 2006 was primarily the result of an increase of $0.3 million in compensation costs for additional specialized staff related to the expanded data center development, combined with an increase of $0.1 million in other research and development expenses. Management believes that a significant level of research and development investment is required to remain competitive and we expect to continue to invest in research and development activities.

We believe that the present level of research and development costs in the second quarter of 2007 will be sufficient in the future to keep the existing products competitive, however, additional development staff and other development resources will be required if a new product development effort is undertaken.

General and Administrative

	For the Three Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Total general and administrative	$ 2.4	$ 1.0	140.0%
As a percentage of net revenue	48.0%	17.9%	

General and administrative expenses consist primarily of salaries, related benefits, and fees for professional services, such as legal and accounting services. General and administrative expenses increased $1.4 million for the three months ended June 30, 2007 compared to the same period in 2006, largely due to an increase in compensation expenses and bonuses of approximately $0.4 million, $0.3 million in FAS 123R expenses, an increase in contract labor and consulting services of $0.2 million due to a combination of SOX 404 consulting fees, Board of Director fees, and IT consulting fees, and the amortization of the capitalized intangible assets of AgaveOne of approximately $0.2 million. In addition, there was an increase in accounting costs of $0.1 million, an increase in legal fees of $0.1 million, and an increase in insurance expenses of $0.1 million. The increased expenses for accounting, legal, and insurance costs are associated with being a public company.

Interest and Other Income, Net

	For the Three Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Total interest and other income, net	$ 0.1	$ 0.1	0.0%
As a percentage of net revenue	2.0%	1.8%	

Interest and other expenses, net, includes interest expenses, interest income, and other expenses. There was no change in interest expense for the three months ended June 30, 2007 over the same period in 2006.

Gain on sale of asset

	For the Three Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Gain (loss) on sale of asset	$ (0.3)	$ 0.0	(100.0)%
As a percentage of net revenue	(0.6)%	0.0%	

The loss on the sale of asset of approximately $0.3 million was due to the sale of our UpdateEXPERT product line. As a result of the sale, the Company realized a loss of $0.3 million during the three months ended June 30, 2007 due to uncollectible accounts receivable amounts.

Comparison of the Six Months Ended June 30, 2007 and 2006

Net Revenues

	For the Six Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Total net revenue	$ 10.4	$ 10.9	(4.6)%

Net revenues decreased $0.5 million for the six months ended June 30, 2007 compared to the same period in the prior year due primarily to a decrease in license revenue of $0.5 million. See discussion of changes in net license revenue below.

Net License Revenues

	For the Six Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Net license revenue	$ 1.4	$ 1.9	(26.3)%
As a percentage of net revenue	13.5%	17.4%	

For the six months ended June 30, 2007, our net license revenue decreased $0.5 million as compared to the same period in 2006. The license revenue decrease was primarily due to a decrease in the UpdateEXPERT license revenue. We sold the UpdateEXPERT product line to Shavlik Technologies in January 2007.

Net Appliance Revenues

	For the Six Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Net appliance revenue	$ 1.6	$ 1.4	14.3%
As a percentage of net revenue	15.4%	12.8%	

For the six months ended June 30, 2007, appliance hardware sales increased by $0.2 million due primarily to more appliance units sold as compared to the same period in 2006. In June 2007, we completed two sales which included a large number of appliances. Total units sold for the six months ended June 30, 2007 and 2006 were 923 and 883, respectively.

Net Subscription Revenues

	For the Six Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Net subscription revenue	$ 7.4	$ 7.6	(2.6)%
As a percentage of net revenue	71.2%	69.7%	

For the six months ended June 30, 2007, our subscription revenue decreased $0.2 million over the same period in 2006 due primarily to the sale of the UpdateEXPERT product line to Shavlik Technologies in January 2007. In addition, as of January 2007, we no longer marketed our Open File Manager product line, causing the subscription revenue for that product to decline in the six months ended June 30, 2007 as compared to the same period on 2006. More marketing efforts were concentrated towards the iPrism product line and the launch of our LivePrism product line. Renewal rates for our products range from 75% to 95%.

Cost of Revenue

	For the Six Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Total cost of revenue	$ 3.5	$ 2.9	20.7%
Gross margin percent	66.3%	73.4%	

Cost of revenue consists primarily of the cost of contract manufactured hardware, royalties paid to third parties under technology licensing agreements, packaging costs, fee-based technical support costs and freight. Cost of revenue increased $0.6 million for the six months ended June 30, 2007 compared to the same period in 2006. Gross margin decreased 7.1% for the six months ended June 30, 2007 compared to the same period in 2006, primarily due to an increase in appliance hardware costs, and the addition of LivePrism costs, which include direct subscription costs and payroll related costs for our LivePrism technical support staff The LivePrism product line has not gained adequate revenue traction to support its costs of revenue.

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Cost of Appliance Revenue

	For the Six Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Total cost of appliance revenue	$ 1.3	$ 1.0	30.0%
Gross margin percent	18.8%	28.6%	

The cost of appliance revenue includes contract manufactured equipment, packaging and freight. The cost of hardware for the six months ended June 30, 2007 increased $0.3 million from the same period in 2006. The increase was due primarily to an increase in the amount of units shipped from the same period in 2006. The 9.8% decrease in gross margin percentage for the six months ended June 30, 2007 compared to the same period in 2006 can be attributed to the 14.3% increase in appliance revenue compared to a 30.0% increase in the costs of appliance revenue. The increase in costs of appliance revenue was primarily due to increased costs of freight, as well as an increase in the net number of outstanding customer-service replacement units at June 30, 2007 compared to June 30, 2006

Cost of Subscription Revenue

	For the Six Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Total cost of subscription revenue	$ 2.1	$ 1.9	10.5%
Gross margin percent	71.6%	75.0%	

The cost of subscription revenue includes the technical operation group that maintains the various databases and the technical support group. The cost of subscription revenue increased $0.2 million for the six months ended June 30, 2007 compared to the same period in 2006. The increase in cost of subscription revenue in 2007 was primarily due to payroll related expenses and other direct expenses related to LivePrism, a subscription only product, which was launched in the first quarter of 2007. Gross margin decreased 3.4% for six months ended June 30, 2007 compared to the same period in 2006 primarily due to the increased costs to support our subscription services, mostly attributable to our LivePrism product line.

Sales and Marketing

	For the Six Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Total sales and marketing	$ 7.5	$ 5.3	41.5%

As a percentage of net revenue	72.1%	48.6%

Sales and marketing expenses consist primarily of salaries, related benefits, commissions, consultant fees, advertising, lead generation and other costs associated with our sales and marketing efforts. For the six months ended June 30, 2007, the sales and marketing expenses increased 41.5%, or $2.2 million, over the same period in 2006. The increase was primarily due to the hiring of additional channel sales staff as a result of a decision to expand the channel sales program in order to reach a broader customer base. This decision resulted in an increase in compensation expenses and commissions of $1.1 million, which was primarily attributed to higher base salaries for the additional staff. In addition, there was an increase in advertising expenses related to the on-demand product line of $0.7 million, an increase in consulting expenses of $0.1 million due to the reorganization of our EMEA office, an increase in travel expenses of $0.1 million due to additional travel for the increased sales staff, and an increase of $0.2 million in other sales and marketing related expenses in the six months ended June 30, 2007. Sales and marketing expenses are incurred to generate billings, which are deferred and recognized according to Generally Accepted Accounting Principles (GAAP).

Research and Development

	For the Six Months Ended June 30,		
	2007	2006	% Change
	(In millions, except percentages)		
Total research and development	$ 3.7	$ 3.0	23.3%
As a percentage of net revenue	35.6%	27.5%	

Research and development expense consists primarily of salaries, related benefits, third-party consultant fees and other engineering related costs. The increase of $0.7 million for the six months ended June 30, 2007 compared to the same period in 2006 was primarily the result of an increase of $0.6 million in compensation costs for additional specialized staff related to the expanded data center development, combined with an increase of $0.1 million in other research and development expenses. Management believes that a significant level of research and development investment is required to remain competitive and we expect to continue to invest in research and development activities.

We believe that the present level of research and development costs in the second quarter of 2007 will be sufficient in the future to keep the existing products competitive, however, additional development staff and other development resources will be required if a new product development effort is undertaken.

General and Administrative

	For the Six Months Ended June 30,		
	2007	2006	% Change
	(In millions, except percentages)		
Total general and administrative	$ 4.9	$ 1.9	157.9%
As a percentage of net revenue	47.1%	17.4%	

General and administrative expenses consist primarily of salaries, related benefits, and fees for professional services, such as legal and accounting services. General and administrative expenses increased $3.0 million for the six months ended June 30, 2007 compared to the same period in 2006, largely due to an increase in compensation expense and bonuses of $1.5 million, which includes FAS 123R expenses of $0.6 million, an increase in amortization expenses of approximately $0.4 million due to the amortization of capitalized intangible assets related to Agaveone, an increase in legal costs of $0.3 million, an increase in accounting costs of $0.3 million, an increase in contract labor and consulting services of $0.3 million due to a combination of SOX 404 consulting fees, Board of Director fees, and IT consulting fees, and an increase in insurance expenses of $0.2 million. The increase in accounting, legal, and insurance costs was due to the costs associated with being a public company.

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Interest and Other Income, Net

	For the Six Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Total interest and other income, net	$ 0.1	$ 0.2	(50.0)%
As a percentage of net revenue	1.0%	1.8%	

Interest and other expenses, net, includes interest expenses, interest income, and other expenses. There was a decrease in interest expense of approximately $0.1 million for the six months ended June 30, 2007 over the same period in 2006 because we paid off the note we had with our former CEO during 2006, and therefore, the interest associated with the note did not exist in 2007.

Gain on sale of asset

	For the Six Months Ended June 30, 2007	2006	% Change
	(In millions, except percentages)		
Gain on sale of asset	$ 3.5	$ 0.0	100.0%
As a percentage of net revenue	33.7%	0.0%	

The gain on the sale of asset of approximately $3.5 million was due to the sale of our UpdateEXPERT product line. As a result of the sale, the Company realized a gain of $3.7 million primarily due to the immediate recognition of deferred revenue offset by a loss during the three months ended June 30, 2007 due to uncollectible accounts receivable amounts, resulting in a $3.5 million gain for the six months ended June 30, 2007.

Recent Accounting Pronouncements

On February 15, 2007, the Financial Accounting Standards Board (FASB) issued *Statement of Financial Accounting Standards* (*SFAS) No. 159*, *The Fair Value Option for Financial Assets and Financial Liabilities* . SFAS No. 159 permits all entities to choose, at specified election dates, to measure eligible items at fair value (the fair value option). A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings, or another performance indicator if the business entity does not report earnings, at each subsequent reporting date. Upfront costs and fees related to items for which the fair value option is elected shall be recognized in earnings as incurred and not deferred. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted. We are currently evaluating whether SFAS No. 159 will have a material effect on our financial position, results of operations or cash flows.

In September 2006, the Financial Accounting Standards Board (FASB) issued *Statement of Financial Accounting Standards (SFAS) No. 157*, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies in those instances where other accounting pronouncements that require or permit fair value measurements, the board of directors having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. We are required to adopt SFAS 157 no later than the fiscal year beginning after November 15, 2007. We are currently evaluating the impact, if any, this pronouncement will have on the financial statements.

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On July 13, 2006, the Financial Accounting Standards Board (FASB) issued *FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*. Interpretation 48 clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with Statement 109 and prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Additionally, Interpretation 48 provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. Interpretation 48 is effective for fiscal years beginning after December 15, 2006, with early adoption permitted. We adopted Interpretation 48 during fiscal year 2007. We did not record, and do not anticipate any adjustments resulting from the adoption of Interpretation 48.

In June 2006, the Financial Accounting Standards Board (FASB) ratified *Emerging Issues Task Force (EITF) No. 06-2, Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, Accounting for Compensated Absences (SFAS No. 43).* EITF 06-2 provides guidelines under which sabbatical leave or other similar benefits provided to an employee are considered to accumulate, as defined in SFAS 43. If such benefits are deemed to accumulate, then the compensation cost associated with a sabbatical or other similar benefit arrangement should be accrued over the requisite service period. The provisions of the EITF are effective for fiscal years beginning after December 15, 2006 and allow for either retrospective application or a cumulative effect adjustment approach upon adoption. We adopted EITF 06-2 during fiscal year 2007. We did not record, and do not anticipate any adjustments resulting from the adoption of EITF 06-2.

Liquidity and Capital Resources

Cash Flows

Our largest source of operating cash flows is cash collections from our customers for purchases of products and subscription, maintenance and technical support. Our standard payment terms for both license and support invoices are net 30 days from the date of invoice. The recurring revenue subscription portion of our business is a mainstay of the cash flow we generate. Our primary uses of cash for operating activities include personnel and facilities related expenditures and technology costs, as well as costs associated with outside support and services.

Cash used by operations for the six months ended June 30, 2007 was $7.4 million compared to cash provided during the six months ended June 30, 2006 of $0.02 million. The increased use of cash was due primarily to an increased investment in general and administrative expenses due to being a public company of $3.0 million, an increased investment in sales and marketing of $2.2 million, a reduction in gross profit of $1.0 million, an increased investment in research and development of $0.7 million, a reduction of accounts payable of $0.6 million, and an increase in accrued expenses and other current liabilities of $0.1 million. Research, development, software license, and technical support costs for the on-demand service product group totaled $1.8 million for the six months ended June 30, 2007. These costs did not exist during the six months ended June 30, 2006.

Cash flows provided by investing activities for the six months ended June 30, 2007 was $0.9 million and cash used for the six months ended June 30, 2006 was $31,000, respectively. The cash provided by investing activities was primarily due to the proceeds from the sale of UpdateEXPERT for $1.2 million offset by additional costs related to the purchase of Singlefin for $0.1 million, and purchase of fixed assets for $0.2 million.

Cash flows provided by financing activities for the six months ended June 30, 2007 and 2006 was $2.0 and $0.5 million, respectively. The increased cash provided by financing activities was due to the additional borrowing of cash from our line of credit.

For the six months ended June 30, 2007, the net decrease in cash was $4.5 million compared to a net increase in cash of approximately $0.5 million for the comparable period in 2006.

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Credit Facility

During 2001, we entered into a short-term credit facility with Camel Financial, Inc. in the amount of $0.5 million. During 2003, the short-term credit facility was renewed and increased to $1.3 million. The credit facility automatically renewed every six months. The line of credit provided for advances of up to 80% of eligible accounts receivable. Eligible accounts receivable were determined solely by the finance company. Interest was payable monthly at 1.5% per month (18% per annum). The agreement included a provision for a 1% annual renewal fee and a 1% per annum charge for the daily average unused portion of the line. The agreement allowed for termination without penalty but required thirty days prior notice for cancellation. The line of credit was secured by all of our assets and all of the assets acquired during the term of the agreement. We were required to deliver all accounts receivable proceeds against the outstanding line of credit balance upon receipt. In May 2007, we terminated the above detailed agreement. At June 30, 2007, the balance was zero on the line of credit with this finance company.

On May 15, 2007, the Company entered into a Loan and Security Agreement (the ***Loan Agreement***) with Silicon Valley Bank, a California corporation (***SVB***). Pursuant to the terms of the Loan Agreement, SVB has agreed to provide St. Bernard with a two year revolving line of credit equal to the lesser of (i) $4,000,000 or (ii) the amount of the Borrowing Base, or eligible accounts receivable, as described in the Loan Agreement. The Loan Agreement also provides for term loans up to $2,000,000 pursuant to which St. Bernard may request up to a maximum of six term loan advances, the first of which was made available after May 15, 2007, in the amount of $1,000,000. The Loan Agreement further provides for letters of credit, advances in connection with SVB cash management services and a special reserve for foreign currency exchange contracts with SVB which in the aggregate may not exceed $250,000. The borrowing availability on the revolving line of credit is reduced by the amount of outstanding principal of any term loans, any outstanding letters of credit, any advances in connection with SVB cash management services and the amount of the reserve for foreign currency exchange contracts with SVB and is subject to the other terms and conditions described in the Loan Agreement. Advances under the revolving line of credit and the term loans shall accrue interest at a per annum rate equal to 2% above the greater of (i) SVB s announced prime rate or (ii) 7.50%.

The obligations under the Loan Agreement are secured by substantially all of St. Bernard s assets other than certain stock of St. Bernard s foreign subsidiary and certain intellectual property rights.

The Loan Agreement contains customary affirmative and negative covenants and other restrictions. The affirmative covenants include, among others, the delivery of financial statements and accounts receivables schedules to SVB, the maintenance of insurance and the maintenance of a minimum level of tangible net worth. St. Bernard has also agreed that without the consent of SVB, it shall refrain from activities such as engaging in a merger or acquisition, incurring indebtedness, paying dividends or making distributions to its stockholders, repurchasing capital stock or making payments on subordinated debt. At June 30, 2007 we were in compliance with the above stated covenants and restrictions.

The Loan Agreement states that the Company will pay interest only for the first six months on Term Loan Advances outstanding. Thereafter, each Term Loan Advance will be payable in equal monthly installments of principal, plus interest, based on a 36 month amortization schedule, commencing in November 2007 and continuing on the same date of each month thereafter until the Term Loan Maturity Date of May 2009, on which date all remaining principal and accrued interest shall be paid in full.

Additionally, the Loan Agreement contains customary events of default including the following: nonpayment of principle or interest; the violation of a Loan Agreement covenant; the occurrence of a material adverse change; the attachment of a material portion of St. Bernard s assets; insolvency; default by St. Bernard of any third party agreement pursuant to which the acceleration of $50,000 in principal may result; entry of a judgment equal or greater than $50,000 against St. Bernard; material misrepresentations by St. Bernard; and the default by St. Bernard under any subordinated debt. Upon the occurrence of an event of default by St. Bernard, the applicable interest rate shall become 5% above the rate that would otherwise be applicable.

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In connection with the execution of the Loan Agreement, St. Bernard issued warrants to SVB on May 16, 2007, which allows SVB to purchase up to 100,000 shares of St. Bernard common stock at an exercise price of $1.60 per share. The warrants expire on the fifth anniversary of the warrant s issue date. Accordingly, the Company recorded prepaid interest expense in the amount of $91,000, based on the estimated fair value allocated to the warrants using the following assumptions; 73.56% volatility, risk free interest rate of 4.71%, an expected life of five years and no dividends. Amortization of the interest expense for the six months ended June 30, 2007 was immaterial. Furthermore, St. Bernard has agreed to grant SVB certain piggyback registration rights with respect to the shares of common stock underlying the warrants. As of June 30, 2007, the balance on the line of credit with SVB was approximately $2.3 million.

Liquidity

As of June 30, 2007, we had $0.3 million of cash and a working capital deficit of $13.6 million. As of June 30, 2007, we did not expect sufficient cash flows from operations during the next twelve months, along with our available line of credit financing and cash on hand, to cover our anticipated operating expenses plus continued development of our on-demand software as a service solution package. Billings from our on demand service have been lower than expected due to a several month delay in developing the new product line to effectively compete in the medium and large customer market space. In addition, we continue to invest in our on-demand service which includes the staffing of technical support personnel, as well as advertising expenses. Lastly, the increased costs associated with being a public company has caused an increase in the use of cash, which includes accounting, legal, and insurance fees; and a combination of SOX 404 , Board of Director, and IT consulting fees. These circumstances raised substantial doubt about our ability to continue as a going concern as of June 30, 2007. Consequently, we were actively seeking additional debt, and/or equity financing, and management was actively marketing for sale certain non-core assets. On August 14, 2007 the assets of Open File Manager were sold and the cash proceeds from the transaction were $6.4 million. There will be additional cash received by the company for transition services provided to the acquirer and the release of $0.5 million from an indemnification escrow.

If the on demand business continues to require cash investment and does not begin to meet sales expectations, we may need to raise additional funds on acceptable terms. If we cannot do so, we will not be able to develop or enhance our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements. To the extent we raise additional capital by issuing equity securities, our stockholders may experience substantial dilution. A material shortage of capital will require us to take drastic steps such as reducing our level of operations, disposing of selected assets or seeking an acquisition partner. If the Company is not able to develop new and enhanced products that achieve widespread market acceptance, it may be unable to recover product development costs, and its earnings and revenue may decline.

On January 1, 2007, we had cash on hand of approximately $4.8 million. We used that cash plus incurred additional debt during the subsequent two quarters. We are developing our on-demand services, which may require a larger cash investment than we currently anticipate. The market for St. Bernard s products is intensely competitive and is likely to become even more so in the future. St. Bernard also faces increasing competition from security solutions providers who may add security modules or features to their product offerings. In addition, pricing pressures and increased competition generally could result in reduced sales, reduced margins or the failure of St. Bernard s products to achieve or maintain more widespread market acceptance, any of which could have a material adverse effect on its business, results of operations and financial condition.

We have a history of losses and have not been able to achieve profitability. Our cumulative net loss was approximately $45.3 million and $39.7 million as of June 30, 2007 and December 31, 2006, respectively. There can be no assurances that we will become or remain profitable or that losses and negative cash flows will not continue to occur.

Off-Balance Sheet Arrangements

Except for the commitments arising from our operating lease arrangements, we have no other off-balance sheet arrangements that are reasonably likely to have a material effect on our financial statements.

Adoption of Employee Stock Purchase Plan

The Company s Employee Stock Purchase Plan, or ESPP, was adopted by our board of directors in December 2006 and approved by our shareholders in June 2007. The ESPP purchase period commenced on March 1, 2007, subject to the approval by the stockholders at the 2007 annual meeting and ended on the last business day in the period ending on June 30, 2007. The ESPP provides a means by which employees of the Company (and any parent or subsidiary of the Company designated by the Board of Directors to participate in the Purchase Plan) may be given an opportunity to purchase Common Stock of the Company at semi-annual intervals through payroll deductions, to assist the Company in retaining the services of its employees, to secure and retain the services of new employees, and to provide incentives for such persons to exert maximum efforts for the success of the Company 400,000 shares have been initially reserved for issuance pursuant to purchase rights under the ESPP. A participant may contribute up to 15% of his or her compensation through payroll deductions, and the accumulated deductions will be applied to the purchase of shares on the purchase date, which is the last trading day of the offering period. The purchase price per share will be equal to 85% of the fair market value per share on the start date of the offering period in which the participant is enrolled or, if lower, 85% of the fair market value per share on the purchase date. In addition, the number of shares available for issuance under the Purchase Plan may be increased annually on the first day of each Company fiscal year, beginning in 2008 and ending in (and including) 2016, by an amount equal to the least of: (i) the difference between four hundred thousand (400,000) and the number of shares remaining authorized for issuance after the last purchase of shares, (ii) four hundred thousand (400,000) shares of Common Stock, or (iii) an amount determined by the Board of Directors or a committee of the Board of Directors appointed to administer the Purchase Plan. If rights granted under the Purchase Plan expire, lapse or otherwise terminate without being exercised, the shares of Common Stock not purchased under such rights again become available for issuance under the Purchase Plan. At June 30, 2007, $14,540 has been withheld from employee earnings for stock purchases under the ESPP.

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Asset Sale and License Agreement

On January 29, 2007, pursuant to the terms of an Asset Sale and License Agreement signed and effective as of January 4, 2007 (the ***Agreement***), by and between the Company and Shavlik Technologies, LLC (***Shavlik***), St. Bernard assigned and sold to Shavlik St. Bernard s UpdateEXPERT and UpdateEXPERT Premium software applications and related customer and end user license agreements, software, programming interfaces and other intellectual property rights and contracts for an aggregate purchase price of $1.2 million plus 45% of any maintenance renewal fees collected by Shavlik in excess of $1.2 million for renewals invoiced by Shavlik between February 1, 2007 and January 31, 2008 (the ***Asset Sale***). As a result of the sale, we realized a gain of $3.7 million primarily due to the immediate recognition of deferred revenue offset by a loss of $0.3 million during the three months ended June 30, 2007 due to uncollectible accounts receivable amounts.

Subsequent Events

On August 14, 2007, pursuant to the terms of an Asset Purchase Agreement signed and effective as of August 13, 2007 (the ***Agreement***), by and between the Company and EVault, Inc., a wholly owned subsidiary of Seagate Technology, Inc., (***EVault***), St. Bernard assigned and sold to EVault St. Bernard s Open File Manager (the ***Product***) software applications, which include all of the rights, title, and interest worldwide of St. Bernard in and to (i) the Product, (ii) the Assumed Contracts, (iii) the St. Bernard Materials, (iv) all St. Bernard Intellectual Property Rights, (v) all claims of St. Bernard against third parties relating to the Purchased Assets, whether choate or inchoate, known or unknown, contingent or noncontingent, (vi) all data and information that is collected from, or on behalf of, customers of St. Bernard who are party to the Assumed Contracts (the ***Customer Base)***, the OEM Partners and any Lead, including to the extent that receipt of such information would not violate any applicable Law, (vii) all routing and billing information and components used in connection with the Assumed Contracts, and (viii) all other tangible or intangible asset of St. Bernard used in the Business and necessary for the operation or use of the Product for an aggregate purchase price of $6.9 million. As a result of the sale, the Company realized a gain of approximately $8.6 million in August 2007, primarily due to cash received and the immediate recognition of previously unrecognized deferred revenue.

Forward-Looking Statements

We believe it is important to communicate our expectations to our stockholders. However, there may be events in the future that we are not able to predict accurately or over which we have no control.

Certain statements contained in this report that are not historical facts, including, but not limited to, statements that can be identified by the use of forward-looking terminology such as may, expect, anticipate, predict, believe, plan, estimate or continue or the negative thereof variations thereon or comparable terminology, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, and involve a number of risks and uncertainties. The actual results of the future events described in the forward-looking statements in this interim report could differ materially from those stated in the forward-looking statements due to various factors, including but not limited to, the fact that we derive a majority of our license revenue from sales of a few product lines, our ability to manage our direct sales and OEM distribution channels effectively, risks associated with the our international sales and operations, our ability to successfully promote awareness of the need for our products and of our brand, risks associated with the IT security industry and those other risks and uncertainties detailed in our filings with the Securities and Exchange Commission, or SEC, including our Annual Report on Form 10-KSB for the year ended December 31, 2006 filed on April 2, 2007. In addition, there is the risk that we may not be successful in our efforts to integrate our acquisitions. Our failure to manage risks associated with our acquisitions could harm our business. A component of our business strategy is to enter new markets and to expand our presence in existing markets by acquiring complementary technologies that allow us to increase our product offerings, augment our distribution channels, expand our market opportunities or broaden our customer base. For example, we acquired Singlefin in October 2006. Acquisitions involve a number of risks, including:

- diversion of management s attention;

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- difficulty in integrating and absorbing the acquired business and its employees, corporate culture, managerial systems and processes, technology, products and services;
- failure to retain key personnel and employee turnover;
- challenges in retaining customers of the acquired business, and customer dissatisfaction or performance problems with the acquired firm;
- inability to develop products or services that meet our customers needs;
- assumption of unknown liabilities;
- dilutive issuances of securities or use of debt or limited cash;
- incremental amortization expenses related to acquired intangible assets, as well as potential future impairment charges to goodwill or intangible assets; and
- other unanticipated events or circumstances.

The foregoing discussion should be read in conjunction with our Financial Statements and related Notes thereto included elsewhere in this report.

You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this Report.

All forward-looking statements included herein attributable to any of us, or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements contained or referred to in this section. Except to the extent required by applicable laws and regulations, we undertake no obligations to update these forward-looking statements to reflect events or circumstances after the date of this document or to reflect the occurrence of unanticipated events.

Item 3. Controls and Procedures

Evaluation of Disclosure Controls

As of June 30, 2007, under the supervision and with the participation of the Company s management, including the Company s chief executive officer and chief financial officer, the Company carried out an evaluation of the effectiveness of the design and operation of the Company s disclosure controls and procedures as defined in Exchange Act Rules 13a-15(f) and 15d-15(f). These disclosure controls and procedures are designed to provide reasonable assurance that the information required to be disclosed by the Company in its periodic reports with the SEC is recorded, processed, summarized and reported within the time periods specified by the SEC s rules and forms, and that the information is accumulated and communicated to the Company s management, including the chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure. The design of any disclosure controls and procedures also is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based upon their evaluation, the chief executive officer and chief financial officer concluded that the Company s disclosure controls and procedures are effective at the reasonable assurance level as of the end of the six months ended June 30, 2007.

Internal Control over Financial Reporting

During the period covered by this report, there have been no changes in the Company s internal control over financial reporting that have materially affected or are reasonably likely to materially affect the Company s internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

In the normal course of business, the Company is occasionally named as a defendant in various lawsuits. On April 13, 2006, eSoft, Inc. filed Civil Action No. 00697-EWN-MJW in the U.S. District Court

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in Denver, Colorado alleging infringement of U.S. Patent No. 6,961,773 by St. Bernard Software, Inc. In connection with this proceeding, the Company filed a counter claim against the plaintiff alleging infringement of U.S. Patent No. 5,557,747. In February 2007, the Company paid a settlement for an undisclosed amount in the lawsuit with eSoft, Inc. In addition, the Company has agreed to a cross license of patent rights.

In March 2007, Arthur Budman a stockholder in the Company, filed a lawsuit against the Company and the chief financial officer, CFO, in the Superior Court of the State of California, San Diego County, seeking monetary damages arising from the alleged negligence of the CFO in connection with communications regarding the terms of the merger of Old St. Bernard Software, Inc. and Sand Hill IT. It is the opinion of management that the outcome of this pending lawsuit will not materially affect the operations, the financial position or cash flows of the Company.

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

The Annual Meeting of Stockholders was held on Thursday, June 14, 2007. The following matters were voted upon at the meeting and were adopted by the margins indicated:

1. The stockholders elected three Directors to hold office for a term expiring upon the 2010 Annual Meeting of Stockholders.

	Number of Shares	
Name of Director Elected	**For**	**Withheld**
Richard Arnold	11,118,147	739,499
Scott Broomfield	11,118,247	739,399
Humphrey Polanen	11,118,147	739,499

The following individuals are continuing directors with terms expiring upon the 2008 Annual Meeting of Stockholders (Class A): Bart A. M. van Hedel and Louis Ryan.

The following individuals are continuing directors with terms expiring upon the 2009 Annual Meeting of Stockholders (Class B): Vince Rossi and Mel S. Lavitt.

2. The stockholders approved an amendment of the Company s Amended and Restated Certificate of Incorporation to eliminate the requirement that the Company s Board of Directors be a classified, staggered board and to provide that after the amendment becomes effective directors of the Company shall serve one year terms and stand for re-election annually.

For	9,752,116
Against	69,574
Abstain	10,472
Broker Non-Votes	2,024,484

3. The stockholders approved the adoption of the Company s 2006 Employee Stock Purchase Plan authorizing issuance of up to 400,000 shares of common stock under the 2006 Employee Stock Purchase Plan in 2007, and each year thereafter during the term of such plan.

For	9,462,858
Against	351,531
Abstain	17,773
Broker Non-Votes	2,024,484

4. The stockholders approved an amendment to the Company s 2005 Stock Option Plan to authorize the issuance of an additional 1,000,000 shares of common stock under such plan.

For	8,787,062
Against	954,002
Abstain	18,598
Broker Non-Votes	2,096,984

5. The stockholders ratified the selection by the Audit Committee of the Board of Directors of Mayer Hoffmann McCann, P.C. as independent auditors of the Company for its fiscal year ending December 31, 2007.

For	11,820,557
Against	2,600
Abstain	33,489
Broker Non-Votes	

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Item 6. Exhibits

2.1 Agreement and Plan of Merger dated October 26, 2005, by and among Sand Hill IT Security Acquisition Corp., Sand Hill Merger Corp. and St. Bernard Software, Inc. (incorporated herein by reference to Exhibit 2.1 to the Company s Registration Statement on Form S-4 initially filed with the Securities and Exchange Commission on December 16, 2005).

2.2 Amendment to Agreement and Plan of Merger by and among Sand Hill IT Security Acquisition Corp., Sand Hill Merger Corp. and St. Bernard Software, Inc. (incorporated herein by reference to Exhibit 2.2 to the Company s Registration Statement on Form S-4 initially filed with the Securities and Exchange Commission on December 16, 2005).

2.3 Amendment to Agreement and Plan of Merger by and among Sand Hill IT Security Acquisition Corp., Sand Hill Merger Corp. and St. Bernard Software, Inc. (incorporated herein by reference to Exhibit 2.3 to the Company s Registration Statement on Form S-4 initially filed with the Securities and Exchange Commission on December 16, 2005).

2.4 Agreement and Plan of Merger and Reorganization dated as of October 3, 2006, by and among St. Bernard Software, Inc., AgaveOne Acquisition Corp., Singlefin Acquisition, LLC, AgaveOne, Inc. (d/b/a Singelfin) and Jake Jacoby (incorporated herein by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K filed with the Securities and Exchange Commission on October 6, 2006).

2.5 Amendment to Agreement and Plan of Merger and Reorganization dated as of October 16, 2006, by and among St. Bernard Software, Inc., AgaveOne Acquisition Corp., Singlefin Acquisition, LLC, AgaveOne, Inc. (d/b/a Singlefin) and Jake Jacoby (incorporated herein by reference to Exhibit 2.2 to the Company s Current Report on Form 8-K filed with the Securities and Exchange Commission on October 19, 2006).

2.6 Asset Sale and License Agreement dated as of January 4, 2007, by and between St. Bernard Software, Inc. and Shavlik Technologies, LLC (incorporated herein by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K filed with the Securities and Exchange Commission on January 9, 2007).

2.7 Asset Purchase Agreement dated as of August 13, 2007, by and between St. Bernard Software, Inc. and EVault, Inc. (incorporated herein by reference to Exhibit 10.1 to the Company s Report on Form 8-K filed with the Securities and Exchange Commission on August 17, 2007).

3.1 Amended and Restated Certificate of Incorporation of St. Bernard Software, Inc. (formerly known as Sand Hill IT Security Acquisition Corp.) (incorporated herein by reference to Exhibit 3.1.1 to the Company s Registration Statement on Form S-4 initially filed with the Securities and Exchange Commission on December 16, 2005).

3.2 Amended and Restated Bylaws of St. Bernard Software, Inc. (formerly known as Sand Hill IT Security Acquisition Corp.) (incorporated herein by reference to Exhibit 3.2 to the Company s Annual Report on Form 10-KSB filed with the Securities and Exchange Commission on April 2, 2007).

4.1 Specimen Unit Certificate of St. Bernard Software, Inc. (formerly known as Sand Hill IT Security Acquisition Corp.) (incorporated herein by reference to Exhibit 4.1 to the Company s Amendment No. 2 to the Registration Statement on Form S-1 (File No. 333-114861) filed with the Securities and Exchange Commission on June 23, 2004).

4.2 Specimen Common Stock Certificate of St. Bernard Software, Inc. (formerly known as Sand Hill IT Security Acquisition Corp.) (incorporated herein by reference to Exhibit 4.2 to the Company s Annual Report on Form 10-KSB filed with the Securities and Exchange Commission on April 2, 2007).

4.3	Specimen Warrant Certificate of St. Bernard Software, Inc. (formerly known as Sand Hill IT Security Acquisition Corp.) (incorporated herein by reference to Exhibit 4.3 to the Company s Amendment No. 2 to the Registration Statement on Form S-1 (File No. 333-114861) filed with the Securities and Exchange Commission on June 23, 2004).
4.4	Unit Purchase Option No. UPO-2 dated July 30, 2004, granted to Newbridge Securities Corporation (incorporated herein by reference to Exhibit 4.4.1 to the Company s Annual Report on Form 10-KSB filed with the Securities and Exchange Commission on March 31, 2005).
4.5	Unit Purchase Option No. UPO-3 dated July 30, 2004, granted to James E. Hosch (incorporated herein by reference to Exhibit 4.4.2 to the Company s Annual Report on Form 10-KSB filed with the Securities and Exchange Commission on March 31, 2005).
4.6	Unit Purchase Option No. UPO-4 dated July 30, 2004, granted to Maxim Group, LLC (incorporated herein by reference to Exhibit 4.4.3 to the Company s Annual Report on Form 10-KSB filed with the Securities and Exchange Commission on March 31, 2005).
4.7	Unit Purchase Option No. UPO-5 dated July 30, 2004, granted to Broadband Capital Management, LLC (incorporated herein by reference to Exhibit 4.4.4 to the Company s Annual Report on Form 10-KSB filed with the Securities and Exchange Commission on March 31, 2005).
4.8	Unit Purchase Option No. UPO-6 dated July 30, 2004, granted to I-Bankers Securities Incorporated (incorporated herein by reference to Exhibit 4.4.5 to the Company s Annual Report on Form 10-KSB filed with the Securities and Exchange Commission on March 31, 2005).
4.9	Warrant Agreement dated July 27, 2004 between American Stock Transfer and Trust Company and St. Bernard Software, Inc. (formerly known as Sand Hill IT Security Acquisition Corp.) (incorporated herein by reference to Exhibit 4.5 to the Company s Annual Report on Form 10-KSB filed with the Securities and Exchange Commission on March 31, 2005).
4.10	Warrant Agreement dated May 16, 2007 between Silicon Valley Bank and St. Bernard Software, Inc. (incorporated herein by reference to Exhibit 4.1 to the Company s Report on Form 8-K filed with the Securities and Exchange Commission on May 23, 2007).
10.1	Employee Separation Agreement with Release of Claims dated May 11, 2007 between St. Bernard Software, Inc. and Robert Crowe (incorporated herein by reference to Exhibit 10.1 to the Company s Report on Form 8-K filed with the Securities and Exchange Commission on May 15, 2007).
10.2	Loan and Security Agreement dated May 15, 2007 by and between St. Bernard Software, Inc. and Silicon Valley Bank (incorporated herein by reference to Exhibit 10.1 to the Company s Report on Form 8-K filed with the Securities and Exchange Commission on May 23, 2007).
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

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

	ST. BERNARD SOFTWARE, INC.
Date: August 17, 2007	By: /s/ Vincent Rossi **Vincent Rossi** **Chief Executive Officer**
Date: August 17, 2007	By: /s/ Alfred F. Riedler **Alfred F. Riedler** **Chief Financial Officer**