

VIRTRA SYSTEMS INC  
Form 10QSB  
May 25, 2006

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-QSB**

(Mark One)

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

For the quarterly period ended March 31, 2006

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

*Commission File Number 000-28381*

**VIRTRA SYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

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Texas  
(State or other jurisdiction of incorporation or  
organization)

93-1207631  
(IRS Employer Identification No.)

2500 City West Blvd., Suite 300, Houston, Texas  
(Address of principal executive offices)

77042  
(Zip Code)

(832) 242-1100

(Registrant's telephone number, including area code)

Check whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

As of May 10, 2006, the Registrant had outstanding 68,313,600 shares of common stock, par value \$.005 per share.

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**PART I. FINANCIAL INFORMATION**

**Item 1.**

**Financial Statements.**

**VIRTRA SYSTEMS, INC.**

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**VIRTRA SYSTEMS, INC.****BALANCE SHEET****March 31, 2006 and December 31, 2005**

| <b><u>ASSETS</u></b>  | <b>March 31,<br/>2006</b> | <b>December 31,<br/>2005</b> |
|---|---------------------------|------------------------------|
| Current assets:   |                           |                              |
| Cash and cash equivalents   | \$ 98,042                 | \$ 764                       |
| Accounts receivable   | 4,274                     | 184,904                      |
| Costs in Excess of Billing  | <u>319,607</u>            | <u>-</u>                     |
| Total current assets  | 421,923                   | 185,668                      |
| Property and equipment, net   | 936,265                   | 951,630                      |
| Capitalized development cost, net   | 114,465                   | 130,815                      |
| Other Assets  | <u>78,741</u>             | <u>-</u>                     |
| Total assets  | <u>\$1,551,394</u>        | <u>\$ 1,268,113</u>          |
| <br><b><u>LIABILITIES AND STOCKHOLDERS DEFICIT</u></b>                      |                           |                              |
| Current liabilities:  |                           |                              |
| Notes payable   | \$ 1,095,104              | \$ 1,095,899                 |
| Obligations under product financing arrangements                            | 506,653                   | 494,372                      |
| Convertible debentures, net of discounts of \$187,624 and \$299,170         | 403,818                   | 474,876                      |
| Accounts payable  | 1,326,239                 | 1,232,779                    |
| Accrued liabilities   | 1,459,277                 | 1,327,702                    |
| Advances held on deposit  | 149,930                   | 183,650                      |
| Billings in excess of costs and estimated earnings on uncompleted contracts | -                         | 84,650                       |
| Payable to related party  | <u>54,550</u>             | <u>35,495</u>                |
| Total current liabilities   | \$4,995,571               | 4,929,423                    |
| Redeemable common stock, 371,834 shares at \$.005 par value                 | <u>1,859</u>              | <u>1,859</u>                 |

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|   |                     |                     |
|---|---------------------|---------------------|
| Total liabilities   | <u>4,997,430</u>    | <u>4,931,282</u>    |
| Commitments and contingencies   |                     |                     |
| Stockholders' deficit:  |                     |                     |
| Common stock, \$.005 par value, 100,000,000 shares authorized,<br>68,313,600 and 65,983,600 shares issued and outstanding as of March 31,<br>2006 and December 31, 2005, respectively | 341,568             | 329,918             |
| Common stock committed, 6,000,000 and 0 shares  | 300,000             | -                   |
| Additional paid-in capital  | 9,926,739           | 9,755,785           |
| Accumulated deficit   | <u>(14,014,343)</u> | <u>(13,748,872)</u> |
| Total stockholders' deficit   | <u>(3,446,036)</u>  | <u>(3,663,169)</u>  |
| Total liabilities and stockholders' deficit   | <u>\$1,551,394</u>  | <u>\$ 1,268,113</u> |

See accompanying notes to financial statements.

**VIRTRA SYSTEMS, INC.****STATEMENT OF OPERATIONS****for the three months ended March 31, 2006 and 2005**

|   | <b>Three Months Ended</b> |                     |
|---|---------------------------|---------------------|
|   | <b>March 31,</b>          |                     |
|   | <b>2006</b>               | <b>2005</b>         |
| Revenue:                                    |                           |                     |
| Custom applications:                        |                           |                     |
| Training/simulation                         | \$ 545,938                | \$ 126,868          |
| Advertising/promotion                       | -                         | 10,794              |
| Other revenue                               | <u>12,714</u>             | <u>28,343</u>       |
| Total revenue                               | 558,652                   | 166,005             |
| Cost of sales and services                  | <u>228,650</u>            | <u>133,044</u>      |
| Gross margin                                | 330,002                   | 32,961              |
| General and administrative expenses         | <u>385,695</u>            | <u>421,529</u>      |
| Net loss from operations                    | <u>(55,693)</u>           | <u>(388,568)</u>    |
| Other income (expenses):                    |                           |                     |
| Interest expense and finance cost           | (209,778)                 | (411,938)           |
| Other income                                | <u>-</u>                  | <u>-</u>            |
| Total other income (expenses)               | <u>(209,778)</u>          | <u>(411,938)</u>    |
| Net loss                                    | <u>\$ (265,471)</u>       | <u>\$ (800,506)</u> |
| Weighted average shares outstanding         | <u>67,396,767</u>         | <u>60,764,278</u>   |
| Basic and diluted net loss per common share | <u>\$ (0.00)</u>          | <u>\$ (0.01)</u>    |

See accompanying notes to financial statements.



**VIRTRA SYSTEMS, INC.****STATEMENT OF CASH FLOWS****for the three months ended March 31, 2006 and 2005**

|   | <b>Three Months Ended</b> |                  |
|---|---------------------------|------------------|
|   | <b>March 31,</b>          |                  |
|   | <b>2006</b>               | <b>2005</b>      |
| Cash flows from operating activities:                                       |                           |                  |
| Net income (loss)   | \$ (265,471)              | \$ (800,506)     |
| Adjustments to reconcile net loss to net cash used in operating activities: |                           |                  |
| Depreciation and amortization   | 40,941                    | 40,678           |
| Bad Debt Expense  | 25,105                    | -                |
| Stock warrants issued as financing costs                                    | -                         | 139,225          |
| Effect of beneficial conversion feature                                     | 111,546                   | 150,000          |
| Stock issued as compensation for services                                   | -                         | 64,750           |
| Increase in operating assets  | (327,473)                 | (154,830)        |
| Increase (decrease) in accounts payable and accrued expenses                | <u>243,295</u>            | <u>(65,002)</u>  |
| Net cash used in operating activities                                       | <u>(172,057)</u>          | <u>(625,685)</u> |
| Cash flows from investing activities:                                       |                           |                  |
| Capital expenditures  | <u>(9,226)</u>            | <u>(1,774)</u>   |
| Net cash used in investing activities                                       | <u>(9,226)</u>            | <u>(1,774)</u>   |
| Cash flows from financing activities:                                       |                           |                  |
| Proceeds from convertible debentures  | -                         | 500,000          |
| Proceeds from issuance of notes payable and other advances                  | 127,000                   | -                |
| Payments on notes payable and other advances                                | (160,720)                 | (161,303)        |
| Proceeds from common stock committed to be issued                           | 300,000                   | 76,142           |
| Increase in product finance obligations                                     | <u>12,281</u>             | <u>52,064</u>    |
| Net cash provided by financing activities                                   | <u>278,561</u>            | <u>466,903</u>   |
| Net increase (decrease) in cash and cash equivalents                        | 97,278                    | (160,556)        |

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|   |                   |                 |
|---|-------------------|-----------------|
| Cash and cash equivalents at beginning of period  | <u>764</u>        | <u>160,556</u>  |
| Cash and cash equivalents at end of period        | <u>\$ 98,042</u>  | <u>\$ -</u>     |
| Non-cash investing and financing activities:      |                   |                 |
| Interest paid                                     | <u>\$ -</u>       | <u>\$ 9,793</u> |
| Income taxes paid                                 | <u>\$ -</u>       | <u>\$ -</u>     |
| Common stock issued upon conversion of debentures | <u>\$ 182,604</u> | <u>\$ -</u>     |

See accompanying notes to financial statements.

## VIRTRA SYSTEMS, INC.

## STATEMENTS OF STOCKHOLDERS DEFICIT

for the three months ended March 31, 2006

|   | Common Stock      |                   | Common Stock      | Additional Paid-In  | Accumulated           | Total                 |
|---|-------------------|-------------------|-------------------|---------------------|-----------------------|-----------------------|
|   | <u>Shares</u>     | <u>Amount</u>     | <u>Committed</u>  | <u>Capital</u>      | <u>Deficit</u>        | <u>Total</u>          |
| Balance at December 31, 2005                      | <u>65,983,600</u> | <u>\$ 329,918</u> | <u>\$ -</u>       | <u>\$9,755,785</u>  | <u>\$(13,748,872)</u> | <u>\$(3,663,169)</u>  |
| Common stock issued upon conversion of debentures | 2,330,000         | \$ 11,650         | -                 | \$ 170,954          | -                     | \$ 182,604            |
| Common stock committed for issuance               | -                 | -                 | \$ 300,000        | -                   | -                     | \$ 300,000            |
| Net loss  | <u>-</u>          | <u>-</u>          | <u>-</u>          | <u>-</u>            | <u>\$ (265,471)</u>   | <u>\$ (265,471)</u>   |
| Balance at March 31, 2006                         | <u>68,313,600</u> | <u>\$ 341,568</u> | <u>\$ 300,000</u> | <u>\$ 9,926,739</u> | <u>\$(14,014,343)</u> | <u>\$ (3,446,036)</u> |

See accompanying notes to financial statements.



**VIRTRA SYSTEMS, INC.**

**NOTES TO FINANCIAL STATEMENTS**

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1.

**Basis of Presentation**

The accompanying unaudited interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules of the U.S. Securities and Exchange Commission, and should be read in conjunction with the audited financial statements and notes thereto for the year ended December 31, 2005. They do not include all information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. However, except as disclosed herein, there has been no material change in the information disclosed in the notes to the financial statements for the year ended December 31, 2005 included in the Company's Form 10-KSB filed with the Securities and Exchange Commission. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of financial position and the results of operations for the interim periods presented have been included. Operating results for the interim periods are not necessarily indicative of the results that may be expected for the respective full year.

2.

**Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts and related disclosures. Actual results could differ from those estimates.

3.

**Acquisitions**

On January 10, 2006 the Company entered into an agreement to merge with a newly-formed entity, Virtra Merger Corporation, which in anticipation of the merger, is to acquire Altatron International, Inc., Chrysalis Manufacturing Corporation and Dynalist Manufacturing.

The Companies are currently in the due diligence phase, however, there can be no assurance that the acquisition will be consummated.

4.

**Convertible Debentures**

During February 2005 and August 2005 the Company issued \$750,000 and \$500,000, respectively, in convertible debentures. The debentures bear interest at 8% per year payable in cash or registered common stock at the Company's option. The debentures mature in February and August 2008 and are convertible, at the option of the holder, to shares of the Company's common stock at a conversion price per share equal to the lower of (i) 80% of the lowest closing bid price for the common stock for the fifteen days prior to the conversion date; or (ii) 125% of the volume weighted average price on the closing date.

In addition the Company issued to the holders of the convertible debentures warrants to purchase 750,000 and 500,000 shares of the Company's common stock. In accordance with generally accepted accounting principles, the Company allocates the proceeds received from debt or convertible debt with detachable warrants or shares of common stock using the relative fair value of the individual elements at the time of issuance. Using the Black-Scholes valuation model, the Company has determined the aggregate value of the 750,000 warrants to be \$117,427 (approximately \$0.16 per warrant) and the value of the 500,000 warrants to be \$48,655 (approximately \$0.10 per warrant). The amount allocated to the warrants as debt discount has been recognized as additional interest expense over the period from the date of issuance of the note to the earlier of the conversion date or the stated maturity date.

In accordance with generally accepted accounting principles, in the event the conversion price on debentures is less than the Company's stock price on the date of issuance, the difference is considered to be a beneficial conversion feature and is amortized as interest expense over the period from the date of issuance to the earlier of the conversion date or the stated

maturity date. The Company has calculated the aggregate beneficial conversion feature of these convertible debentures to be \$398,677 on the \$750,000 debentures and \$140,760 on the \$500,000 debentures.

During the quarter ended March 31, 2006, the Company recognized \$111,546 in interest expense related to the accretion of the debt discount and beneficial conversion features recorded on these convertible debentures including the portion of the debentures that converted. As of March 31, 2006, the remaining balance of the debt discount and beneficial conversion features was \$187,624.

5.

### **Stock Options and Warrants**

Effective January 1, 2006, the Company adopted the Statement of Financial Accounting Standards No. 123 (Revised), Share-Based Payments (SFAS 123R) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors based on estimated fair values. The Company adopted SFAS 123R using the modified prospective method, therefore, the prior period financial statements will not reflect any restated amounts. The Company estimates that there is no additional stock based compensation expense related to outstanding options to be recorded during the quarter ended March 31, 2006. The outstanding stock options as of March 31, 2006, are based on certain performance criteria and vest upon the occurrence of an event. Therefore, the Company used an estimate of when the event will occur to determine which options will ultimately vest and if expense should be recorded.

The Company periodically issues incentive stock options to key employees, officers, directors and outside consultants to provide additional incentives to promote the success of the Company's business and to enhance the ability to attract and retain the services of qualified persons. There were no stock options issued during the three months ended March 31, 2006.

A summary of the Company's stock option activity and related information for the three months ended March 31, 2006 and the year ended December 31, 2005 follows:

| <b>Number of<br/>Shares Under<br/>Options</b> | <b>Weighted-Average<br/>Exercise Price</b> |
|---|--|
|---|--|



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|             |                   |                  |        |
|-------------|-------------------|------------------|--------|
| Outstanding | December 31, 2004 | <u>6,100,000</u> | \$0.22 |
| Granted     |                   | -                | -      |
| Exercised   |                   | -                | -      |
| Forfeited   |                   | <u>300,000</u>   | \$0.10 |
| Outstanding | December 31, 2005 | <u>5,800,000</u> | \$0.23 |
| Granted     |                   | -                | -      |
| Exercised   |                   | -                | -      |
| Forfeited   |                   | <u>-</u>         | -      |
| Outstanding | March 31, 2006    | <u>5,800,000</u> | \$0.23 |
| Exercisable | March 31, 2006    | <u>4,300,000</u> | \$0.30 |

Following is a summary of outstanding stock options at March 31, 2006:

| <b>Number of</b>     |                      | <b>Expiration</b>  | <b>Weighted Average</b>      |
|----------------------|----------------------|--------------------|------------------------------|
| <b><u>Shares</u></b> | <b><u>Vested</u></b> | <b><u>Date</u></b> | <b><u>Exercise Price</u></b> |
| 100,000              | 100,000              | 2012               | \$0.21                       |
| 700,000              | 200,000              | 2009               | \$0.10                       |
| 1,000,000            | -                    | 2009               | \$0.005                      |
| <u>4,000,000</u>     | <u>4,000,000</u>     | 2009               | \$0.31                       |
| <br>                 |                      |                    |                              |
| <u>5,800,000</u>     | <u>4,300,000</u>     |                    |                              |

A summary of the Company's stock warrant activity is as follows:

|             |                   | <b>Number of</b>     | <b>Weighted-Average</b>      |
|-------------|-------------------|----------------------|------------------------------|
|             |                   | <b><u>Shares</u></b> | <b><u>Exercise Price</u></b> |
| Outstanding | December 31, 2004 | 996,703              | \$0.38                       |
| Granted     |                   | 1,750,000            | \$0.29                       |
| Exercised   |                   | -                    |                              |
| Forfeited   |                   | <u>-</u>             |                              |
| Outstanding | December 31, 2005 | 2,746,703            | \$0.29                       |
| Granted     |                   | -                    |                              |
| Exercised   |                   | -                    |                              |
| Forfeited   |                   | <u>-</u>             |                              |
| Outstanding | March 31, 2006    | 2,746,703            | \$0.29                       |

6.

**Going Concern Considerations**

During the three months ended March 31, 2006 and 2005, the Company has defaulted on its notes payable and obligations under product financing arrangements, has continued to accumulate payables to its vendors and has experienced negative financial results as follows:

|  | <b><u>2006</u></b> | <b><u>2005</u></b> |
|--|--------------------|--------------------|
| Net loss for the three months ended March 31 | \$ (265,471)       | \$ (800,506)       |
| Negative cash flows from operations          | \$ (172,057)       | \$ (625,685)       |
| Negative working capital                     | \$ (4,573,648)     | \$ (4,801,998)     |
| Accumulated deficit                          | \$(14,014,343)     | \$(12,554,322)     |
| Stockholders deficit                         | \$ (3,446,036)     | \$ (3,611,620)     |

Management has developed specific current and long-term plans to address its viability as a going concern as follows:

The Company's anticipated entry into the training/simulation market was advanced by the aftermath of September 11, 2001. The Company is currently in advanced discussions with representatives of various government authorities regarding use of the Company's technology in detecting and mitigating the risk of similar problems in the future.

The Company is also attempting to raise funds through debt and/or equity offerings. If successful, these additional funds would be used to pay down debt and for working capital purposes.

In the long-term, the Company believes that cash flows from continued growth in its operations will provide the resources for continued operations.

There can be no assurance that the Company's debt reduction plans will be successful or that the Company will have the ability to implement its business plan and ultimately attain profitability. The Company's long-term viability as a going concern is dependent upon three key factors, as follows:

The Company's ability to obtain adequate sources of debt or equity funding to meet current commitments and fund the continuation of its business operations in the near term.

The ability of the Company to control costs and expand revenues from existing or new businesses.

The ability of the Company to ultimately achieve adequate profitability and cash flows from operations to sustain its operations.

## **7. Subsequent Event**

As of March 31, 2006, the Company had \$848,247 accrued for various payroll tax liabilities. In May 2006, the Company received notices from the IRS of tax liens that have been filed related to these accrued amounts.



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

The statements contained in this report that are not historical are forward-looking statements, including statements regarding our expectations, intentions, beliefs or strategies regarding the future. Forward-looking statements include our statements regarding liquidity, anticipated cash needs, and availability and anticipated expense levels. All forward-looking statements included in this report are based on information available to us on this date, and we assume no obligation to update any such forward-looking statement. It is important to note that our actual results could differ materially from those in such forward-looking statements. The following discussion and analysis should be read in conjunction with the financial statements and accompanying notes appearing elsewhere in this report.

### **Business Overview**

Our principal business began in 1993 with the organization of Ferris Productions, Inc. Ferris designed, developed, distributed, and operated virtual reality products for the entertainment, simulation, promotion, and education markets.

Virtual reality is a generic term associated with computer systems that create a real-time visual/audio/haptic (touch and feel) experience. Virtual reality immerses participants into a three-dimensional real-time synthetic environment generated or controlled by one (or several) computer(s). In September of 2001, Ferris merged into GameCom, Inc., a publicly-held Texas company whose principal business at the time was the development and marketing of an Internet-enabled video game system. Our historic areas of application have included the entertainment/amusement, advertising/promotion, and training/simulation markets. We effectively left the entertainment/amusement market in the spring of 2003 in order to more fully focus on the advertising/promotional and training/simulation markets.

Our “*immersive virtual reality*™” devices are computer-based, and allow participants to view and manipulate graphical representations of physical reality. Stimulating the senses of sight, sound, touch, and smell simultaneously, our virtual reality devices envelop the participant in dynamic filmed or computer-generated imagery, and allow the participant to interact with what he or she sees using simple controls and body motions. Virtual reality products have traditionally employed head-mounted displays that combine high-resolution miniature image source monitors, wide field-of-view optics, and tracking sensors in a unit small and light enough to be worn on the head. These products usually surround the participant with dynamic three-dimensional imagery, allowing the user to change perspective on the artificial scenes by simply moving his or her head. Virtual reality devices have in the past been used primarily in connection with electronic games, as, by surrounding the player with the sights, sounds, and smells he or she would experience in the real world, play is made far more realistic than it would be if merely presented in a two-dimensional flat screen display. Now, however, virtual reality is finding increasing applications in the advertising/promotion and training/simulation markets.

We maintain our corporate office at 2500 City West Blvd., Suite 300, Houston, Texas 77042, and our telephone number is (832) 242-1100. We also maintain engineering, technical, and production offices, and a demonstration

facility, at 5631 South 24<sup>th</sup> Street, Phoenix, Arizona 85040, with a phone number of (602) 470-1177.

We face all the risks, expenses, and difficulties frequently encountered in connection with the expansion and development of a business, difficulties in maintaining delivery schedules if and when volume increases, the need to develop support arrangements for systems at widely dispersed physical locations, and the need to control operating and general and administrative expenses.

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue, and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. These estimates and assumptions provide a basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions, and these differences may be material.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements.

### **Revenue Recognition**

Revenue from custom application contracts are recognized on a percentage-of-completion basis, measured by the percentage of costs incurred to date to total estimated costs for each contract. Contract costs include all direct material and labor costs, and those indirect costs related to contract performance, such as indirect labor, supplies, tools, repairs, and depreciation costs. General and administrative costs are charged to expense as incurred.

Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions, and estimated profitability may result in revisions to costs and income, and are recognized in the period in which the revisions are determined. An amount equal to contract costs attributable to claims is included in revenue when realization is probable and the amount can be reliably estimated.

Costs and estimated earnings in excess of billings on uncompleted contracts represent revenue recognized in excess of amounts billed. Billings in excess of costs and estimated earnings on uncompleted contracts represent amounts billed in excess of revenue recognized.

### **Results of Operations**

#### **Three Months Ended March 31, 2006 Compared to Three Months Ended March 31, 2005**

The Company narrowed its net loss by over 67% compared to the quarter ending March 31, 2005 primarily from increased revenues, higher margins on products and services sold, and lower financing costs.

Revenues from our virtual reality product lines are somewhat unpredictable. Our products are custom made to a particular client's needs and delivery schedules. Thus, our products tend to consist of a few large projects at any time, and the stage of completion of any particular project can significantly affect revenue. Revenues from our training/simulation products, at \$545,938, were 330% higher than the same period last year. Work provided us by the Army Research Lab, Buckley Air Force Base and Case-Western Reserve University accounted for most of the increment. The Case-Western project was originally conceived as an advertising/promotion application for the Company's Immersadome products. However in a very innovative fashion, the speech pathology application turned out



to be an application for the Company's flagship IVR technology; the first of its kind outside the military and law enforcement arenas, and an opportunity for VirTra Systems to exploit applications in the medical services field. Delayed orders from customers experienced in early to mid-2004 finally commenced and were benefited from their revenue in the first quarter. We had total revenue of \$558,652 for the three months ended March 31, 2006, compared to \$166,005 for the corresponding three months of 2005. Cost of sales and services increased 72% this quarter but was proportionally lower and our gross margin improved.

General and administrative expense declined to \$385,695 for the three months ended March 31, 2006, compared to \$421,529 for the corresponding period of 2005. The Company maintains tight controls on personnel additions and has become less reliant upon outside consulting, legal and other professional fees. Interest expense and finance charges fell to \$209,778 for the three months ended March 31, 2006, compared to \$411,938 for the corresponding period of 2005. Despite the results of the December, 2004 debt holder conversion, the Company's new financial arrangement with Dutchess Private Equities Fund, L.P. and Dutchess Private Equities Fund II, L.P., included \$139,225 related to stock warrants issued as financing costs, and \$150,000 related to beneficial conversion cost associated with the new \$750,000 debenture negotiated and completed during the first quarter of 2005. Costs for the quarter ending March 31, 2006 related to these debentures and the debentures issued in August 2005, were \$111,546 and were the result of the amortization of debt discount and beneficial conversion features.

### **Liquidity and Plan of Operations**

As of March 31, 2006, our liquidity position remained extremely precarious. Current liabilities grew slightly to \$4,995,571 from \$4,929,423 the year before as accounts payable and accrued liabilities exceeded the Company's reduction in convertible debentures. As of March 31, 2006, there was only \$421,923 in current assets available to meet those liabilities.

To date we have met our capital requirements by acquiring needed equipment under the Ferris non-cancelable leasing arrangements, through capital contributions, loans from principal shareholders and officers, certain private placement offerings, through our previous equity line financing with Dutchess Private Equities Fund, L.P., and through our current convertible debenture with Dutchess Private Equities Fund, L.P. and Dutchess Private Equities Fund II, L.P.

For the three months ended March 31, 2006, our net loss was \$(265,471). After taking into account the non-cash items included in that loss, our cash requirements for operations were \$172,057, far less than the \$625,685 cash deficit from operations in the same period of the year before. We made capital expenditures of \$9,226. The predominant source of cash to cover the operating deficit was the sale of \$300,000 in a private placement of restricted common stock.

As of March 31, 2006, the Company had \$848,247 accrued for various payroll tax liabilities for prior periods. The Company had filed an offer in compromise with the Internal Revenue Service that was rejected as deficient. In May, 2006, the Company received notice from the IRS of tax liens they have been filed that relate to these accrued amounts. The Company plans to appeal a portion of the amount that the IRS claims is owed.

The opinion of our independent auditor for the year ended December 31, 2005 expressed substantial doubt as to our ability to continue as a going concern. Despite expense reductions that the Company is presently initiating, we will need substantial additional capital or new lucrative custom application projects to become profitable. In February of 2005, we entered into a financial contract with Dutchess Private Equities Fund, L.P. and Dutchess Private Equities Fund II, L.P. Under this arrangement, the Dutchess funds were to purchase up to \$6 million of our common stock over the next three years under an equity line. The number of shares we might have sold to the Dutchess funds was to be based upon the trading volume of our stock. Additionally in 2005, we completed two private placements with Dutchess for \$1,250,000 in convertible debentures. Management believes that a continuation of sales growth, purchase order financing to sustain the production and additional sales of common stock will carry the Company through the next twelve months.

### **Item 3.**

#### **Controls and Procedures**

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our chief executive officer and the chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures in accordance with Rule 13a-15 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based on this evaluation, our chief executive officer and the chief financial officer concluded that our disclosure controls and procedures are effective for gathering, analyzing and disclosing the information that we are required to disclose in the reports we file under the Exchange Act, within the time periods specified in the SEC's rules and forms. Our chief executive officer and the chief financial officer also concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to our company required to be included in our periodic SEC filings.

There have been no significant changes in our internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II - OTHER INFORMATION**

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

(a) Exhibits

31.1

Chief Executive Officer Rule 13a-15(e) Certification

31.2

Chief Financial Officer - Rule 13a-15(e) Certification

32.1

Chief Executive Officer Sarbanes-Oxley Act Section 906 Certification

32.2

Chief Financial Officer - Sarbanes-Oxley Act Section 906 Certification

## **SIGNATURES**



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

**VIRTRA SYSTEMS, INC.**

Date: May 24, 2006

/s/ Robert Ferris

Robert Ferris  
Chief Executive Officer and President