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DALRADA FINANCIAL CORP
Form 10QSB
November 22, 2004

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

FORM 10-QSB

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2004

or

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

Commission file No. 0-12641

DALRADA FINANCIAL CORPORATION
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)

33-0021693
(IRS EMPLOYER ID NO.)

9449 BALBOA AVENUE, SUITE 211
SAN DIEGO, CA 92123
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

Registrant's telephone number, including area code: (858) 277-5300

N/A
(FORMER NAME AND ADDRESS, IF CHANGED SINCE LAST REPORT)

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 past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

The number of shares outstanding of the registrant's common stock as of November 18, 2004 was 631,187,872.

Transitional Small Business Disclosure Format (check one): Yes No

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PART I. - FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES
(formerly Imaging Technologies Corporation)
CONSOLIDATED BALANCE SHEET
(IN THOUSANDS, EXCEPT SHARE DATA)
(UNAUDITED)

	SEPTEMBER 30, 2004
	----- (unaudited)
ASSETS	
CURRENT ASSETS	
Cash and cash equivalents	\$ 56
Accounts receivable, net of allowance of \$66	726
Inventories, net of reserve of \$15	--
Prepaid expenses and other current assets	645

TOTAL CURRENT ASSETS	1,427

PATENT, net of accumulated amortization of \$210	1,408
PROPERTY AND EQUIPMENT, net of accumulated depreciation of \$1,994	151
OTHER ASSETS	21

TOTAL ASSETS	\$ 3,007
	=====

LIABILITIES AND STOCKHOLDERS' DEFICIT

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CURRENT LIABILITIES	
Borrowings under bank notes payable	\$ 3,220
Notes payable, current portion (including related party note of \$1,558)	2,166
Convertible debentures, net of discount of \$31	783
Accounts payable	1,339
Obligations under capital lease	10
PEO payroll taxes and other payroll deductions	6,022
Other accrued expenses	10,404

TOTAL CURRENT LIABILITIES	23,944

CONVERTIBLE DEBENTURES, net of current portion and net of discounts of \$254	107
NOTES PAYABLE, net of current portion (including related party note of \$288)	503
CAPITAL LEASE, net of current portion	61

TOTAL LIABILITIES	24,615

COMMITMENTS AND CONTINGENCIES	--
STOCKHOLDERS' DEFICIT	
Series A convertible, redeemable preferred stock, \$1,000 par value, 7,500 shares authorized 420.5 shares issued and outstanding	420
Common stock; \$0.005 par value; 1,000,000,000 shares authorized; 602,417,418 shares issued and outstanding	3,012
Common stock warrants	475
Additional paid-in capital	83,080
Accumulated deficit	(108,595)

TOTAL STOCKHOLDERS' DEFICIT	(21,608)

TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT	\$ 3,007
	=====

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

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DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES
(formerly Imaging Technologies Corporation)
CONSOLIDATED STATEMENTS OF OPERATIONS
THREE MONTHS ENDED SEPTEMBER 30, 2004 AND 2003
(IN THOUSANDS, EXCEPT SHARE DATA)
(UNAUDITED)

	THREE MONTHS ENDED	
	SEPTEMBER 30, 2004	SEPTEMBER 30, 2003
	----- (unaudited)	----- (unaudited)
REVENUES		
Sales of products	\$ 125	\$ 131

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Software sales, licenses and royalties	26	36
Temporary staffing services	3,905	767
PEO Services	372	1,427
	-----	-----
TOTAL REVENUES	4,428	2,361
	-----	-----
COST OF REVENUES		
Cost of products sold	23	83
Cost of software sales, licenses and royalties	3	3
Cost of temporary staffing	3,548	693
Cost of PEO services	280	1,270
	-----	-----
TOTAL COST OF REVENUES	3,854	2,049
	-----	-----
GROSS PROFIT	574	312
	-----	-----
OPERATING EXPENSES		
Selling, general and administrative	1,009	1,904
Research and development	--	--
	-----	-----
TOTAL OPERATING EXPENSES	1,009	1,904
	-----	-----
INCOME (LOSS) FROM OPERATIONS	(435)	(1,592)
	-----	-----
OTHER INCOME (EXPENSES):		
Interest and financing costs, net	(483)	(328)
Gain on extinguishment of debt	--	--
Loss on disposition of assets	--	--
Other, net	--	3
	-----	-----
TOTAL OTHER INCOME (EXPENSE)	(483)	(325)
	-----	-----
LOSS BEFORE PROVISION FOR INCOME TAXES AND DISCONTINUED OPERATIONS	(918)	(1,917)
	-----	-----
PROVISION FOR INCOME TAXES	--	--
	-----	-----
NET LOSS FROM CONTINUING OPERATIONS	(918)	(1,917)
	-----	-----
DISCONTINUED OPERATON:		
Loss from operations of discontinued operation	--	(436)
Gain on disposition of discontinued operation	--	--
	-----	-----
	--	(436)
	-----	-----
NET LOSS	(918)	(2,353)
	-----	-----
PREFERRED STOCK DIVIDENDS	(5)	(5)
	-----	-----
NET LOSS ATTRIBUTED TO COMMON STOCKHOLDERS	\$ (923)	\$ (2,358)

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	=====	=====
NET LOSS PER SHARE - BASIC		
Continuing operations	\$ (0.00)	\$ (0.01)
Discontinued operations	--	(0.00)
	-----	-----
	\$ (0.00)	\$ (0.01)
	=====	=====
WEIGHTED AVERAGE COMMON EQUIVALENT SHARES OUSTANDING - BASIC	585,977	240,556
	=====	=====

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

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DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES
(formerly Imaging Technologies Corporation)
CONSOLIDATED STATEMENTS OF CASH FLOWS
THREE MONTHS ENDED SEPTEMBER 30, 2004 AND 2003
(IN THOUSANDS, EXCEPT SHARE DATA)
(UNAUDITED)

	THREE MONTHS ----- SEPTEMBER 30, 2004 ----- (unaudited)
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net loss from continuing operations	\$ (918)
Adjustment to reconcile net loss to net cash used in operating activities	
Depreciation and amortization	39
Stock issued for services	10
Amortization of debt discounts	223
Changes in operating assets and liabilities:	
(Increase) decrease in:	
Accounts receivable	(144)
Inventories	--
Prepaid expenses and other current assets	(201)
Other assets	(21)
Increase (decrease) in:	
Accounts payable and accrued expenses	(295)
PEO liabilities	871

Net cash provided by (used in) operating activities from continuing operations	(436)
Net cash used in operating activities from discontinued operations	--

Net cash used in operating activities	(436)

CASH FLOWS FROM INVESTING ACTIVITIES:	
Purchase of furniture and equipment	--

Net cash used in investing activities from continuing operations	--
Net cash used in investing activities from discontinued operations	--

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Net cash used in investing activities	----- -- -----
CASH FLOWS FROM FINANCING ACTIVITIES:	
Change in cash overdraft, net	--
Net borrowings under bank notes payable	--
Proceeds from notes payable	275
Repayments of notes payable	(9)
Repayments of capital lease obligations	(2)

Net cash provided by (used in) financing activities from continuing operations	264
Net cash used in financing activities from discontinued operations	--

Net cash provided by (used in) investing activities	264

CASH OF DISCONTINUED OPERATION	--
NET DECREASE IN CASH AND CASH EQUIVALENTS	(172)
CASH AND CASH EQUIVALENTS, Beginning of period	228

CASH AND CASH EQUIVALENTS, End of period	\$ 56 =====

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

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DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES
(formerly Imaging Technologies Corporation)
CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)
THREE MONTHS ENDED SEPTEMBER 30, 2004 AND 2003
(IN THOUSANDS, EXCEPT SHARE DATA)
(UNAUDITED)

NON-CASH INVESTING AND FINANCING ACTIVITIES

During the three months ended September 30, 2004, the Company issued: (1) 1,950,000 shares of its common stock for services valued at \$10; (2) 10,108,676 shares of its common stock for debt of \$21; and (3) 38,000,000 shares of its common stock for the conversion of convertible debentures in the amount of \$175.

During the three months ended September 30, 2003, the Company issued: 1) 5,220,000 shares of its common stock for services valued at \$129; 2) 10,272,110 shares of its common stock for compensation valued at \$140; 3) 20,260,000 shares of its common stock for debt of \$405; and 4) 48,400,337 shares of its common stock for the conversion of convertible debentures in the amount of \$346.

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DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES
(formerly Imaging Technologies Corporation)

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (IN THOUSANDS, EXCEPT SHARE DATA) (UNAUDITED)

NOTE 1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements of Dalrada Financial Corporation and Subsidiaries (the "Company" or "DRDF") have been prepared pursuant to the rules of the Securities and Exchange Commission (the "SEC") for quarterly reports on Form 10-QSB and do not include all of the information and note disclosures required by accounting principles generally accepted in the United States of America. These financial statements and notes herein are unaudited, but in the opinion of management, include all the adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the Company's financial position, results of operations, and cash flows for the periods presented. These financial statements should be read in conjunction with the Company's audited financial statements and notes thereto for the years ended June 30, 2004 included in the Company's annual report on Form 10-KSB filed with the SEC. Interim operating results are not necessarily indicative of operating results for any future interim period or for the full year. The consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. All inter-company transactions have been eliminated.

RECLASSIFICATIONS

Certain reclassifications have been made to the prior years' financial statements to conform to the current year presentation. These reclassifications had no effect on previously reported results of operations or retained earnings.

Comprehensive Income

The Company has adopted SFAS No. 130, "Reporting Comprehensive Income." SFAS No. 130 establishes standards for reporting and presentation of comprehensive income and its components in a full set of financial statements. During the three months ended September 30, 2004 and 2003, the Company had no elements of comprehensive income.

NOTE 2. GOING CONCERN CONSIDERATIONS

The accompanying unaudited consolidated financial statements have been prepared assuming that the Company will continue as a going concern. For the three months ended September 30, 2004, the Company had a net loss of \$918. As of September 30, 2004, the Company had a negative working capital deficiency of \$22,517 and had a stockholders' deficit of \$21,608. In addition, the Company is in default on certain note payable obligations and is being sued by numerous trade creditors for nonpayment of amounts due. The Company is also deficient in its payments relating to payroll tax liabilities. These conditions raise substantial doubt about the Company's ability to continue as a going concern.

The Company must obtain additional funds to provide adequate working capital and finance operations. However, there can be no assurance that the Company will be able to complete any additional debt or equity financings on favorable terms or at all, or that any such financings, if completed, will be adequate to meet the Company's capital requirements including compliance with the Imperial Bank settlement agreement. Any additional equity or convertible debt financings could result in substantial dilution to the Company's stockholders. If adequate funds are not available, the Company may be required to delay, reduce or eliminate some or all of its planned activities, including any potential mergers or acquisitions. The Company's inability to fund its capital requirements would have a material adverse effect on the Company. The financial statements do not

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include any adjustments that might result from the outcome of this uncertainty.

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NOTE 3. STOCK BASED COMPENSATION

The Company accounts for employee stock options in accordance with Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees". Under APB 25, the Company does not recognize compensation expense related to options issued under the Company's employee stock option plans, unless the option is granted at a price below market price on the date of grant. In 1996, SFAS No. 123 "Accounting for Stock-Based Compensation", became effective for the Company. SFAS No. 123, which prescribes the recognition of compensation expense based on the fair value of options on the grant date, allows companies to continue applying APB 25 if certain pro forma disclosures are made assuming hypothetical fair value method, for which the Company uses the Black-Scholes option-pricing model.

For non-employee stock based compensation, the Company recognizes an expense in accordance with SFAS No. 123 and values the equity securities based on the fair value of the security on the date of grant. For stock-based awards, the value is based on the market value for the stock on the date of grant and if the stock has restrictions as to transferability, a discount is provided for lack of tradability. Stock option awards are valued using the Black-Scholes option-pricing model.

The Company applies Accounting Principles Board Opinion No. 25 and related Interpretations in accounting for its stock option plans. The Company has opted under SFAS No. 123 to disclose its stock-based compensation with no financial effect. The pro forma effects of applying SFAS No. 123 in this initial phase-in period are not necessarily representative of the effects on reported net income or loss for future years. Had compensation expense for the Company's stock option plans been determined based upon the fair value at the grant date for awards under these plans consistent with the methodology prescribed under SFAS No. 123, the Company's pro forma net loss and net loss per share would have been as follows for the three months ended September 30, 2004:

(In thousands, except share amounts)	2004	2003
	----	----
Net loss attributed to common stockholders		
As reported	\$ (923)	\$2,358)
Compensation recognized under APB No. 25	--	--
Compensation recognized under SFAS No. 123	--	--
Pro forma	\$ (923)	\$2,358)
	=====	=====
Basic earnings (loss) per share		
As reported	\$ (0.00)	\$ (0.01)
Pro forma	\$ (0.00)	\$ (0.01)

This option valuation model requires input of highly subjective assumptions. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing model does not necessarily provide a reliable single measure of fair value of its employee stock options.

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The weighted average fair value of the options granted during fiscal years 2004 and 2003 is estimated on the date of grant using the Black-Scholes option-pricing model. All options granted in fiscal years 2004 and 2003 vested immediately. The weighted average fair values and weighted average assumptions used in calculating the fair values were as follows for the years ended June 30:

	2004	2003
	----	----
Fair Value of options granted	N/A	\$ 0.015
Risk free interest rate	N/A	3.5%
Expected life (years)	N/A	3
Expected volatility	N/A	421%
Expected dividends	N/A	0%

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NOTE 4. EARNINGS (LOSS) PER COMMON SHARE

The Company reports earnings (loss) per share in accordance with SFAS No. 128, "Earnings per Share." Basic earnings (loss) per share are computed by dividing income (loss) available to common stockholders by the weighted average number of common shares available. Diluted earnings (loss) per share is computed similar to basic earnings (loss) per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if the potential common shares had been issued and if the additional common shares were dilutive. Diluted earnings (loss) per share have not been presented since the effect of the assumed conversion of options and warrants to purchase common shares would have an anti-dilutive effect. The following potential common shares have been excluded from the computation of diluted net loss per share for the three months ended September 30, 2004: warrants - 26,563,435 and stock options - 39,150,000.

NOTE 5. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities" (an interpretation of Accounting Research Bulletin (ARB) No. 51, Consolidated Financial Statements). Interpretation 46 addresses consolidation by business enterprises of entities to which the usual condition of consolidation described in ARB-51 does not apply. The Interpretation changes the criteria by which one company includes another entity in its consolidated financial statements. The general requirement to consolidate under ARB-51 is based on the presumption that an enterprise's financial statement should include all of the entities in which it has a controlling financial interest (i.e., majority voting interest). Interpretation 46 requires a variable interest entity to be consolidated by a company that does not have a majority voting interest, but nevertheless, is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. A company that consolidates a variable interest entity is called the primary beneficiary of that entity. In December 2003, the FASB concluded to revise certain elements of FIN 46, primarily to clarify the required accounting for interests in variable interest entities. FIN-46R replaces FIN-46 that was issued in January 2003. FIN-46R exempts certain entities from its requirements and provides for special effective dates for entities that have fully or partially applied FIN-46 as of December 24, 2003. In certain situations, entities have the option of applying or continuing to apply FIN-46 for a short period of time before applying FIN-46R. In general, for all entities that were previously considered special purpose entities, FIN 46 should be applied for registrants who file under Regulation SX in periods ending after March 31, 2004, and for registrants who file under Regulation SB, in periods

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ending after December 15, 2004. The Company does not expect the adoption to have a material impact on the Company's financial position or results of operations.

During April 2003, the FASB issued SFAS 149 - "Amendment of Statement 133 on Derivative Instruments and Hedging Activities", effective for contracts entered into or modified after September 30, 2003, except as stated below and for hedging relationships designated after September 30, 2003. In addition, except as stated below, all provisions of this Statement should be applied prospectively. The provisions of this Statement that relate to Statement 133 Implementation Issues that have been effective for fiscal quarters that began prior to June 15, 2003, should continue to be applied in accordance with their respective effective dates. In addition, paragraphs 7(a) and 23(a), which relate to forward purchases or sales of when-issued securities or other securities that do not yet exist, should be applied to both existing contracts and new contracts entered into after September 30, 2003. The adoption of this statement had no impact on the Company's consolidated financial statements.

During May 2003, the FASB issued SFAS 150 - "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity", effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective for public entities at the beginning of the first interim period beginning after June 15, 2003. This Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a freestanding financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. Some of the provisions of this Statement are consistent with the current definition of liabilities in FASB Concepts Statement No. 6, Elements of Consolidated Financial Statements. The adoption of this statement had no impact on the Company's consolidated financial statements.

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In December 2003, the FASB issued a revised SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits" which replaces the previously issued Statement. The revised Statement increases the existing disclosures for defined benefit pension plans and other defined benefit postretirement plans. However, it does not change the measurement or recognition of those plans as required under SFAS No. 87, "Employers' Accounting for Pensions," SFAS No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits," and SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." Specifically, the revised Statement requires companies to provide additional disclosures about pension plan assets, benefit obligations, cash flows, and benefit costs of defined benefit pension plans and other defined benefit postretirement plans. Also, companies are required to provide a breakdown of plan assets by category, such as debt, equity and real estate, and to provide certain expected rates of return and target allocation percentages for these asset categories. The Company has implemented this pronouncement and has concluded that the adoption has no material impact to the consolidated financial statements.

In December 2003, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition." SAB 104 supersedes SAB 101, "Revenue Recognition in Consolidated Financial Statements." SAB 104's primary purpose is to rescind accounting guidance contained in SAB 101 related to multiple element revenue arrangements, superseded as a result of the issuance of EITF 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables." Additionally, SAB 104 rescinds the SEC's Revenue Recognition in Consolidated Financial Statements Frequently Asked Questions and Answers ("the FAQ") issued

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with SAB 101 that had been codified in SEC Topic 13, Revenue Recognition. Selected portions of the FAQ have been incorporated into SAB 104. While the wording of SAB 104 has changed to reflect the issuance of EITF 00-21, the revenue recognition principles of SAB 101 remain largely unchanged by the issuance of SAB 104, which was effective upon issuance. The adoption of SAB 104 did not impact the consolidated financial statements.

NOTE 6. CONVERTIBLE NOTES PAYABLE

Listed below is a roll-forward schedule of the convertible debentures:

(In Thousands)	
Balance at June 30, 2004	\$ 871
Issuance of convertible debentures during the three months ended September 30, 2004	--
Increase in debt discount and beneficial conversion feature	--
Converted into common stock	(175)
Amortization of value of warrants and preferential conversion feature	194

Balance at September 30, 2004	\$ 890
	=====

NOTE 7. NOTES PAYABLE

On July 1, 2004, the Company entered into two note payable obligations aggregating \$275,000 that bear interest at an annual rate of 40% and are due on September 30, 2004. In addition, in connection with these two notes payable, the Company issued to the holder a total of 5,000,000 warrants to purchase shares of the Company's common stock for \$0.005 per shares. The estimated value of the warrants of \$28,500 was determined using the Black-Scholes option pricing model and the following assumptions: term of 5 years, a risk free interest rate of 3.5%, a dividend yield of 0% and volatility of 426%. As of September 30, 2004, the entire \$28,500 has been amortized to financings costs in the accompanying consolidated statements of operations.

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NOTE 8. STOCKHOLDERS' DEFICIENCY

Stock Issuances

During the three months ended September 30, 2004, DRDF issued the following:

- o 1,950,000 shares of its common stock for legal and consulting services valued at \$10. The value of the services was determined using the market value of DRDF's common stock on the date of issuance;
- o 10,108,676 shares of its common stock for debt of \$21; and
- o 38,000,000 shares of its common stock for the conversion of convertible debentures in the amount of \$175.

NOTE 9. SEGMENT INFORMATION

The Company managed and internally reported the Company's business has four reportable segments, principally, (1) products and accessories, (2) software,

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(3) temporary staffing, and (4) PEO services.

Segment information for the three months ended September 30, 2004 is as follows:

(IN THOUSANDS)

	PRODUCTS -----	SOFTWARE -----	TEMPORARY STAFFING -----	PEO SERVICES -----	TOTAL -----
3-months ended 9/30/04 -----					
Revenues	\$ 125	\$ 26	\$ 3,905	\$ 372	\$ 4,428
Operating income (loss)	(327)	(64)	48	(92)	(435)
3-months ended 9/30/04 -----					
Revenues	\$ 131	\$ 36	\$ 767	\$ 1,427	\$ 2,361
Operating income (loss)	(368)	(935)	40	(329)	(1,592)

NOTE 10. DISPOSITION OF GREENLAND CORPORATION

In January 2004, the Company determined to discontinue operations of Greenland Corporation, its professional employment business division, and sold its shares in Greenland, back to Greenland. Effective March 1, 2004, the Company completed the sale of Greenland. Effective March 1, 2004, four new directors were elected to serve on Greenland's Board of Directors due to the resignation of the four directors nominated by DRDF. The operations of Greenland have been shown as discontinued operations in the accompanying consolidated statements of operations.

The operations of Greenland for the three month period ended September 30, 2003 are shown as discontinued operations.

NOTE 11. RELATED PARTY TRANSACTIONS

Warning Management Services, Inc.

The Company CEO and Chairman, Mr. Brian Bonar, is also the CEO and Chairman of Warning Management, Inc. Warning a public company, located in Southern California. Warning's operations consist of a modeling agency and providing temporary staffing services to government agencies and private companies.

GUARANTEE OF INDEBTEDNESS OF WARNING

As of September 8, 2004, Warning Management Services, Inc. ("Warning") purchased all of the issued and outstanding shares of Employment Systems, Inc. ("ESI") for \$1,500. The purchase was \$750 cash paid at the closing and a \$750 note payable. In connection with this transaction, the Company agreed to be a guarantor of the \$750 note payable. As inducement to enter into this guarantee, the Company was given a non-cancelable 2-year payroll processing contract with ESI. Management has evaluated this contingent liability and has determined that no loss is anticipated as a result of this guarantee.

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WARNING HAS A MONTH-TO-MONTH LEASE WITH THE COMPANY

Warning leases offices for its ESI subsidiary, on a month-to-month basis from the Company that started in October 2004. Monthly rental expense will be approximately \$3 per month.

PEO SERVICES AGREEMENT WITH WARNING PROVIDES FOR A FEE AT PREVAILING MARKET RATE

In April 2004, the Company entered into an Agreement for PEO service with Warning. The Company receives from Warning a monthly administrative fee of \$12 and a \$20 deposit as an advance against payments due pursuant to this agreement. The Company recorded revenue totaling \$24 during the three months ended September 30, 2004 from Warning.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(IN THOUSANDS, EXCEPT SHARE DATA)

The following discussion and analysis should be read in conjunction with the consolidated financial statements and notes thereto included in the Company Annual Report on Form 10-KSB for the year ended June 30, 2004. The statements contained in this Report on Form 10-QSB that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements regarding our expectations, hopes, intentions or strategies regarding the future. Forward-looking statements include statements regarding: future product or product development; future research and development spending and our product development strategies, and are generally identifiable by the use of the words "may", "should", "expect", "anticipate", "estimates", "believe", "intend", or "project" or the negative thereof or other variations thereon or comparable terminology. Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements (or industry results, performance or achievements) expressed or implied by these forward-looking statements to be materially different from those predicted. The factors that could affect our actual results include, but are not limited to, the following: general economic and business conditions, both nationally and in the regions in which we operate; competition; changes in business strategy or development plans; our inability to retain key employees; our inability to obtain sufficient financing to continue to expand operations; and changes in demand for products by our customers.

OVERVIEW

We provide a variety of financial services to small and medium-size businesses. These services allow our customers to outsource many human resources tasks, including payroll processing, workers' compensation insurance, health insurance, employee benefits, 401k investment services, personal financial management, and income tax consultation. In November 2001, we began to provide these services to relieve some of the negative impact they have on the business operations of our existing and potential customers. To this end, through strategic acquisitions, we became a professional employer organization ("PEO").

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We provide financial services principally through our wholly-owned SourceOne Group, Inc. ("SOG") subsidiary. These units provide a broad range of financial services, including: benefits and payroll administration, health and workers' compensation insurance programs, personnel records management, and employer liability management. Through our Jackson Staffing subsidiary (and MedicalHR and CallCenterHR operating units), we provide temporary staffing services to small and medium-sized businesses - primarily to call centers and medical facilities.

In January 2003, we completed the acquisition of controlling interest (approximately 85%) in the shares of Greenland Corporation whose shares are traded on the NASD Electronic Bulletin Board under the symbol GRLC. Subsequently, in March 2004, we entered into an agreement with Greenland to return most of our shares in Greenland in return for Greenland's forgiveness of certain DRDF indebtedness and business opportunities.

In January 2003, we completed the acquisition of a controlling interest (85%) in the shares of Quik Pix, Inc. ("QPI"). QPI shares are traded on the National Quotation Bureau Pink Sheets under the symbol QPIX. QPI is a visual marketing support firm located in Buena Park, California. Its principal service is to provide photographic and digital images mounted for customer displays in tradeshow and other displays. Its principal product, PhotoMotion is a patented color medium of multi-image transparencies. The process uses existing originals to create the illusion of movement, and allows for three to five distinct images to be displayed with an existing lightbox.

In September 2003, we hired two key persons and acquired the operations of the temporary staffing service then owned by Jackson Staffing, LLC. In order to formalize this arrangement, we entered into an acquisition agreement with Jackson Staffing effective September 1, 2003 and accordingly, the financial statements of Jackson Staffing from September 1, 2003 are included in our financial statements.

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In April 2004, we transferred our ColorBlind software technology to QPI. ColorBlind software provides color management to improve the accuracy of color reproduction - especially as it relates to matching color between different devices in a network, such as monitors and printers. ColorBlind software products are marketed internationally through direct distribution, resellers, and on the internet through our color.com website.

Our business continues to experience operational and liquidity challenges. Accordingly, year-to-year financial comparisons may be of limited usefulness now and for the next several periods due to anticipated changes in our business as these changes relate to potential acquisitions of new businesses and changes in products and services.

On June 28, 2004, we completed an acquisition of certain assets of M&M Nursing (M&M"). The purchase price was 5,000,000 shares of our common stock valued at \$31 plus the assumption of \$204 of liabilities. M&M is a temporary staffing agency primarily for nurses.

Our current strategy is: to expand our financial services businesses, including PEO services and temporary staffing, and to continue to commercialize imaging technologies, including PhotoMotion Images and ColorBlind color management software through our QPI subsidiary.

To successfully execute our current strategy, we will need to improve our working capital position. The report of our independent auditors accompanying our June 30, 2004 financial statements included in our Annual Report on Form

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10KSB includes an explanatory paragraph indicating there is a substantial doubt about our ability to continue as a going concern, due primarily to our recent loss from operations, the decreases in our working capital and net worth. We plan to overcome the circumstances that impact our ability to remain a going concern through a combination of achieving profitability, raising additional debt and equity financing, and renegotiating existing obligations.

In recent years, we have been working to reduce costs through the reduction in staff and reorganizing our business activities. Additionally, we have sought to reduce our debt through debt to equity conversions. We continue to pursue the acquisition of businesses that will grow our business.

There can be no assurance that we will be able to complete any additional debt or equity financings on favorable terms or at all, or that any such financings, if completed, will be adequate to meet our capital requirements. Any additional equity or convertible debt financings could result in substantial dilution to our shareholders. If adequate funds are not available, we may be required to delay, reduce or eliminate some or all of our planned activities, including any potential mergers or acquisitions. Our inability to fund our capital requirements would have a material adverse effect on the Company.

RESTRUCTURING AND NEW BUSINESS UNITS

In April 2004, we transferred our ColorBlind software products and technologies to our QPI subsidiary in order to focus on financial services and enable QPI to concentrate on imaging technology products and services.

ACQUISITIONS, DISPOSITIONS AND SALE OF BUSINESS UNITS

In August 2002, we entered into an agreement to acquire controlling interest in Greenland Corporation. Greenland shares are traded on the Electronic Bulletin Board under the symbol GRLC. On January 14, 2003, we completed the acquisition of shares, representing controlling interest, of Greenland. The terms of the acquisitions were disclosed on Form 8-K filed January 21, 2003.

Pursuant to a mutual agreement between the Board of Directors of both Greenland Corporation and us, Greenland has been separated from us, effective February, 23, 2004. Under the separation agreement, Greenland forgave its note receivable from us of \$2,250 together with any accrued interest thereon in consideration for our granting our acquisition rights to acquire ePEO Link to Greenland. In addition, for returning 95,949,610 shares of Greenland common stock acquired by us pursuant to our acquisition agreement with Greenland in January 2003, Greenland forgave its inter-company account receivable from us, which amount aggregated approximately \$1,375. Further, the agreement provided for us to effect the resignation of our Directors who also served on the Board of Directors of Greenland, which was completed in March 2004.

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In September 2003, we hired two key persons, and acquired the operations of the temporary staffing service then owned by Jackson Staffing, LLC. In order to formalize this arrangement, we entered into an acquisition agreement with Jackson Staffing effective September 1, 2003 and accordingly, the financial statements of Jackson Staffing from September 1, 2003 are included in our financial statements. On June 28, 2004, we completed an acquisition of certain assets of M&M Nursing (M&M"). The purchase price was 5,000,000 shares of our common stock valued at \$31 plus the assumption of \$204 of liabilities. M&M is a temporary staffing agency primarily for nurses. The financial statements of M&M from July 1, 2004 are included in our financial statements.

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SIGNIFICANT ACCOUNTING POLICIES AND ESTIMATES

Management's Discussion and Analysis of Financial Condition and Results of Operations discuss our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, we evaluate our estimates and judgments, including those related to allowance for doubtful accounts, value of intangible assets and valuation of non-cash compensation. We base our estimates and judgments on historical experiences and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The most significant accounting estimates inherent in the preparation of our consolidated financial statements include estimates as to the appropriate carrying value of certain assets and liabilities which are not readily apparent from other sources, primarily allowance for doubtful accounts, estimated fair value of equity instruments used for compensation, estimated tax liabilities from PEO operations and estimated liabilities associated with Worker's Compensation liabilities. These accounting policies are described at relevant sections in this discussion and analysis and in the notes to the consolidated financial statements included in our Annual Report on Form 10-KSB for the fiscal year ended June 30, 2004.

REVENUE RECOGNITION

PEO SERVICE FEES AND WORKSITE EMPLOYEE PAYROLL COSTS

We recognize our revenues associated with our PEO business pursuant to EITF 99-19 "Reporting Revenue Gross as a Principal versus Net as an Agent." Our revenues are reported net of worksite employee payroll cost (net method). Pursuant to discussions with the Securities and Exchange Commission staff, we changed our presentation of revenues from the gross method to an approach that presents our revenues net of worksite employee payroll costs (net method) primarily because we are not generally responsible for the output and quality of work performed by the worksite employees.

In determining the pricing of the markup component of the gross billings, we take into consideration our estimates of the costs directly associated with our worksite employees, including payroll taxes, benefits and workers' compensation costs, plus an acceptable gross profit margin. As a result, our operating results are significantly impacted by our ability to accurately estimate, control and manage our direct costs relative to the revenues derived from the markup component of our gross billings.

Consistent with our revenue recognition policy, our direct costs do not include the payroll cost of our worksite employees. Our direct costs associated with our revenue generating activities are comprised of all other costs related to our worksite employees, such as the employer portion of payroll-related taxes, employee benefit plan premiums and workers' compensation insurance premiums.

SALES OF PRODUCTS

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Revenue is recognized when earned. Our revenue recognition policies are in compliance with all applicable accounting regulations, including American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, Software Revenue Recognition, and SOP 98-9, Modification of SOP 97-2, With Respect to Certain Transactions. Revenue from products licensed to original equipment manufacturers is recorded when OEMs ship licensed products while revenue from certain license programs is recorded when the software has been delivered and the customer is invoiced. Revenue from packaged product sales to and through distributors and resellers is recorded when related products are shipped. Maintenance and subscription revenue is recognized ratably over the contract period. When the revenue recognition criteria required for distributor and reseller arrangements are not met, revenue is recognized as payments are received. Provisions are recorded for returns and bad debts. Our software arrangements do not contain multiple elements, and we do not offer post contract support.

TEMPORARY STAFFING

We record gross revenue for temporary staffing. We have concluded that gross reporting is appropriate because we (i) have the risk of identifying and hiring qualified employees, (ii) have the discretion to select the employees and establish their price and duties and (iii) bear the risk for services that are not fully paid for by customers. Temporary staffing revenues are recognized when the services are rendered by our temporary employees. Temporary employees placed by us are our legal employees while they are working on assignments. We pay all related costs of employment, including workers' compensation insurance, state and federal unemployment taxes, social security and certain fringe benefits. We assume the risk of acceptability of our employees to our customers.

RESULTS OF OPERATIONS (IN \$000)

THREE MONTHS ENDED SEPTEMBER 30, 2004 COMPARED TO THREE MONTHS ENDED SEPTEMBER

30, 2003

REVENUES

Total revenues were \$4,428 and \$2,361 for the three months ended September 30, 2004 and 2003, respectively; an increase of \$2,067 (88%). The increase was due primarily to the addition of temporary staffing services, which contributed \$3,905 of revenues for the three months ended September 30, 2004.

PEO SERVICES

PEO revenues were \$372 and \$1,427 for the three months ended September 30, 2004 and 2003, respectively; a decrease of \$1,055 (74%) due primarily to the decrease in our PEO customer base.

TEMPORARY STAFFING

In September 2003, we entered into an agreement to purchase a temporary staffing business through the organization of CallCenterHR and MedicalHR and the acquisition of Jackson Staffing. In June 2004, we entered into an agreement to purchase certain assets of M&M Nursing, a temporary staffing agency for nurses. Temporary Staffing revenues were \$3,905 and \$767 for the three months ended September 30, 2004 and 2003, respectively; an increase of \$3,138 (409%). The significant increase is due to the acquisition of Jackson Staffing and M&M Nursing.

IMAGING PRODUCTS

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Sales of imaging products were generated principally from our QPI subsidiary. Imaging Products revenues were \$125 and \$131 for the three months ended September 30, 2004 and 2003, respectively; a decrease of \$6 (5%).

SOFTWARE

Software revenues were \$26 and \$36 for the three months ended September 30, 2004 and 2003, respectively; a decrease of \$10 (28%). The reduction in software revenues was due to a delay in completing certain versions of our software which can be used with multiple computer operating systems. Revenues from licenses and royalties for the periods were insignificant.

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Royalties and licensing fees vary from quarter to quarter and are dependent on the sales of products sold by OEM customers using our technologies. These revenues continue to decline as we have elected to transfer our ColorBlind software to QPI, which has accelerated product development and begun to implement a more aggressive product sales program.

COST OF PRODUCTS SOLD

Cost of PEO services for the three months ended September 30, 2004 and 2003 \$280 (75% of PEO revenues) and \$1,270 (89% of PEO revenues), respectively. The increase in gross profit is due primarily to us being able to provide more profitable services to our PEO customers.

Costs of temporary staffing for the three months ended September 30, 2004 was \$3,548 (91% of temporary staffing revenue) and \$693 (90% of temporary staffing revenue), respectively. The significant increase is due to the increase in temporary staffing revenue.

Cost of products sold for the three months ended September 30, 2004 and 2003 were \$23 (18% of product sales) and \$83 (63% of product sales), respectively. Product sales continue to decline as we concentrate on other products and services. The increase in margins is due primarily to changes in product mix and our competitive position with customers.

Cost of software, licenses and royalties for the three months ended September 30, 2004 and 2003 were \$3 (12% of software, license and royalties revenue) and \$3 (8% of software, license and royalties revenue), respectively.

OPERATING EXPENSES

Operating expenses have consisted primarily of salaries and commissions of sales and marketing personnel, salaries and related costs for general corporate functions, including finance, accounting, facilities and legal, advertising, rent, depreciation and amortization, and other marketing related expenses, and fees for professional services.

Operating expenses for the three months ended September 30, 2004 and 2003 were \$1,009 and \$1,904, respectively; a decrease of \$895 (47%). The significant decrease is due to a reduction of payroll and related benefits due to a significant reduction in our personnel. Also, as disclosed in "Significant Accounting Policies and Estimates", we rely on estimates for such liabilities related to, among other areas, worker's compensation and accrued payroll taxes. During the three months ended September 30, 2004, we changed our estimate of workers' compensation claims aggregating approximately \$200.

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OTHER INCOME AND EXPENSE

Interest expense for the three months ended September 30, 2004 and 2003 was \$483 and \$328 respectively; an increase of \$155 (47%). The increase is principally due to i) the write off of the unamortized debt discounts associated with the conversion of debentures into common stock, ii) the penalties and interest incurred for not registering shares underlying the conversion of certain convertible debentures, and iii) an increase in the amount of debt outstanding.

LIQUIDITY AND CAPITAL RESOURCES

Historically, we have financed our operations primarily through cash generated from operations, debt financing, and the sale of equity securities. Additionally, in order to facilitate our growth and future liquidity, we have made some strategic acquisitions.

As a result of some of our financing activities, there has been a significant increase in the number of issued and outstanding shares. During the three months ended September 30, 2004 and the year ended June 30, 2004, we issued an additional 50,058,676 and 371,126,679 shares, respectively. These shares of common stock were issued primarily for corporate expenses in lieu of cash, for acquisition of businesses, for the conversion of convertible debentures and other debt, and for the exercise of warrants.

As of June 30, 2004, we had negative working capital of \$22,517, a decrease in working capital of \$581 since June 30, 2004. This decrease was due primarily to the increase in PEO payroll tax liabilities.

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Net cash used in operating activities was \$436 for the three months ended September 30, 2004 as compared to net cash used in activities of \$465 for the prior-year period; a decrease of \$29.

Cash provided by financing activities was \$264 for the three months ended September 30, 2004, an increase of \$411 from the prior-year period. The increase is principally a result of \$275 received from the issuance of a note payable.

We have no material commitments for capital expenditures. Our 5% convertible preferred stock (which ranks prior to our common stock), carries cumulative dividends, when and as declared, at an annual rate of \$50 per share. The aggregate amount of such dividends in arrears at September 30, 2004, was approximately \$425.

Our capital requirements depend on numerous factors, including market acceptance of our products and services, the resources we devote to marketing and selling our products and services, and other factors. The report of our independent auditors accompanying our June 30, 2004 financial statements includes an explanatory paragraph indicating there is a substantial doubt about our ability to continue as a going concern, due primarily to the decreases in our working capital and net worth.

CONTINGENT LIABILITY

The Company accrues and discloses contingent liabilities in its consolidated financial statements in accordance with Statement of Financial Accounting Standards ("SFAS") No. 5, Accounting for Contingencies. SFAS No. 5 requires accrual of contingent liabilities that are considered probable to occur and that can be reasonably estimated. For contingent liabilities that are considered

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reasonably possible to occur, financial statement disclosure is required, including the range of possible loss if it can be reasonably determined. The Company has disclosed in its audited financial statements several issues that it believes are reasonably possible to occur, although it cannot determine the range of possible loss in all cases. As these issues develop, the Company will continue to evaluate the probability of future loss and the potential range of such losses. If such evaluation were to determine that a loss was probable and the loss could be reasonably estimated, the Company would be required to accrue its estimated loss, which would reduce net income in the period that such determination was made.

Off-Balance Sheet Arrangements

There are no off balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors, except for the following.. As of September 8, 2004, Warning Management Services, Inc. ("Warning") purchased all of the issued and outstanding shares of Employment Systems, Inc. ("ESI") for \$1,500. The purchase was \$750 cash paid at the closing and a \$750 note payable. In connection with this transaction, the Company agreed to be a guarantor of the \$750 note payable. Our CEO, Brian Bonar, is also the CEO of Warning. As inducement to enter into this guarantee, we were given a non-cancelable 2-year payroll processing contract with ESI. Currently the \$750 note payable is in dispute. Warning is claiming that certain representations made by ESI were not correct and is proposing that the purchase price be reduced, thus reducing the \$750 note payable to \$258. Management has evaluated this contingent liability and has determined that no loss is anticipated as a result of this guarantee.

RISKS AND UNCERTAINTIES

Risks Relating to our Business:

IF WE ARE UNABLE TO SECURE FUTURE CAPITAL, WE WILL BE UNABLE TO CONTINUE OUR OPERATIONS.

Our business has not been profitable in the past and it may not be profitable in the future. We may incur losses on a quarterly or annual basis for a number of reasons, some within and others outside our control. See "Potential Fluctuation in Our Quarterly Performance." The growth of our business will require the commitment of substantial capital resources. If funds are not available from operations, we will need additional funds. We may seek such additional funding through public and private financing, including debt or equity financing. Adequate funds for these purposes, whether through financial markets or from other sources, may not be available when we need them. Even if funds are available, the terms under which the funds are available to us may not be acceptable to us. Insufficient funds may require us to delay, reduce or eliminate some or all of our planned activities.

To successfully execute our current strategy, we will need to improve our working capital position. The report of our independent auditors accompanying the Company's June 30, 2003 financial statements includes an explanatory paragraph indicating there is a substantial doubt about the Company's ability to continue as a going concern, due primarily to the decreases in our working capital and net worth. The Company plans to overcome the circumstances that

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impact our ability to remain a going concern through a combination of increased revenues and decreased costs, with interim cash flow deficiencies being addressed through additional equity financing.

IF OUR QUARTERLY PERFORMANCE CONTINUES TO FLUCTUATE, IT MAY HAVE A NEGATIVE IMPACT ON OUR BUSINESS.

Our quarterly operating results can fluctuate significantly depending on a number of factors, any one of which could have a negative impact on our results of operations. We may experience significant quarterly fluctuations in revenues and operating expenses as we introduce new products and services. Accordingly, any inaccuracy in our forecasts could adversely affect our financial condition and results of operations. Demand for our products and services could be adversely affected by a slowdown in the overall demand for imaging products and/or financial and PEO services. Our failure to complete shipments during a quarter could have a material adverse effect on our results of operations for that quarter. Quarterly results are not necessarily indicative of future performance for any particular period.

SINCE MANY OF OUR COMPETITORS HAVE GREATER FINANCIAL AND MARKETING RESOURCES THAN WE DO, WE MAY EXPERIENCE A REDUCTION IN MARKET SHARE AND REVENUES.

The markets for our products and services are highly competitive and rapidly changing. Some of our current and prospective competitors have significantly greater financial, technical, and marketing resources than we do. Our ability to compete in our markets depends on a number of factors, some within and others outside our control. These factors include: the frequency and success of product and services introductions by us and by our competitors, the selling prices of our products and services and of our competitors' products and services, the performance of our products and of our competitors' products, product distribution by us and by our competitors, our marketing ability and the marketing ability of our competitors, and the quality of customer support offered by us and by our competitors.

The PEO industry is highly fragmented. While many of our competitors have limited operations, there are several PEO companies equal or substantially greater in size than ours. We also encounter competition from "fee-for-service" companies such as payroll processing firms, insurance companies, and human resources consultants. The large PEO companies have substantially more resources than us and provide a broader range of resources than we do.

IF WE ACQUIRE COMPLEMENTARY BUSINESSES, WE MAY NOT BE ABLE TO EFFECTIVELY INTEGRATE THEM INTO OUR CURRENT OPERATIONS, WHICH WOULD ADVERSELY AFFECT OUR OVERALL FINANCIAL PERFORMANCE.

In order to grow our business, we may acquire businesses that we believe are complementary. To successfully implement this strategy, we must identify suitable acquisition candidates, acquire these candidates on acceptable terms, integrate their operations and technology successfully with ours, retain existing customers and maintain the goodwill of the acquired business. We may fail in our efforts to implement one or more of these tasks. Moreover, in pursuing acquisition opportunities, we may compete for acquisition targets with other companies with similar growth strategies. Some of these competitors may be larger and have greater financial and other resources than we do. Competition for these acquisition targets likely could also result in increased prices of acquisition targets and a diminished pool of companies available for acquisition. Our overall financial performance will be materially and adversely affected if we are unable to manage internal or acquisition-based growth effectively. Acquisitions involve a number of risks, including: integrating acquired products and technologies in a timely manner, integrating businesses and employees with our business, managing geographically-dispersed operations, reductions in our reported operating results from acquisition-related charges

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and amortization of goodwill, potential increases in stock compensation expense and increased compensation expense resulting from newly-hired employees, the diversion of management attention, the assumption of unknown liabilities, potential disputes with the sellers of one or more acquired entities, our inability to maintain customers or goodwill of an acquired business, the need to divest unwanted assets or products, and the possible failure to retain key acquired personnel.

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Client satisfaction or performance problems with an acquired business could also have a material adverse effect on our reputation, and any acquired business could significantly under perform relative to our expectations. We cannot be certain that we will be able to integrate acquired businesses, products or technologies successfully or in a timely manner in accordance with our strategic objectives, which could have a material adverse effect on our overall financial performance.

In addition, if we issue equity securities as consideration for any future acquisitions, existing stockholders will experience ownership dilution and these equity securities may have rights, preferences or privileges superior to those of our common stock.

IF WE ARE UNABLE TO DEVELOP AND/OR ACQUIRE NEW PRODUCTS IN A TIMELY MANNER, WE MAY EXPERIENCE A SIGNIFICANT DECLINE IN SALES AND REVENUES, WHICH MAY HURT OUR ABILITY TO CONTINUE OPERATIONS.

The markets for our products are characterized by rapidly evolving technology, frequent new product introductions and significant price competition. Consequently, short product life cycles and reductions in product selling prices due to competitive pressures over the life of a product are common. Our future success will depend on our ability to continue to develop new versions of our ColorBlind software, and to acquire competitive products from other manufacturers. We monitor new technology developments and coordinate with suppliers, distributors and dealers to enhance our products and to lower costs. If we are unable to develop and acquire new, competitive products in a timely manner, our financial condition and results of operations will be adversely affected.

IF WE ARE FOUND TO BE INFRINGING ON A COMPETITOR'S INTELLECTUAL PROPERTY RIGHTS OR IF WE ARE REQUIRED TO DEFEND AGAINST A CLAIM OF INFRINGEMENT, WE MAY BE REQUIRED TO REDESIGN OUR PRODUCTS OR DEFEND A LEGAL ACTION AT SUBSTANTIAL COSTS TO US.

We currently hold only one patent through our QPI subsidiary for its Photomotion product. Our software products are copyrighted. However, copyright protection does not prevent other companies from emulating the features and benefits provided by our software. We protect our software source code as trade secrets and make our proprietary source code available to OEM customers only under limited circumstances and specific security and confidentiality constraints.

IF OUR DISTRIBUTORS REDUCE OR DISCONTINUE SALES OF OUR PRODUCTS, OUR BUSINESS MAY BE MATERIALLY AND ADVERSELY AFFECTED.

Our products are marketed and sold through a distribution channel of value added resellers, manufacturers' representatives, retail vendors, and systems integrators. We have a small network of dealers and distributors in the United States and internationally. We support our worldwide distribution network and end-user customers through operations headquartered in San Diego.

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Portions of our sales are made through distributors, who may carry competing product lines. These distributors could reduce or discontinue sales of our products, which could adversely affect us. These independent distributors may not devote the resources necessary to provide effective sales and marketing support of our products. In addition, we are dependent upon the continued viability and financial stability of these distributors, many of which are small organizations with limited capital. These distributors, in turn, are substantially dependent on general economic conditions and other unique factors affecting our markets.

INCREASES IN HEALTH INSURANCE PREMIUMS, UNEMPLOYMENT TAXES, AND WORKERS' COMPENSATION RATES WILL HAVE A SIGNIFICANT EFFECT ON OUR FUTURE FINANCIAL PERFORMANCE.

Health insurance premiums, state unemployment taxes, and workers' compensation rates are, in part, determined by our PEO companies' claims experience, and comprise a significant portion of our direct costs. We employ risk management procedures in an attempt to control claims incidence and structure our benefits contracts to provide as much cost stability as possible. However, should we

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experience a large increase in claims activity, the unemployment taxes, health insurance premiums, or workers' compensation insurance rates we pay could increase. Our ability to incorporate such increases into service fees to clients is generally constrained by contractual agreements with our clients. Consequently, we could experience a delay before such increases could be reflected in the service fees we charge. As a result, such increases could have a material adverse effect on our financial condition or results of operations.

WE CARRY SUBSTANTIAL LIABILITY FOR WORKSITE EMPLOYEE PAYROLL AND BENEFITS COSTS.

Under our client service agreements, we become a co-employer of worksite employees and we assume the obligations to pay the salaries, wages, and related benefits costs and payroll taxes of such worksite employees. We assume such obligations as a principal, not merely as an agent of the client company. Our obligations include responsibility for (a) payment of the salaries and wages for work performed by worksite employees, regardless of whether the client company makes timely payment to us of the associated service fee; and (2) providing benefits to worksite employees even if the costs incurred by us to provide such benefits exceed the fees paid by the client company. If a client company does not pay us, or if the costs of benefits provided to worksite employees exceed the fees paid by a client company, our ultimate liability for worksite employee payroll and benefits costs could have a material adverse effect on the our financial condition or results of operations.

AS A MAJOR EMPLOYER, OUR OPERATIONS ARE AFFECTED BY NUMEROUS FEDERAL, STATE, AND LOCAL LAWS RELATED TO LABOR, TAX, AND EMPLOYMENT MATTERS.

By entering into a co-employer relationship with employees assigned to work at client company locations, we assume certain obligations and responsibilities or an employer under these laws. However, many of these laws (such as the Employee Retirement Income Security Act ("ERISA") and federal and state employment tax laws) do not specifically address the obligations and responsibilities of non-traditional employers such as PEOs; and the definition of "employer" under these laws is not uniform. Additionally, some of the states in which we operate have not addressed the PEO relationship for purposes of compliance with applicable state laws governing the employer/employee relationship. If these other federal or state laws are ultimately applied to our PEO relationship with our worksite employees in a manner adverse to us, such an application could have

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a material adverse effect on our financial condition or results of operations.

While many states do not explicitly regulate PEOs, over 20 states have passed laws that have licensing or registration requirements for PEOs, and several other states are considering such regulation. Such laws vary from state to state, but generally provide for monitoring the fiscal responsibility of PEOs and, in some cases, codify and clarify the co-employment relationship for unemployment, workers' compensation, and other purposes under state law. There can be no assurance that we will be able to satisfy licensing requirements of other applicable relations for all states. Additionally, there can be no assurance that we will be able to renew our licenses in all states.

THE MAINTENANCE OF HEALTH AND WORKERS' COMPENSATION INSURANCE PLANS THAT COVER WORKSITE EMPLOYEES IS A SIGNIFICANT PART OF OUR BUSINESS.

The current health and workers' compensation contracts are provided by vendors with whom we have an established relationship, and on terms that we believe to be favorable. While we believe that replacement contracts could be secured on competitive terms without causing significant disruption to our business, there can be no assurance in this regard.

OUR STANDARD AGREEMENTS WITH PEO CLIENTS ARE SUBJECT TO CANCELLATION ON 60-DAYS WRITTEN NOTICE BY EITHER THE COMPANY OR THE CLIENT.

Accordingly, the short-term nature of our client service agreements make us vulnerable to potential cancellations by existing clients, which could materially and adversely affect our financial condition and results of operations. Additionally, our results of operations are dependent, in part, upon our ability to retain or replace client companies upon the termination or cancellation of our agreements.

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A NUMBER OF PEO INDUSTRY LEGAL ISSUES REMAIN UNRESOLVED WITH RESPECT TO THE CO-EMPLOYMENT AGREEMENT BETWEEN A PEO AND ITS WORKSITE EMPLOYEES, INCLUDING QUESTIONS CONCERNING THE ULTIMATE LIABILITY FOR VIOLATIONS OF EMPLOYMENT AND DISCRIMINATION LAWS.

Our client service agreement establishes a contractual division of responsibilities between our clients and us for various personnel management matters, including compliance with and liability under various government regulations. However, because we act as a co-employer, we may be subject to liability for violations of these or other laws despite these contractual provisions, even if we do not participate in such violations. Although our agreement provides that the client is to indemnify us for any liability attributable to the conduct of the client, we may not be able to collect on such a contractual indemnification claim, and thus may be responsible for satisfying such liabilities. Additionally, worksite employees may be deemed to be our agents, subjecting us to liability for the actions of such worksite employees.

IF THE SUPERIOR SECURITY INTEREST HELD BY IMPERIAL BANK IS REMOVED AND IF ALL OF THE LAWSUITS CURRENTLY FILED WERE DECIDED AGAINST US AND/OR ALL THE JUDGMENTS CURRENTLY OBTAINED AGAINST US WERE TO BE IMMEDIATELY COLLECTED, WE WOULD HAVE TO CEASE OUR OPERATIONS.

Throughout fiscal 2001, 2002 and 2003, and through the date of this filing, approximately fifty trade creditors have made claims and/or filed actions alleging the failure of us to pay our obligations to them in a total amount exceeding \$3 million. These actions are in various stages of litigation, with many resulting in judgments being entered against us. Several of those who have

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obtained judgments have filed judgment liens on our assets. These claims range in value from less than one thousand dollars to just over one million dollars, with the great majority being less than twenty thousand dollars. Should we be required to pay the full amount demanded in each of these claims and lawsuits, we may have to cease our operations. However, to date, the superior security interest held by Imperial Bank has prevented nearly all of these trade creditors from collecting on their judgments.

IF OUR OPERATIONS CONTINUE TO RESULT IN A NET LOSS, NEGATIVE WORKING CAPITAL AND A DECLINE IN NET WORTH, AND WE ARE UNABLE TO OBTAIN NEEDED FUNDING, WE MAY BE FORCED TO DISCONTINUE OPERATIONS.

For several recent periods, up through the present, we had a net loss and negative working capital, which raises substantial doubt about our ability to continue as a going concern. Our losses have resulted primarily from an inability to achieve revenue targets due to insufficient working capital. Our ability to continue operations will depend on positive cash flow, if any, from future operations and on our ability to raise additional funds through equity or debt financing. Although we have reduced our work force, suspended some of our operations, and entered into new market segments (financial services), if we are unable to achieve the necessary revenues or raise or obtain needed funding, we may be forced to discontinue operations.

IF AN OPERATIONAL RECEIVER IS REINSTATED TO CONTROL OUR OPERATIONS, WE MAY NOT BE ABLE TO CARRY OUT OUR BUSINESS PLAN.

On August 20, 1999, at the request of Imperial Bank, our primary lender, the Superior Court, San Diego appointed an operational receiver to us. On August 23, 1999, the operational receiver took control of our day-to-day operations. On June 21, 2000, the Superior Court, San Diego issued an order dismissing the operational receiver as a part of a settlement of litigation with Imperial Bank pursuant to the Settlement Agreement effective as of June 20, 2000. The Settlement Agreement requires that we make monthly payments of \$150,000 to Imperial Bank until the indebtedness is paid in full. This agreement does not require us to pay any interest unless we default on the settlement agreement and fail to cure the default. Regardless, we have continued to accrue interest on this debt until it has been paid and there is no possibility that such interest will become due and payable. However, in the future, without additional funding sufficient to satisfy Imperial Bank and our other creditors, as well as providing for our working capital, there can be no assurances that an operational receiver may not be reinstated. If an operational receiver is reinstated, we will not be able to expand our products nor will we have complete control over sales policies or the allocation of funds.

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The penalty for noncompliance of the Settlement Agreement is a stipulated judgment that allows Imperial Bank to immediately reinstate the operational receiver and begin liquidation proceedings against us. Our current arrangement with CoAmerica Bank (formerly Imperial Bank) reduces our monthly payments of \$50,000. The remaining balance due as of September 30, 2004, is \$3.1 million.

WE HAVE NOT REMAINED CURRENT IN OUR PAYMENT OF FEDERAL AND STATE INCOME AND OTHER PAYROLL-RELATED TAXES WITHHELD IN OUR PEO BUSINESS.

We have not been able to remain current in our payments of federal and state tax obligations related to our PEO operations. We are currently working with the Internal Revenue Service and state agencies to resolve these issues and establish repayment plans. If we are not able to establish repayment plans that allow us to continue our operations, we may be forced to cease doing business in

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the financial services marketplace. The amount due as of September 30, 2004 is approximately \$6.4 million.

RISKS RELATING TO OUR STOCK:

THE ISSUANCE OF THE SHARES IN THIS OFFERING, PLUS THE EXISTING OUTSTANDING CONVERTIBLE NOTES, WILL RESULT IN DILUTION.

There are a large number of shares underlying the convertible note and warrants in this offering that may be available for future sale and the sale of these shares may depress the market price of DRDF's common stock and may cause substantial dilution to DRDF's existing stockholders.

The number of shares of common stock issuable upon conversion of the convertible note in this offering may increase if the market price of DRDF's stock declines. All of the shares, including all of the shares issuable upon conversion of the notes and debentures and upon exercise of DRDF's warrants, may be sold without restriction. The sale of these shares may adversely affect the market price of DRDF's common stock. The issuance of shares upon conversion of the convertible notes and debentures and exercise of outstanding warrants will also cause immediate and substantial dilution to DRDF's existing stockholders and may make it difficult to obtain additional capital.

The following gives examples of the number of shares that would be issued if the debentures in this offering were converted at one time at prices representing 70%, 50%, and 25% of the current market price (assuming a market price of approximately \$0.01. As of September 30, 2004, we had 602,417,418 shares of common stock outstanding.

- 70% of current stock price:

DRDF's stock converted at 70% of current stock price would result in a debenture conversion rate of \$.007 cents. To convert the \$800,000 convertible debenture would require 114,285,714 shares of DRDF's common stock, or 19% of DRDF's current outstanding shares.

- 50% of current stock price:

DRDF's stock converted at 50% of current stock price would result in a debenture conversion rate of \$.005 cents. To convert the \$800,000 convertible debenture would require 160,000,000 shares of DRDF's common stock, or 26% of DRDF's current outstanding shares.

- 25% of current stock price

DRDF's stock converted at 25% of current stock price would result in a debenture conversion rate of \$.0025 cents. To convert the \$800,000 of convertible debentures would require 320,000,000 shares of DRDF's common stock, or 54% of DRDF's current outstanding shares.

THE OVERHANG AFFECT FROM THE RESALE OF THE SELLING SHAREHOLDERS SECURITIES ON THE MARKET COULD RESULT IN LOWER STOCK PRICES WHEN CONVERTED

Overhang can translate into a potential decrease in DRDF's market price per share. The common stock underlying unconverted debentures represents overhang. These debentures are converted into common stock at a discount to the market price providing the debenture holder the ability to sell his or her stock at or below market and still make a profit, which is incentive for the holder to sell

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the shares as quickly as possible to ensure as much profit as possible in case the stock price falls. If the share volume cannot absorb the discounted shares, DRDF's market price per share will likely decrease. As the market price decreases, each subsequent conversion will require a larger quantity of shares.

SHORT SELLING COMMON STOCK BY WARRANT AND DEBENTURE HOLDERS MAY DRIVE DOWN THE MARKET PRICE OF DRDF'S STOCK.

The warrant and debenture holder may sell shares of DRDF's common stock on the market before exercising the warrant or converting the debenture. The stock is usually offered at or below market since the warrant and debenture holders receive stock at a discount to market. Once the sale is completed the holders exercise or convert a like dollar amount of shares. If the stock sale lowered the market price, upon exercise or conversion, the holders would receive a greater number of shares than they would have absent the short sale. This pattern may result in the spiraling down of DRDF's stock's market price.

THE MARKET PRICE OF OUR COMMON STOCK HISTORICALLY HAS FLUCTUATED SIGNIFICANTLY.

Our stock price could fluctuate significantly in the future based upon any number of factors such as: general stock market trends, announcements of developments related to our business, fluctuations in our operating results, a shortfall in our revenues or earnings compared to the estimates of securities analysts, announcements of technological innovations, new products or enhancements by us or our competitors, general conditions in the markets we serve, general conditions in the worldwide economy, developments in patents or other intellectual property rights, and developments in our relationships with our customers and suppliers.

In addition, in recent years the stock market in general, and the market for shares of technology and other stocks have experienced extreme price fluctuations, which have often been unrelated to the operating performance of affected companies. Similarly, the market price of our common stock may fluctuate significantly based upon factors unrelated to our operating performance.

DRDF'S COMMON STOCK IS SUBJECT TO THE "PENNY STOCK" RULES OF THE SEC AND THE TRADING MARKET IN DRDF'S SECURITIES IS LIMITED, WHICH MAKES TRANSACTIONS IN DRDF'S STOCK CUMBERSOME AND MAY REDUCE THE VALUE OF AN INVESTMENT IN DRDF'S STOCK.

DRDF's shares of Common Stock are "penny stocks" as defined in the Exchange Act, which are quoted in the over-the-counter market on the OTC Bulletin Board. As a result, an investor may find it more difficult to dispose of or obtain accurate quotations as to the price of the shares of the Common Stock being registered hereby. In addition, the "penny stock" rules adopted by the Commission under the Exchange Act subject the sale of the shares of the Common Stock to certain regulations which impose sales practice requirements on broker-dealers. For example, broker-dealers selling such securities must, prior to effecting the transaction, provide their customers with a document that discloses the risks of investing in such securities. Included in this document are the following:

- The bid and offer price quotes for the penny stock, and the number of shares to which the quoted prices apply.
- The brokerage firm's compensation for the trade.
- The compensation received by the brokerages firm's salesperson for the trade.

In addition, the brokerage firm must send the investor:

- Monthly account statement that gives an estimate of the value

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- of each penny stock in your account.
- A written statement of your financial situation and investment goals.

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Legal remedies, which may be available to you, are as follows:

- If penny stocks are sold to you in violation of your rights listed above, or other federal or state securities laws, you may be able to cancel your purchase and get your money back.
- If the stocks are sold in a fraudulent manner, you may be able to sue the persons and firms that caused the fraud for damages.
- If you have signed an arbitration agreement, however, you may have to pursue your claim through arbitration.

If the person purchasing the securities is someone other than an accredited investor or an established customer of the broker-dealer, the broker-dealer must also approve the potential customer's account by obtaining information concerning the customer's financial situation, investment experience and investment objectives. The broker-dealer must also make a determination whether the transaction is suitable for the customer and whether the customer has sufficient knowledge and experience in financial matters to be reasonably expected to be capable of evaluating the risk of transactions in such securities. Accordingly, the Commission's rules may limit the number of potential purchasers of the shares of the Common Stock.

RESALE RESTRICTIONS ON TRANSFERRING "PENNY STOCKS" ARE SOMETIMES IMPOSED BY SOME STATES, WHICH MAY MAKE TRANSACTIONS IN OUR STOCK CUMBERSOME AND MAY REDUCE THE VALUE OF AN INVESTMENT IN OUR STOCK.

Various state securities laws impose restrictions on transferring "penny stocks" and as a result, investors in the Common Stock may have their ability to sell their shares of the Common Stock impaired. For example, the Utah Securities Commission prohibits brokers from soliciting buyers for "penny stocks", which makes selling them more difficult.

DRDF'S ABSENCE OF DIVIDENDS OR THE ABILITY TO PAY THEM PLACES A LIMITATION ON ANY INVESTORS RETURN.

DRDF anticipates that for the foreseeable future, earnings will be retained for the development of its business. Accordingly, DRDF does not anticipate paying dividends on the common stock in the foreseeable future. The payment of future dividends will be at the sole discretion of DRDF's Board of Directors and will depend on DRDF's general business condition.

Information about forward-looking statements

This report contains certain forward-looking statements, which involve substantial risks and uncertainties. These forward-looking statements can generally be identified because the context of the statement includes words such as "may," "will," "except," "anticipate," "intend," "estimate," "continue," "believe," or other similar words. Similarly, this prospectus also contains forward-looking statements about our future. Forward-looking statements include statements about our plans, objectives, goals, strategies, expectations for the future, future performance and events, underlying assumptions for all of the above, and other statements, which are not statements of historical facts.

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These forward-looking statements involve risks and uncertainties discussed in the risk factor section, which could cause our actual results to materially differ from our forward-looking statements. We make these forward-looking statements based on our analysis of internal and external historical trends, but there can be no assurance that we will achieve the results set forth in these forward-looking statements. Our forward-looking statements are expressed in good faith and we believe that there is a reasonable basis for us to make them.

We have no obligation to update or revise these forward-looking statements to reflect future events.

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ITEM 3. CONTROLS AND PROCEDURES

As required by SEC rules, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures at the end of the period covered by this report. This evaluation was carried out under the supervision and with the participation of our management, including our principal executive officer and principal financial officer. Based on this evaluation, these officers have concluded that the design and operation of our disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting or in other factors that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Disclosure controls and procedures are our controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file under the Exchange Act is accumulated and communicated to our management, including principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In October 1999, the law firms of Weiss & Yourman and Stull, Stull & Brody made a public announcement that they had filed a lawsuit against the Company and certain current and past officers and/or directors, alleging violation of federal securities laws and, in November 1999, the lawsuit, filed in the name of Nahid Nazarian Behfarin, on her own behalf and others purported to be similarly situated, was served on the Company. In January 2003, the Company entered into a Stipulation of Settlement with the plaintiffs. It agreed to pay the plaintiffs 5,000,000 shares of common stock and \$200 in cash. The Parties have accepted the settlement. DRDF has issued the shares, and its insurance carrier has paid the \$200 cash payment. Pursuant to a hearing in May 2003 the Court provided approval to the settlement.

On August 22, 2002, the Company was sued by its former landlord, Carmel Mountain #8 Associates, L.P. or past due rent on its former facilities at 15175 Innovation Drive, San Diego, CA 92127.

DRDF was a party to a lawsuit filed by Symphony Partners, L.P. related to its acquisition of SourceOne Group, LLC. As reported on Form 8-K, dated July 22, 2003, the plaintiffs sought payment of \$702. In June 2003, the Company entered

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into a settlement with the plaintiffs for a cash payment of \$274, which has been paid.

DRDF is one of dozens of companies sued by The Massachusetts Institute of Technology, et al., related to a patent held by the plaintiffs that may be related to part of the Company's ColorBlind software. Subsequent to the period reported in this filing, in June 2003, the Company entered into a settlement with the plaintiffs who have agreed to dismiss their claims against DRDF with prejudice in exchange for a settlement fee payment of \$10, which has been paid.

The Company has been sued in Illinois state court along with AIA/Mirriman, its insurance brokers by the Arena Football League-2 ("AFS"). Damages payable to AF2, should they win the suit, could exceed \$700. The Company expects to defend its position and rely on representations of its insurance brokers.

Throughout fiscal 2003 and 2004, and through the date of this filing, trade creditors have made claims and/or filed actions alleging the failure of the Company to pay its obligations to them in a total amount exceeding \$3,000. These actions are in various stages of litigation, with many resulting in judgments being entered against the Company. Several of those who have obtained judgments have filed judgment liens on the Company's assets. These claims range in value from less than one thousand dollars to just over one million dollars, with the great majority being less than twenty thousand dollars.

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In connection with the Company's acquisition of controlling interest of Quik Pix, Inc., we are unaware of any pending litigation. From time to time, QPI may be involved in litigation relating to claims arising out of its operations in the normal course of business.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Common Stock

During the three months ended September 30, 2004, DRDF issued the following:

- o 1,950,000 shares of its common stock for legal and consulting services valued at \$10. The value of the services was determined using the market value of DRDF's common stock on the date of issuance;
- o 10,108,676 shares of its common stock for debt of \$21; and
- o 38,000,000 shares of its common stock for the conversion of convertible debentures in the amount of \$175.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

The Company is currently in default on certain bank loans that have an aggregate outstanding balance at September 30, 2004 of \$3,220,000.

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

None

ITEM 5. OTHER INFORMATION

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None

ITEM 6. EXHIBITS

31.1 Rule 13a-14(a) Certification

32.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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.

Dated: November 22, 2004

DALRADA FINANCIAL CORPORATION
(Registrant)

By: /S/ Brian Bonar

Brian Bonar
Chairman , Chief Executive Officer, and Acting Chief Financial Officer