

Item 1. Financial Statements

DIGITILITI, INC.
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

ASSETS	March 31, 2009	December 31, 2008
CURRENT ASSETS		
Cash	\$ 58,769	\$ 36,317
Accounts receivable	572,176	549,127
Prepaid and other current assets	286,953	201,488
TOTAL CURRENT ASSETS	917,898	786,932
PROPERTY AND EQUIPMENT	940,260	1,105,113
SOFTWARE LICENSE	1,309,250	1,302,158
DEFERRED FINANCING COSTS	114,286	202,484
Other assets	6,322	6,322
TOTAL ASSETS	\$ 3,288,016	\$ 3,403,009
LIABILITIES AND STOCKHOLDERS' DEFICIT		
CURRENT LIABILITIES		
Accounts payable	\$ 313,510	\$ 234,957
Accounts payable – related parties	104,869	104,869
Accrued expenses	887,568	1,136,408
Due to related parties	88,936	87,622
Current maturities of note payable	1,104,100	875,365
Current maturities of capital lease obligations	368,900	439,318
Current maturities of notes payable – related parties	231,540	156,540
Current maturities of convertible debt	721,859	2,435,466
TOTAL CURRENT LIABILITIES	3,821,282	5,470,545
CAPITAL LEASE OBLIGATIONS	59,150	65,037
CONVERTIBLE DEBT	1,726,532	1,758,252
CONVERTIBLE DEBT – related parties	466,203	342,532
DEFERRED RENT	16,418	18,130
Other liabilities	3,607	3,607
TOTAL LIABILITIES	6,093,192	7,658,103
STOCKHOLDERS' DEFICIT		
Common stock, \$.001 par value; 100,000,000 shares authorized, 33,552,845 and 26,665,020 shares issued and outstanding	33,553	26,665
Additional paid-in capital	13,126,076	10,092,294
Accumulated deficit	(15,964,805)	(14,374,053)
TOTAL STOCKHOLDERS' DEFICIT	(2,805,176)	(4,255,094)
TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT	\$ 3,288,016	\$ 3,403,009

See accompanying notes to consolidated financial statements.

DIGITAL, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended	
	March 31,	
	<u>2009</u>	<u>2008</u>
REVENUES	\$ 860,279	\$ 563,206
COST OF REVENUES	<u>462,405</u>	<u>427,621</u>
GROSS MARGIN	<u>397,874</u>	<u>135,585</u>
OPERATING EXPENSES		
Selling and marketing	86,751	161,690
General and administrative	592,574	769,864
Research and development	90,507	670,079
Total Operating Expenses	<u>769,832</u>	<u>1,601,633</u>
LOSS FROM OPERATIONS	(371,958)	(1,466,048)
INTEREST EXPENSE	<u>1,281,794</u>	<u>331,833</u>
NET LOSS	<u>\$ (1,590,752)</u>	<u>\$ (1,797,881)</u>
NET LOSS PER SHARE – BASIC AND DILUTED	\$ (0.05)	\$ (0.07)
WEIGHTED-AVERAGE SHARES OUTSTANDING BASIC AND DILUTED	32,175,280	25,149,884

See accompanying notes to consolidated financial statements.

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

	Three Months Ended	
	March 31,	
	<u>2009</u>	<u>2008</u>
OPERATING ACTIVITIES		
Net loss	\$ (1,590,752)	\$ (1,797,881)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation and amortization	271,435	254,032
Common stock issued for services -	-	124,312
Amortization of deferred financing costs	88,198	49,220
Amortization of discount on convertible debt	670,335	112,459
Stock issued for professional services	-	-
Employee stock option expense	63,241	21,412
Common stock issued for purchase of R & D	-	375,000
Incremental compensation cost of warrants with converted notes	116,377	-
Incremental compensation cost of warrants with extended notes	84,730	-
Beneficial Conversion Features on converted notes	161,377	-
Stock issued for professional services	-	-
Changes in operating assets and liabilities:		
Accounts receivable	(30,264)	(90,064)
Prepaid and other current assets	(78,250)	(62,632)
Accounts payable	78,553	505,821
Accrued expenses	88,112	-
Due to related parties	1,314	-
Deferred rent	(1,712)	2,979
Net cash provided by operating activities	<u>(77,306)</u>	<u>(505,342)</u>
INVESTING ACTIVITIES		
Purchases of property and equipment	-	(276,357)
Purchases of software licenses	(1,419)	-
Net cash used in investing activities	<u>(1,419)</u>	<u>(276,357)</u>
FINANCING ACTIVITIES		
Proceeds from notes payable	165,197	-
Payments on notes payable	(54,485)	-
Proceeds from issuance of convertible debt	-	808,500
Financing costs	-	(80,850)
Payments on capital lease obligations	(84,535)	(156,207)
Proceeds from bank note	-	18,965
Proceeds from note payable – related party	75,000	14,000
Payments on notes payable – related party	-	(10,000)
Net cash used in financing activities	<u>101,177</u>	<u>594,408</u>
NET DECREASE IN CASH	22,452	(187,291)
CASH		
Beginning of period	<u>36,317</u>	<u>241,333</u>
End of period	<u>\$ 58,769</u>	<u>\$ 54,042</u>

The Company is in default on \$465,000 convertible debt net of discount of \$12,965 as of March 31, 2009.

A summary of the convertible debt as of March 31, 2009, and December 31, 2008, is as follows:

	2009	2008
Gross proceeds from the debts	\$ 5,500,000	\$ 5,500,000
Less: discount on the warrants	(2,116,131)	(2,116,131)
Less: principal converted to common stock	(2,532,700)	(270,000)
Add: amortization of discount	1,597,222	1,079,849
Subtotal	\$ 2,448,391	\$ 4,193,718
Less: current maturities	(721,859)	(2,435,466)
Long-term portion of convertible debt	\$ 1,726,532	\$ 1,758,252

4. Stockholders' Equity

Common Stock:

During the quarter ended March 31, 2009, several convertible debt holders converted their investment in Convertible Debt in the amount of \$2,262,700, net of discount of \$373,732, in principal and accrued interest, to common stock. Total shares issued in exchange for the debt were 6,887,825.

Stock Options:

During the first quarter of 2009, options to purchase 650,000 shares of common stock were granted by the Company to four employees at an exercise price of \$0.385. These options have a contractual term of 5 years, and have a vesting term of 3 years. Fair value of \$74,637 was calculated using the Black-Scholes option-pricing model. Variables used in the Black-Scholes option-pricing model for options issued during the quarter ended March 31, 2009 include (1) discount rate of 1.44%, (2) expected life of 3.5 years (3) expected volatility of 152.07% and (4) zero expected dividends.

A summary of option activities for the quarter ended March 31, 2009 was as follows:

	Options	Weighted- Average Exercise Price
Outstanding at December 31, 2008	4,116,806	\$ 0.37
Granted	650,000	0.39
Outstanding at March 31, 2009	<u>4,766,806</u>	0.37

Stock option expense for the quarter ended March 31, 2009, was \$46,971.

Stock Warrants:

During the first quarter of 2009, warrants to purchase 100,000 shares of common stock were granted by the Company to one of its former employee at an exercise price of \$0.35. These warrants have a term of 5 years and they vest immediately. Fair value of \$16,270 was calculated using the Black-Scholes option-pricing model. Variables used in the Black-Scholes option-pricing model for warrants issued during the quarter ended March 31, 2009 include (1) discount rate of 1.79%, (2) warrant life of 5 years (3) expected volatility of 142.26% and (4) zero expected dividends.

A summary of warrant activities for the quarter ended March 31, 2009 was as follows:

	Warrants	Weighted- Average Exercise Price
Outstanding at December 31, 2008	6,200,348	\$ 1.59
Granted	100,000	0.35
Outstanding at March 31, 2009	<u>6,300,348</u>	1.57

Stock warrant expense for the quarter ended March 31, 2009. was \$16,270.

Cash paid for interest	21,509	18,875
Cash paid for income tax	-	-

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Non-Cash Financing and Investing Activities

Issuance of warrants in connection with convertible debt	-	371,950
Stock rescission payable	-	105,000
Equipment acquired under capital lease	8,230	-
Shares issued for accrued interest on convertible debt	307,954	-
Shares issued for convertible debt	2,262,700	-
Notes payable issued to acquire software	104,025	-

See accompanying notes to consolidated financial statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1. Organization, Basis of Presentation and Significant Accounting Policies

The accompanying unaudited interim financial statements of Digitiliti, Inc. have been prepared in accordance with accounting principles generally accepted in the United States of America and rules of the Securities and Exchange Commission, and should be read in conjunction with the audited financial statements and notes thereto contained in Digitiliti's audited financial statements for the year ended December 31, 2008. In the opinion of management, all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of financial position and the results of operations for the interim periods presented have been reflected herein. The results of operations for interim periods are not necessarily indicative of the results to be expected for the full year. Notes to the consolidated financial statements, which would substantially duplicate the disclosure contained in the audited financial statements, included in Digitiliti's Form 10-K, have been omitted.

New Accounting Pronouncements

In April 2009, the FASB issued FASB Staff Position (FSP) No. FAS 107-1 and Accounting Principles Board (APB) 28-1, Interim Disclosures about Fair Value of Financial Instruments, (FAS 107-1) to amend SFAS No. 107, Disclosures about Fair Value of Financial Instruments and APB 28, Interim Financial Reporting. FAS 107-1 changes the reporting requirements on certain fair value disclosures of financial instruments to include interim reporting periods. FAS 107-1 is effective for interim reporting periods ending after June 15, 2009, with early adoption encouraged. We are currently assessing the impact, if any, that the adoption of this pronouncement will have on our disclosures.

In April 2009, the FASB issued FSP No. FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, (FAS 157-4) to amend SFAS No. 157, Fair Value Measurements, (SFAS 157). FAS 157-4 provides additional guidance for estimating fair value in accordance with SFAS 157 when the volume and level of activity for an asset or liability has significantly decreased. In addition, FAS 157-4 includes guidance on identifying circumstances that indicate a transaction is not orderly. FAS 157-4 is effective for interim and annual reporting periods ending after June 15, 2009. We are currently assessing the impact, if any, that the adoption of this pronouncement will have on our operating results, financial position or cash flows.

In May 2008, the FASB issued Staff Position No. APB 14-1, "Accounting for Convertible Debt Instruments That May be Settled in Cash upon Conversion (Including Partial Cash Settlement)" ("FSP APB 14-1"). FSP APB 14-1 states that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of Accounting Principles Board Opinion No. 14 and that issuers of such instruments should account separately for the liability and equity components of the instruments in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. FSP APB 14-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and must be applied retrospectively to all periods presented. Adoption of this statement did not have a material effect on our financial statements.

In June 2008, the FASB ratified EITF Issue 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock" ("EITF 07-5"). Paragraph 11(a) of Statement of Financial Accounting Standard No 133 "Accounting for Derivatives and Hedging Activities" ("SFAS 133") specifies that a contract that would otherwise meet the definition of a derivative but is both (a) indexed to the Company's own stock and (b) classified in stockholders' equity in the statement of financial position would not be considered a derivative financial instrument. EITF 07-5 provides a new two-step model to be applied in determining whether a financial instrument or an embedded feature is indexed to an issuer's own stock and thus able to qualify for the SFAS 133 paragraph 11(a) scope exception. EITF 07-5 is effective for the first annual reporting period beginning after December 15, 2008, and early adoption is prohibited. On January 1, 2009, we adopted EITF 07-5 and the adoption of this statement had no material effect on our financial statements.

In June 2008, the Emerging Issues Task Force (EITF) reached final consensus on EITF Issue 08-4, "Transition Guidance for Conforming Changes to Issue No. 98-5." Certain conclusions reached in EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," were nullified in EITF Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments." Moreover, some of the conclusions in Issue No. 98-5 and Issue No. 00-27 were superseded by SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." While the conclusions reached in Issue No. 98-5 were subsequently updated to reflect the issuance of Issue No. 00-27 and SFAS No. 150, the transition guidance in Issue No. 98-

5 was not revised. On January 1, 2009, we adopted EITF 08-4. The adoption of this standard did not have a material impact on our financial condition, results of operations, or cash flows.

2. Going Concern

The accompanying condensed consolidated financial statements for the three months ended March 31, 2009, have been prepared assuming that the Company will continue as a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business.

As shown in the accompanying financial statements, we have incurred a net loss of \$1,590,752 and an accumulated deficit of \$15,964,805 for the three months ended March 31, 2009. These conditions raise substantial doubt as to our ability to continue as a going concern.

We continue to be dependent on our ability to generate future revenues, positive cash flows and additional financing. Management acknowledges that its ability to continue executing its current business plan, even on a short-term basis, is dependent on its ability to obtain additional debt or equity financing. There can be no guarantee that the Company will be successful in generating future revenues, in obtaining additional debt of equity financing or that such additional debt or equity financing will be available on terms acceptable to the Company.

3. Convertible Debt

In November 2008, we initiated a request to all of our 12% convertible debt holders to either extend their respective convertible debt for another 18 months or to convert their principal and accrued interest into common stock. During the first quarter of 2009, \$2,262,700 of the convertible debt was converted into 6,887,825 shares and \$1,614,300 of convertible debt was extended for an additional 18 months. The total extended as of March 31, 2009 was \$2,184,300, with \$927,800 due in the next 12 months; \$1,380,000 due in the next 24 months; and \$659,500 are due in next 29 months. In addition, \$465,000 of the debt is in default as of March 31, 2009.

In exchange for extending their convertible debt for an additional 18 months, we agreed to reduce the exercise price of the associated warrants from \$1.50 and \$2.25 per share to \$1.00 per share, respectively for the A and B warrants. In addition, we agreed to extend the term of both the A and B warrants from 5 years to 6 ½ years. Furthermore, the requirement of an effective registration was not removed in the case of extending the note.

In exchange for converting their convertible debt into common stock, we agreed to reduce the exercise price from \$0.50 to \$0.35 per share. We also agreed to reduce the exercise price of the associated warrants from the \$1.50 and \$2.25 per share to \$1.00 per share, respectively for the A and B warrants. In addition, we agreed to extend the term of both the A and B warrants from 5 years to 6 ½ years. Furthermore, the requirement of an effective registration was removed to allow conversion.

We evaluated the extension event in late December under FAS No. 15, EITF 02-4 and EITF 96-19. Because the investors did not grant concession on these outstanding loans, the transactions were not accounted for as troubled debt restructuring. Consequently, we evaluated these transactions under EITF 96-19 "*Debtor's Accounting for a Modification or Exchange of Debt Instruments*" to determine if the modification was substantial. As a result, no gain or loss was recorded on the date of the extension since the modification in terms is not considered significant. The Company recognized \$84,730 warrant expense associated with the extended debt under FAS 84 and charged the unamortized warrant discount to interest expense over the remaining life of the convertible debt under the new terms.

We accounted for the conversion event during the quarter ended March 31, 2009, under the provisions of Financial Accounting Standard (FAS) No. 84 "*Induced Conversions of Convertible Debt*" and recognized expense totaling \$201,017, which is equal to the fair value of the incremental compensation cost created by the modification of the exercise price of the warrants. The remaining unamortized warrant discount of \$16,377 was recognized through Additional Paid in Capital under the guidance of Emerging Issues Task Force (EITF) 98-5.

In addition, the contingency related to the contingent beneficial conversion feature was resolved on the date of conversion. The beneficial conversion feature calculated on the commitment date was fully recognized through interest expense and Additional Paid in Capital according to EITF 00-27. During the quarter ended March 31, 2009, \$2,262,700 of debt was converted and \$161,377 of the contingent beneficial conversion feature was recognized into interest expense.

The Company is in default on \$465,000 convertible debt net of discount of \$12,965 as of March 31, 2009.

A summary of the convertible debt as of March 31, 2009, and December 31, 2008, is as follows:

	2009	2008
Gross proceeds from the debts	\$ 5,500,000	\$ 5,500,000
Less: discount on the warrants	(2,116,131)	(2,116,131)
Less: principal converted to common stock	(2,532,700)	(270,000)
Add: amortization of discount	1,597,222	1,079,849
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