

DIGITILITI, INC.
CONSOLIDATED BALANCE SHEETS

ASSETS	December 31,	
	2008	2007
CURRENT ASSETS		
Cash	\$ 36,317	\$ 241,333
Accounts receivable, net	549,127	292,542
Other current assets	201,488	95,527
Total current assets	786,932	629,402
Property and equipment	1,105,113	1,433,482
Software license	1,302,158	1,153,999
Deferred financing costs	202,484	242,906
Other assets	6,322	-
Total assets	\$ 3,403,009	\$ 3,459,789
LIABILITIES AND STOCKHOLDERS' DEFICIT		
CURRENT LIABILITIES		
Accounts payable – trade	\$ 234,957	\$ 92,000
Accounts payable – related parties	104,869	-
Accrued expenses	1,136,408	377,308
Due to related parties	87,622	60,176
Current maturities of notes payable	875,365	45,906
Current maturities of notes payable – related parties	156,540	241,540
Current maturities of convertible debt	2,435,466	1,062,631
Current maturities of capital lease obligations	439,318	687,159
Total current liabilities	5,470,545	2,566,720
Notes payable, non-current	-	439,094
Convertible debt, non-current	1,758,252	1,054,290
Convertible debt – related parties, non-current	342,532	-
Capital lease obligations, non-current	65,037	198,162
Deferred rent	18,130	21,153
Other liabilities	3,607	-
Total liabilities	7,658,103	4,279,419
STOCKHOLDERS' DEFICIT		
Common stock, \$.001 par value; 100,000,000 shares authorized, 26,665,020 and 25,081,444 shares issued and outstanding	26,665	25,081
Additional paid-in capital	10,092,294	6,206,496
Accumulated deficit	(14,374,053)	(7,051,207)
Total stockholders' deficit	(4,255,094)	(819,630)
Total liabilities and stockholders' deficit	\$ 3,403,009	\$ 3,459,789

See notes to consolidated financial statements.

DIGITILITI, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Years Ended December 31,	
	2008	2007
Revenues	\$ 3,075,308	\$ 1,329,386
Cost of revenues	<u>2,047,281</u>	<u>1,454,529</u>
Gross profit	<u>1,028,027</u>	<u>(125,143)</u>
Operating expenses:		
Selling and marketing	782,546	794,431
General and administrative	3,469,272	2,606,977
Research and development	1,731,766	24,784
Total operating expenses	<u>5,983,584</u>	<u>3,426,192</u>
Loss from operations	(4,955,557)	(3,551,335)
Loss on settlement of debt	124,204	-
Interest expense	2,243,085	545,673
Net loss	<u>\$ (7,322,846)</u>	<u>\$ (4,097,008)</u>
Net loss per common share – basic and diluted	\$ (0.29)	\$ (0.19)
Weighted-average shares outstanding – basic and diluted	25,613,237	21,885,026

See notes to consolidated financial statements.

DIGITILITI, INC.

CONSOLIDATED STATEMENT OF STOCKHOLDERS' DEFICIT

	Common Stock		Additional	Accumulated	Stockholders'
	Shares	Amount	Paid-In Capital	Deficit	Deficit
BALANCE AT DECEMBER 31, 2006	17,172,520	\$ 17,172	\$ 2,961,358	\$ (2,954,199)	\$ 24,331
Issuance of common stock, net of \$83,131 fee	2,395,783	2,396	752,997	-	755,393
Conversion of debt to equity	224,857	225	78,475	-	78,700
Stock issued for services	1,524,000	1,524	547,476	-	549,000
Merger of investment in Cyclone Holdings, Inc.	122,262	122	(230,622)	-	(230,500)
Warrants exercised cashless	3,642,022	3,642	(3,642)	-	-
Warrants issued for:					
Services	-	-	113,596	-	113,596
Capital leases	-	-	367,252	-	367,252
Convertible debts	-	-	1,260,412	-	1,260,412
Employee stock option compensation expense	-	-	359,194	-	359,194
Net loss	-	-	-	(4,097,008)	(4,097,008)
BALANCE, DECEMBER 31, 2007	25,081,444	25,081	6,206,496	(7,051,207)	(819,630)
Stock issued for convertible debt	869,562	870	260,790	-	261,660
Stock issued for settlement of debt	108,004	108	161,898	-	162,006
Stock issued for services	219,760	220	405,466	-	405,686
Stock issued for R&D project	250,000	250	374,750	-	375,000
Cashless exercise of warrants	136,250	136	(136)	-	-
Discount on convertible debt relating to warrants	-	-	1,288,767	-	1,288,767
Additional Beneficial Conversion Feature on converted debts	-	-	85,812	-	85,812
Warrants expense	-	-	90,713	-	90,713
Employee stock option expense	-	-	1,217,738	-	1,217,738
Net loss	-	-	-	(7,322,846)	(7,322,846)
BALANCE, DECEMBER 31, 2008	<u>26,665,020</u>	<u>\$ 26,665</u>	<u>\$ 10,092,294</u>	<u>\$ (14,374,053)</u>	<u>\$ (4,255,094)</u>

See notes to consolidated financial statements.

DIGITILITI, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	<u>Years Ended December 31,</u>	
	<u>2008</u>	<u>2007</u>
OPERATING ACTIVITIES		
Net loss	\$ (7,322,846)	\$ (4,097,008)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation expense	753,803	542,638
Amortization of software licenses	299,356	167,193
Amortization of deferred financing costs	295,472	77,049
Amortization of discount on convertible debt	1,124,548	177,783
Loss on settlement of debt	124,204	-
Bad debt expense	98,376	-
Accounts payable written off	-	(76,140)
Interest added to due to related party	-	5,703
Common stock issued for services	405,686	525,000
Common stock issued for R&D project	375,000	-
Employee stock option expense	1,217,738	359,194
Additional Beneficial Conversion Feature on converted debts	85,812	-
Warrants expense	74,423	113,596
Changes in operating assets and liabilities:		
Accounts receivable	(354,961)	(190,588)
Other current assets	(105,961)	29,036
Other assets	(5,172)	-
Accounts payable - trade	777,672	(220,376)
Accounts payable – related parties	104,869	-
Accrued expenses	816,324	311,935
Due to related parties	19,341	-
Deferred rent	584	8,499
Net cash used by operating activities	<u>(1,215,732)</u>	<u>(2,266,486)</u>
INVESTING ACTIVITIES		
Purchases of property and equipment	(112,110)	(44,629)
Purchases of software licenses	(447,525)	(436,655)
Investment in Cyclone Holdings, Inc.	-	(175,000)
Net cash used by investing activities	<u>(559,635)</u>	<u>(656,284)</u>
FINANCING ACTIVITIES		
Proceeds from issuance of convertible debt, net financing costs	2,545,400	2,829,595
Payments on capital lease obligations	(679,140)	(448,419)
Payments on notes payable	(210,909)	-
Proceeds from notes payable – related parties	175,000	-
Payments on notes payable – related parties	(260,000)	(56,136)
Proceeds from sales of common stock	-	755,393
Payments on stock rescission payable	-	(105,000)
Net cash provided by financing activities	<u>1,570,351</u>	<u>2,975,433</u>
NET INCREASE(DECREASE) IN CASH	(205,016)	52,663
CASH		
Beginning of year	<u>241,333</u>	<u>188,670</u>
End of year	<u>\$ 36,317</u>	<u>\$ 241,333</u>

Cash paid for interest	103,382	113,946
Cash paid for income tax	-	-

Non-Cash Financing and Investing Activities:

Equipment acquired under capital lease, including issuance of warrants for capital lease	314,464	974,405
Cashless exercise of warrants	136	3,642
Discount on convertible debt relating to warrants	1,288,767	1,260,412
Conversion of debt and accounts payable to equity	261,660	78,700
Issuance of common stock through accrued expense	37,802	24,000
Merger of investment in Cyclone Holdings, Inc.	-	225,000
Software licenses purchased with note payable	-	485,000
Reclassification of common stock and additional paid-in-capital due to change in par value from merger	-	15,456
Conversion of payables to convertible debt	-	50,000

See notes to consolidated financial statements.

DIGITILITI, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

The Company and Nature of Operations

Digitiliti, Inc. (the Company or Digitiliti (f/k/a Cyclone Holdings, Inc.)) provides cost effective data protection solutions to the small to medium businesses and markets in the United States. The Company is also developing software products to offer data storage solutions for Apple networks.

In December 2006, Storage Elements, Inc. (Storage) agreed to acquire a controlling interest in Cyclone Holdings, Inc. for \$225,000 and made an initial payment of \$50,000 toward the purchase. On January 5, 2007, Storage paid the remaining balance of \$175,000. Digitiliti is currently filing with the Securities and Exchange Commission and experiences limited public trading on the “pink sheets”. The purpose of acquiring a controlling interest was to effect a “reverse” merger of Storage with Digitiliti under which Storage would become a publicly traded company. On August 16, 2007, Storage held a special meeting of its stockholders and approved an Agreement and Plan of Merger among Storage, a Minnesota corporation; Cyclone Acquisition Corp., a wholly-owned subsidiary of Digitiliti, Inc., a Minnesota corporation (Subsidiary); and Digitiliti, Inc., a Delaware corporation formerly known as Cyclone Holdings, Inc. (Digitiliti), sometimes call the “Storage Merger.”

The consolidated financial statements account for the merger as a capital transaction in substance (and not a business combination of two operating entities) that would be equivalent to Storage issuing securities to Digitiliti in exchange for the net monetary liabilities of Digitiliti, accompanied by a recapitalization and, as a result, no goodwill relating to the merger was recorded. Additionally, the merger entities retained the Digitiliti name.

Principles of Consolidation

The consolidated financial statements included the accounts of Storage prior to the merger and Digitiliti, Inc., a Delaware corporation and its wholly owned subsidiary, Cyclone Acquisition Corp., a Minnesota corporation since the merger. All significant intercompany balances and transactions were eliminated.

Use of Estimates

The preparation of these consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that may affect certain reported amounts and disclosures in the consolidated financial statements and accompanying notes. The significant estimates relate to the collectability of accounts receivable, useful lives of software licenses, valuation of beneficial conversion feature on convertible debts, valuation of warrants and stock options, and valuation allowance for deferred income taxes. Actual results could differ from those estimates.

Credit Risk

Cash is maintained in bank accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts and does not believe it is exposed to any significant credit risk on cash.

Cash and Cash Equivalents

For purposes of the statements of cash flows, cash equivalents include all highly liquid investments with original maturities of three months or less.

Allowance for Doubtful Accounts

The allowance for doubtful accounts is based on the aging, historical experience and management's judgment of the individual accounts receivable. Accounts receivable are written off against the allowance when management determines a balance is uncollectible and no longer actively pursues collection. Accounts receivable is presented net of the allowance for doubtful accounts of \$100,366 and \$1,990 at December 31, 2008 and 2007, respectively.

Property and Equipment

Property and equipment are recorded at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets. Computer equipment and furniture and fixtures are depreciated over three to five years. Maintenance and repairs are charged to operations when incurred.

Software Licenses

Certain software is licensed from two vendors to facilitate the secure online data storage solution. The licenses are nonexclusive. The term of the licenses is for three years after which the agreements automatically renew for additional one year periods. Either party may terminate the agreements if notice is received sixty days prior to the renewal date. The license fees are amortized over five years.

Long-Lived Assets

All long-lived assets are reviewed when events or changes in circumstances indicate that the carrying amounts of such assets may not be recoverable. An impairment loss is recognized when estimated undiscounted cash flows that can be generated by those assets are less than the carrying value of the assets. When an impairment loss is recognized, the carrying amount is reduced to its estimated fair value based on appraisals or other reasonable methods to estimate fair value.

Deferred Financing Costs

Costs associated with the issuance of debt is capitalized as deferred financing costs and amortized into interest expense using the effective interest method over the life of the related debt. At December 31, 2008 and 2007, deferred financing costs incurred totaled \$575,005 and \$319,955, respectively. Accumulated amortization was \$372,521 and \$77,049, respectively.

Income Taxes

Storage was organized as an S corporation for income tax purposes. Effective April 2006, Storage terminated its S corporation election and became a C corporation.

Deferred income tax assets and liabilities are recognized for the expected future income tax consequences of events that have been included in the consolidated financial statements or income tax returns. Deferred income tax assets and liabilities are determined based on differences between the financial statement and tax bases of assets and liabilities using tax rates in effect for the years in which the differences are expected to reverse.

In evaluating the ultimate realization of deferred income tax assets, management considers whether it is more likely than not that the deferred income tax assets will be realized. Management establishes a valuation allowance if it is more likely than not that all or a portion of the deferred income tax assets will not be utilized. The ultimate realization of deferred income tax assets is dependent on the generation of future taxable income, which must occur prior to the expiration of the net operating loss carryforwards.

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. (FIN) 48, "Accounting for Uncertainty in Income Taxes (as amended)," which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, "Accounting for Income Taxes." FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected

to be taken in a tax return. Any change in the net assets or liabilities recognized as a result of adopting the provisions of FIN 48 would be recorded as an adjustment to the opening balance of retained earnings. FIN 48 is effective for the Company as of January 1, 2007. The adoption of FIN 48 did not have a significant impact on the Company's consolidated financial statements.

It is the Company's practice to recognize penalties and/or interest related to income tax matters in interest and penalties expense.

The Company is subject to income taxes in the U.S. federal jurisdiction and various states and local jurisdictions. Tax regulations within each jurisdiction are subject to the interpretation of the related tax laws and regulations and require significant judgment to apply. The Company is not currently under examination by any taxing jurisdiction.

Revenue Recognition

Substantially all of our revenues are derived from monthly fees for storages services pursuant to each customer's service agreement. Service agreements with customers are typically 36-months and allow for termination upon 30 days written notice. The monthly fee is based on the volume data storage utilized. Revenues are recognized in the month the services are provided. Our product offering does not include hardware and we currently do not offer bundled arrangements. To the extent that future revenues are derived from such offerings, those revenues will be accounted for pursuant to SOP 97-2 and EITF 00-21.

Revenues from monthly fees are recognized based on the Company's determination that the criteria provided in SEC Staff Accounting Bulletin 104 - Revenue Recognition have been met. These criteria include that persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller's price to the buyer is fixed or determinable and collectability is reasonably assured. The Company determines that these criteria have been met by entering into written service agreements with its customers that specifically state the fees for set-up and monthly services. Set-up fees are invoiced after the actual set-up has been performed. Monthly fees are invoiced based on the actual amount of data stored on the Company's secure vault system during a particular month. Collectability of revenues has not been an issue as of December 31, 2008 and 2007. If the monthly service fees were not paid, the monthly service would be discontinued.

Research and Development Costs

Research and development costs are expensed as incurred. The Company expensed third party development costs totaling \$1,731,766 and \$24,784 in 2008 and 2007, respectively.

Share-Based Payment

Effective January 1, 2006, the Company adopted the provisions of SFAS No. 123 (R), "Share-Based Payment (as amended)," which establishes the accounting treatment for transactions in which an entity exchanges its equity instruments for goods or services. Under the provisions of SFAS No. 123 (R), share-based payment compensation is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the requisite service period (generally the vesting period).

Net Loss Per Share

Basic net loss per share is computed by dividing the net loss by the weighted-average number of common shares outstanding. Diluted net loss per share is computed based on the weighted-average number of common shares outstanding increased by dilutive common stock equivalents. For the years ended December 31, 2008 and 2007, potential dilutive securities had an anti-dilutive effect and were not included in the calculation of diluted earnings per common share.

New Accounting Pronouncements

Effective January 1, 2008, we adopted SFAS No. 157, Fair Value Measurements ("SFAS 157"), which provides guidance on how to measure assets and liabilities that use fair value. SFAS 157 applies whenever another U.S.

GAAP standard requires (or permits) measurement of assets or liabilities at fair value, but does not expand the use of fair value to any new circumstances. We also adopted FASB Staff Position ("FSP") No. FAS 157-2, Effective Date of FASB Statement No. 157, which allows us to partially defer the adoption of SFAS 157. This FSP defers the effective date of SFAS 157 for nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. Nonfinancial assets and nonfinancial liabilities include all assets and liabilities other than those meeting the definition of a financial asset or financial liability as defined in paragraph 6 of Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. The adoption of SFAS No. 157 and FSP No. 157-2 had no impact on our financial statements.

In December 2007, the FASB issued SFAS No. 141R, "Business Combinations" ("SFAS 141R") which establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and for disclosure to enable evaluation of the nature and financial effects of the business combination. SFAS 141R is effective for us as to business combinations we make beginning in 2009. We are evaluating the impact of SFAS No. 141R, but do not currently expect it to have a significant impact on our financial statements when effective. However, the nature and magnitude of the specific future effects will depend upon the nature, terms and size of any acquisitions we consummate after the effective date.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51" ("SFAS 160"). SFAS 160 introduces significant changes in the accounting and reporting for business acquisitions and noncontrolling interest in a subsidiary. SFAS 160 also changes the accounting and reporting for the deconsolidation of a subsidiary. Companies are required to adopt the new standard for fiscal years beginning after January 1, 2009. We adopted this standard as of January 1, 2009 and do not expect it to have an impact on our financial statements.

In April 2008, the FASB issued Staff Position FSP FAS 142-3, "Determination of the Useful Life of Intangible Assets" ("FSP FAS 142-3"). The FSP amends the factors considered in developing renewal or extension assumptions for determining the useful life of a recognized intangible asset under SFAS No. 142, "Goodwill and Other Intangible Assets." The FSP's intent is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under other accounting principles generally accepted in the U.S. Companies must adopt the FSP for fiscal years and interim periods beginning after December 15, 2008. Early adoption is prohibited. Companies must apply the guidance for determining the useful life of a recognized intangible asset prospectively to intangible assets acquired after the effective date. Companies must also apply certain disclosure requirements prospectively to all intangible assets recognized as of, and subsequent to, the effective date. We adopted this standard as of January 1, 2009 and do not expect it to have a significant impact on our financial statements.

In May 2008, the FASB issued FSP APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement), which specifies that issuers of convertible debt instruments that may be settled in cash upon conversion should separately account for the liability and equity components in a manner reflecting their nonconvertible debt borrowing rate when interest costs are recognized in subsequent periods. FSP APB 14-1 is effective for interim periods and fiscal years beginning after December 15, 2008. The Company will adopt FSP APB 14-1 effective January 1, 2009. We are in the process of assessing the impact of the adoption of FSP APB 14-1 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 our 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, including evaluating the instrument's contingent exercise and settlement provisions, and thus able to qualify for the SFAS 133 paragraph 11(a) scope exception. It

also clarifies the impact of foreign-currency-denominated strike prices and market-based employee stock option valuation instruments on the evaluation. EITF 07-5 will be effective for the first annual reporting period beginning after December 15, 2008, and early adoption is prohibited. We are assessing the impact of adopting EITF 07-5 on our financial statements.

2. Going Concern

As shown in the accompanying financial statements, the Company has incurred net losses of \$7,322,846 and \$4,097,008 for the years ended December 31, 2008 and 2007, respectively. In addition, the Company has an accumulated deficit of \$14,374,053 and a working capital deficit of \$4,683,613 as of December 31, 2008. These conditions raise substantial doubt as to our ability to continue as a going concern. In response to these conditions, we may raise additional capital through the sale of equity securities, through an offering of debt securities or through borrowings from financial institutions or individuals. The financial statements do not include any adjustments that might be necessary if we are unable to continue as a going concern.

3. Note Receivable

During August 2006, the Company entered into a promissory note formalizing the payment terms related to \$25,000 owed to the Company. During September 2007, the Company entered into a promissory note with another party to repay the entire \$25,000. The payments were not made in accordance with the promissory note. The Company has fully reserved the balance of the note for years ending December 31, 2008 and 2007.

4. Acquisition of Software

On March 13, 2008, Digitiliti executed a Technology Purchase Agreement (“TPA”) with StorageSwitch, LLC, a Colorado limited liability company (“StorageSwitch”), to acquire a commercially-proven technology software. This technology software compliments Digitiliti’s current business model and also provides a base layer that Digitiliti will build upon to develop enhanced storage service offerings.

In connection with the purchase, we made an initial cash payment of \$10,000 upon execution of the Letter of Intent in January 2008, and a cash payment of \$200,000 on the date of closing. In addition, we will make a \$40,000 cash payment payable when the software is fully developed and in production. We also issued 250,000 shares of common stock in connection with the purchase, valued at \$375,000 based upon the quoted market price of our stock on the date of the purchase. We will issue an additional 250,000 shares when the software is fully developed and in production. These shares will be valued based on the quoted market price of our stock on the date of issuance.

The software was not technologically feasible on the date of the acquisition. As a result, this transaction was accounted for as purchased research and development costs and was expensed as research and development expense in accordance with SFAS No. 2.

In conjunction with the execution of the TPA, Digitiliti and StorageSwitch also signed the following agreements: (1) a Non-Compete Agreement, (2) a Non-Disclosure Agreement, (3) a Statement of Work Agreement and (4) a Consulting Services Agreement. Under the Consulting Service Agreement, up through August 1, 2008 we will make the following payments to 2 principals of StorageSwitch: (1) semi-monthly cash payments of \$6,250 (totaling \$25,000 per month) and (2) the issuance of 12,480 shares of Digitiliti common stock (totaling 24,960 share of common stock per month). Stock issued under this arrangement is accounted for in accordance with EITF 96-18 and valued using the quoted market price of our common stock at the end of each month.

5. Property and Equipment

Property and equipment consisted of the following:

	December 31,	
	<u>2008</u>	<u>2007</u>
Computer equipment	\$ 2,551,913	\$ 2,126,479
Furniture and fixtures	<u>14,511</u>	<u>14,511</u>
Total cost	2,566,424	2,140,990
Less accumulated depreciation	<u>(1,461,311)</u>	<u>(707,508)</u>
Property and Equipment	<u>\$ 1,105,113</u>	<u>\$ 1,433,482</u>

Property and equipment is carried at cost less accumulated depreciation. Depreciation is calculated by the straight-line method over the estimated useful life of three to five years, depending upon the type of equipment. Depreciation expense totaled \$753,803 and \$542,638 in 2008 and 2007, respectively.

6. Software Licenses

Software licenses (Note 1) consisted of the following:

	December 31,	
	<u>2008</u>	<u>2007</u>
Software licenses	\$ 1,834,625	\$ 1,387,110
Less accumulated amortization	<u>(532,467)</u>	<u>(233,111)</u>
Software Licenses	<u>\$ 1,302,158</u>	<u>\$ 1,153,999</u>

Amortization expense totaled \$299,356 and \$167,193 in 2008 and 2007, respectively.

7. Related Parties Transactions

At December 31, 2008 and 2007, balances due to the related parties consisted of the following:

	2008	2007
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Note payable to a stockholder, bearing interest at 2% above prime rate, per annum, due on demand, unsecured	\$ 66,481	\$ 60,176
Note payable to an officer, bearing interest at 12.25% per annum, due on demand, unsecured	14,414	-
Note payable to an officer, bearing interest at 12.25% per annum, due on demand, unsecured	6,727	-
Total due to related parties	<u>\$ 87,622</u>	<u>\$ 60,176</u>
	=====	=====

Interest expense on these payable was \$16,912 and \$5,704 for 2008 and 2007, respectively.

Management and Founders Agreements:

Jonathan S. Miner and Pamela J. Miner

Effective December 5, 2008, we issued a convertible note to Jonathan S. Miner and Pamela J. Miner, who both currently serve on our Board of Directors, for their advance to us of the sum of \$175,000 and their agreement to advance up to an additional \$75,000 (which additional sum has been advanced to us), all to be utilized in the development of the Pyramid software storage product. We also executed a Security Agreement with them whereby we granted to them as collateral and security a lien for the payment of the convertible note and additional indebtedness of theirs or indebtedness they had guaranteed in the past on our behalf in the further aggregate amount of \$500,000. (Also see Note 10)

Dan Herbeck

Our interim CEO, Dan Herbeck, who resigned in February 2009, provided consulting services to us through his company, Continental Technologies Solutions, LLC (“Continental”). Total consulting fees for 2008 was \$121,969. As of December 31, 2008, accounts payable to Continental was \$104,869.

M2 Capital Advisors, Inc.

On May 3, 2006, we executed a consulting agreement with M2. The duties of M2 include introducing the Company to the financial community; researching and identifying potential business partners, executives, consultants and Board of Director candidates; assisting with securing leases or equipment financing; and other general business consulting services. The agreement also provided for the payment of various fees for raising capital, identifying an acquisition/reverse merger candidate, assisting with capital lease arrangements, etc. This agreement was amended March 2007, effective May 6, 2006. Pursuant to the agreement, warrants for 3,643,270 shares were exercised cashless in September and October 2007 with the issuance of 3,359,397 shares of common stock.

At the time, Mark Savage, our former President and a former director, was the President and a principal stockholder of M2. While M2 was engaged, they assisted in raising \$3,504,010 of capital from the sale of our common stock and received \$350,401 in fees for these services. In addition, M2 assisted in raising \$2,035,950 and \$3,199,550 in 12% convertible notes and received fees totaling \$203,595 and \$319,955 in 2008 and 2007, respectively.

In April 2007, M2 received 750,000 shares of restricted common stock as a fee for identifying a potential reverse merger candidate. Of the total shares issued, 297,166 of these shares were issued directly to Mr. Savage.

On or about March 23, 2009, we agreed to pay a 10% introduction fee to M2 under their current Letter Agreement with us that had been extended into May, 2009, on any funds raised by us in a planned \$1,500,000 financing through the sale of secured and unsecured convertible notes. We will be making the offer and sale of these convertible notes following any introductions by M2.

M2 partners earned total fees of \$297,300 and \$444,735 for the year ended December 31, 2008; and 2007, respectively. These expenses were included in balances of general and administrative expenses in statements of operations. M2 also received 3,726,520 warrants in 2006 to purchase our common stock at a strike price of \$0.35, which were valued at \$894,365 on the date of grant and was recognized into income within the year of grant.

5X Partners, LLC.

In August 2007, we entered into a consulting arrangement with 5X Partners, LLC (“5X”). Under the agreement, 5X provided services such as senior leadership, business development, sales and marketing, product packaging, infrastructure scaling methods and other key areas of management, business assessment and strategies. Under the arrangement, which was amended several times, we agreed to pay 5X a fixed fee of \$60,484 and monthly fees of \$28,000, of which \$8,000 would be deferred until reaching a financial funding goal. In addition, we agreed to issue 5X stock options to purchase 2,850,000 shares of our common stock at a strike price of \$0.385 per share, which vests over 24 months.

In October 2008, 5X principals resigned their executive positions with the Company, and we are currently negotiating a settlement for amounts due under the consulting arrangement (see Note 19 – Commitments and Contingencies).

5X earned fees and received expense reimbursements of \$146,295 and \$77,284 for the years ended December 31, 2008 and 2007, respectively. These expenses were included in balances of general and administrative expenses in statements of operations.

Other Management and Founder Transactions

In January 2006, we entered into two leases for computer equipment, one of which expired in 2007 and one of which will expire in 2008. One of the leasing companies, Wenzel Data, Inc., is owned by Ronald G. Wenzel, a former officer and director of Storage and a current stockholder of ours, and Brad D. Wenzel, our Chairman of the Board of Directors until April 20, 2009. The lease payments are guaranteed by Messrs. Wenzel and Wenzel. The amount outstanding for the capital lease obligation to Messrs. Wenzel and Wenzel was \$21,708 and \$71,686 at December 31, 2008 and 2007 respectively.

During February, 2006, we entered into a promissory note for \$150,000 with Mr. Miner bearing interest at 12.25% and due in monthly payments of \$5,000. In January 2007, he converted \$75,000 of the debt into 214,286 shares of our common stock. The remaining balance of the note was paid in full in November 2007. Interest expense was \$3,863 for 2007.

We and two stockholders, Ronald G. and Laura Wenzel (Ms. Wenzel is our Vice President, Secretary and a director), were guarantors on a bank promissory note of a stockholder (Pamela J. Miner, a current director) totaling \$250,000 plus interest. The proceeds from the promissory note were used by these stockholders to purchase 1,801,082 additional shares of Storage common stock that were exchanged under the Storage Merger. If these stockholders defaulted on any part of the note and we had to pay a portion of the note, then the parties would have calculated the amount of such payment as a percentage of the original note. These stockholders' shares previously received would be reduced by that percentage, but not below 94,439 common shares. The note and accrued interest were approximately \$230,000 at December 31, 2006. In March 2007, the bank released us as a guarantor on the note.

We made lease payments on a building and computer equipment that was leased by Wenzel Data, Inc. which is owned by Brad D. Wenzel, our Chairman of the Board of Directors until April 20, 2009, and used by us. The building lease expired in 2006, and the equipment lease expired in 2007. Related party rent expense for 2007 was \$3,851.

8. Notes Payable – Related Parties

We issued a \$250,000 promissory note to a stockholder dated December 15, 2005. The note mirrors a promissory note between the stockholder and his bank, which matured on December 15, 2008 and had an interest rate 0.5% above the bank's index rate (6.00% and 8.00% at December 31, 2008 and 2007, respectively). In December 2008, the note was renewed to December 31, 2009. The balance of the note was \$156,540 and \$241,540 at December 31, 2008 and 2007, respectively. Interest expense was \$14,360 and \$22,656 for 2008 and 2007, respectively.

9. Notes Payable

In December 2007, we entered into a Software Purchase Agreement (SPA) with Exanet, Inc. The terms of the SPA reflect the financing of \$485,000 of software over 36-months at 12% interest. Commencing on January 15, 2008, we are obligated to make minimum monthly interest only payments of \$4,850 that increase to \$20,000 effective October 15, 2008. The terms of the SPA include a possible \$2,500 increase to the minimum monthly interest only payments predicated on performance goals. We have the right to prepay the outstanding balance without penalty throughout the term of the agreement.

In May 2008, we entered into negotiations with Exanet resulting in a tentative agreement to discharge all debt

owing to Exanet as of December 31, 2008 (including the SPA) in exchange for the return of excess Exanet software license. At present, efforts are still in process to effectuate the return of the excess Exanet software detailed in the SPA. Accordingly, our financial statements reflect the inclusion of all debt owed Exanet classified as current liability as of December 31, 2008.

In June 2008, we negotiated a six-month payment plan with its primary software vendor – Asigra, Inc. Under the terms of the arrangement, we were granted extended payment terms in exchange for the revocation of 20% discount under net 30 payment terms. This payment plan reflected monthly payments based on a percentage of outstanding invoices owed for software licenses and maintenance, with any remaining outstanding balance payable in December 2008. In December 2008, this payment plan was extended for another 6 months with all outstanding debt payable in May 2009. As of December 31, 2008, outstanding balance under this payment plan is \$390,365.

10. Convertible Debt – Related Parties

In October 2008, we issued a \$250,000 12% convertible debt to an individual. The debt can be converted into our common stock at \$0.50 per share, subject to an effective registration statement covering the underlying common stock that has been filed with the Securities and Exchange Commission. The debt is guaranteed by a stockholder of the Company. In conjunction with this convertible debt, we issued stock warrants to purchase 150,000 shares and 100,000 shares, respectively, of Digitiliti common stock with a five year term at \$0.50 per share.

In November 2008, we issued a \$250,000 12% convertible debt to a stockholder. The debt can be converted into our common stock at \$0.35 per share, subject to an effective registration statement covering the underlying common stock that has been filed with the Securities and Exchange Commission. In conjunction with this convertible debt, we issued stock warrants to purchase 250,000 shares of Digitiliti common stock with a five year term at \$0.50 per share.

Pursuant to a security agreement with the stockholder, our Pyramid software and vaults along with other intellectual properties serve as the collateral for the above guarantee, convertible debt and the related party note payable.

We analyzed these two convertible debt and the warrants issued for derivative accounting consideration under SFAS 133 and EITF 00-19, and determined that derivative accounting is not applicable for these debts.

Under the provisions of EITF Issue 98-5 and 00-27, we discounted the relative fair value of warrants attached to the debt and calculated the intrinsic value of the beneficial conversion feature of the debt. The resulting discount of \$210,974 is being amortized over the life of the debts using the effective interest method. The amortized amount for the year ended December 31, 2008 is \$44,699.

A summary of the convertible debt – related parties as of December 31, 2008 is as follows:

Gross proceeds from the debts	\$	500,000
Less: discount on the warrants		(120,844)
Less: beneficial conversion feature		(90,130)
Add: amortization of discount		44,699
Add: accrued interest		8,807

Carrying amount as of December 31, 2008	\$	342,532
		=====

11. Convertible Debt

A summary of the convertible debt as of December 31, 2008 and 2007 is as follows:

	2008	2007
	-----	-----
Gross proceeds from the debts	\$ 5,500,000	\$ 3,199,550
Less: discount on the warrants	(2,116,131)	(1,260,412)
Less: principal converted to common stock	(270,000)	-
Add: amortization of discount	1,079,849	177,783
	-----	-----
Subtotal	\$ 4,193,718	\$ 2,116,921
Less: current maturities	(2,435,466)	(1,062,631)
	-----	-----
Long-term portion of convertible debt	\$ 1,758,252	\$ 1,054,290
	=====	=====

In March 2007, we engaged M2 (see Note 7 – Related Party Transactions) to raise up to \$5.5 million from the sale of 12% convertible debt and warrants. This \$5.5 million raise was closed in September 2008. Under the initial conversion terms, the debt was convertible into common stock at \$0.50 per share, subject to an effective registration statement covering the underlying common stock that has been filed with the Securities and Exchange Commission. In addition, for each \$1 invested, the investor receives one half warrant to acquire one half of a share of common stock with a five year term at \$1.50 per share (the A warrants); and one half warrant to acquire one half share of common stock with a five year term at \$2.25 per share (the B warrants) (see inducement discussion below). Each warrant cannot be exercised during the first 6-months and one day following issuance, unless there is an effective registration statement covering the underlying common stock that has been filed with the Securities and Exchange Commission. The warrants are callable at \$0.01 per warrant, if the common stock of the Company trades for 20 consecutive days on its principal market above \$2.25 for the first one half warrant and \$3.00 for the second one half warrant, provided there is an effective registration statement covering the underlying common stock that has been filed with the Securities and Exchange Commission.

In conjunction with the sale of the 12% convertible debt referenced above, M2 received a 10% introductory fee, which totaled \$523,550 pursuant to a Consulting Agreement and an officer also received a 10% introductory fee which totaled \$26,450. These introductory fees were accounted for as deferred financing cost and are being amortized using the effective interest method over the term of the convertible debt.

Through December 31, 2008, we have issued \$5,500,000 in convertible debt and 840,000 warrants at \$1.00, 2,330,000 warrants at \$1.50 and 2,330,000 warrants at \$2.25. As of December 31, 2007, we have issued \$3,199,550 in convertible debt and 1,599,775 warrants at \$1.50 and 1,599,775 warrants at \$2.25.

We analyzed these convertible debt and the warrants issued for derivative accounting consideration under SFAS 133 and EITF 00-19, and determined that derivative accounting is not applicable for these debts.

The convertible debt was evaluated for a beneficial conversion feature under EITF Issue 98-5 and 00-27, at which time it was concluded that a contingent beneficial conversion feature existed for a substantial portion of the convertible debt. The beneficial conversion feature was measured using the commitment-date stock price and will be recognized once the contingency is resolved. (see further discussion below regarding induced conversion of debt below.)

In addition, the relative fair value of the warrants were measured using the Black-Scholes Option Pricing Model and recorded as a debt discount, which is being amortized over the life of the debt using the effective interest method. The total discount recorded was \$2,338,205 and the unamortized balance at December 31, 2008 and 2007 was \$1,036,282 and \$1,082,629.

In November 2008, we initiated a request to all of these 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.

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.

At present, this “extension/conversion” initiative is still in progress and the deadline for extending or converting is April 15th 2009.

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. Therefore, the Company recognized \$46,214 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 in late December under the provisions of Financial Accounting Standard (FAS) No. 84 “*Induced Conversions of Convertible Debt*” and recognized expense totaling \$74,423, 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 \$1,077,793 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 fourth quarter of 2008, \$270,000 of debt was converted and \$85,812 of the contingent beneficial conversion feature was recognized into interest expense. At December 31, 2008, unrecognized contingent beneficial conversion feature amounted to \$1,767,041.

In total, we recognized into expense \$74,423 of expense related to inducements, \$85,812 related to additional beneficial conversion features.

The Company is also in default on \$420,000 convertible debt net of discount of \$11,878 as of December 31, 2008.

12. Capital Leases Obligations

In January 2006, the Company entered into two leases for computer equipment that expire in 2007 and 2008. One of the leasing companies is owned by related parties. The lease payments are guaranteed by the CEO and stockholder. The present value of the monthly lease payments was capitalized using an imputed interest rate of 10%. The amount outstanding for the capital lease obligation to related parties was \$21,708 and \$71,686 at December 31, 2008 and 2007, respectively.

In November 2006, the Company entered into a lease for computer equipment that expires in 2008 (hereafter referred to as Lease # 1). The present value of the monthly lease payments was capitalized using an imputed interest rate of 10%. In addition, the Company issued warrants to purchase 262,500 shares of common stock at \$0.35 per warrant to the lessor. The warrants have a seven-year term and include a cashless exercise provision. The fair value of the warrants was \$63,000 and was capitalized in the cost of assets under capital leases. The warrants were exercised cashless in September 2007 with the issuance of 240,882 shares of common stock.

During January and February 2007, the Company entered into two leases for computer equipment (hereinafter referred to as Lease # 2 and # 3, respectively). The present value of the monthly lease payments was capitalized using an imputed interest rate of 10%. In addition, the Company issued warrants to purchase 45,490 shares of common stock at \$0.35 per warrant. The warrants have a seven-year term and include a cashless exercise provision. The fair value of the warrants was \$10,918 and was capitalized in the cost of assets under capital leases. The warrants were exercised cashless in September 2007 with the issuance of 41,743 shares of common stock.

In December 2007, the Company entered into a 24-month lease for computer equipment (hereinafter referred to as Lease # 4). The present value of the monthly lease payments was capitalized using an imputed interest rate of 10%. The lease payments are guaranteed by the CEO and stockholder. In addition, the Company issued warrants to purchase 136,250 shares of common stock at \$0.75 per warrant. The warrants have a seven-year term. The fair value of the warrants was \$356,335 and was capitalized in the cost of assets under capital leases. In a subsequent lease with this lessor, the terms of the above-mentioned warrants were revised to reflect a cashless exercise feature. These warrants were exercised cashless on December 31, 2008 with the issuance of 136 shares of common stock.

In December 2008, the Company negotiated the consolidation of Lease 1 through 4 into a 12-month lease (hereinafter referred to as Lease # 5) for all associated computer equipment. The present value of the monthly lease payments was capitalized using an imputed interest rate of 10%. The amount outstanding for the capital lease obligation was \$381,946 at December 31, 2008

M2 Capital Advisors, Inc. (M2), a related party as the CEO of M2 was also the Company's president in 2007, charged the Company a finder's fee equal to 5% of the computer equipment lease.

In August and September 2008, the Company entered into three 36-month leases for computer equipment with two financial institutions. The present value of the monthly lease payments was capitalized using an imputed interest rate of approximately 20% and 10%. The amount outstanding for the capital lease obligation was \$49,670, \$34,798 and \$16,233, respectively, at December 31, 2008.

Amortization of capital lease property is included in depreciation expense and was \$640,153 and \$453,932 in 2008 and 2007, respectively.

Assets under capital leases, included in property and equipment, consisted of the following:

	December 31,	
	2008	2007
Computer equipment	\$ 2,140,614	\$ 1,826,150
Less accumulated depreciation	<u>(1,194,803)</u>	<u>(554,649)</u>
Assets under Capital Leases	<u>\$ 945,811</u>	<u>\$ 1,271,501</u>

The following are the minimum future lease payments for the capital leases:

<u>Year</u>	<u>Amount</u>
2009	\$ 474,953
2010	49,746
2011	<u>25,004</u>
Minimum lease payments under capital leases	549,703
Less amount representing interest	(45,348)
Less current maturities	<u>(439,318)</u>
Capital Lease Obligations, net of current maturities	<u>\$ 65,037</u>

13. Income Taxes

Income tax computed at the U.S. federal statutory rate reconciled to the effective tax rate consisted of the following:

	Years Ended December 31,			
	2008		2007	
Federal tax benefit at statutory rate	\$ (1,808,484)	(34.0)%	\$ (1,393,000)	(34.0)%
Merger related costs	-	-	227,500	5.6
Stock based compensation	679,464	12.8	40,500	1.0
State income taxes, net of federal tax	(581,191)	(10.9)	(200,200)	(4.9)
Valuation allowance for deferred tax	1,695,701	31.9	1,303,100	31.8
Other	14,510	0.2	22,100	0.5
Income Tax	\$ -	- %	\$ -	- %

The components of deferred income taxes consisted of the following:

	December 31	
	2008	2007
Current Deferred Income Tax Assets		
Vacation accrual	\$ 11,283	\$ 13,300
Allowance for uncollectible accounts	34,124	10,500
Stock based compensation	679,464	143,300
Total	724,871	167,100
Noncurrent Deferred Income Tax Assets		
Net operating loss carryforward	10,017,757	2,005,500
Noncurrent Deferred Income Tax Liabilities		
Depreciation	(32,112)	(150,800)
Deferred rent	(1,028)	(3,300)
Deferred revenue	(1,338)	(5,900)
Total	(35,478)	(160,000)
Valuation Allowance	(10,707,150)	(2,012,600)
Net Deferred Income Tax	\$ -	\$ -

The Company established a valuation allowance to fully offset the net deferred income tax assets due to the uncertainty of the Company's ability to generate the future taxable income necessary to realize those net deferred income tax assets, considering the Company's history of significant operating losses. In addition, future utilization of the available net operating loss carryforward may be limited under Internal Revenue Code Section 382 as a result of changes in ownership that have or may result from the issuance of common stock, and from options and warrants for the purchase of common stock.

At December 31, 2008 and 2007 respectively, the Company had federal net operating loss carryforward of approximately \$10,707,000 and \$2,012,000 and state net operating loss carryforward of approximately \$7,297,000 and \$1,465,000 begin to expire in 2026.

14. Operating Leases

The Company leases office space in Minneapolis that expires in October 2010 with monthly base rentals plus common area maintenance and operating charges. The monthly base rentals increase over the term of the lease. The Company is recording deferred rent to equalize the monthly payments during the lease term. This lease was guaranteed by certain officers and stockholders of the Company. This office space was vacated in August 2007. In March 2008, the Company entered into a sublease agreement which expires in October 2010 with monthly rental income that range from \$3,607 to \$3,865 including all common area maintenance and operating charges. In December 2008, the subtenant filed for Chapter 11 bankruptcy and was 2 months delinquent at that time. The company reflected this delinquent amount as a rent receivable as of December 31, 2008. The subtenant has been current on all sublease payments throughout 2009.

In April 2007, the Company entered into a lease for office space. The lease expires December 2011 and requires monthly payments that range from \$4,450 to \$6,450 through December 2008. Thereafter the rent will be determined consistent with other similar commercial properties. The Company is recording deferred rent to equalize the monthly payments during the lease term.

Rent expense was \$121,757, net of \$25,250 sublease rental income for 2008 and \$126,040 for 2007.

Approximate future minimum lease payments are as follows:

<u>Year</u>	<u>Amount</u>
2009	\$ 108,015
2010	102,403 *
2011	<u>74,345 *</u>
Total	284,763
Less sublease income	<u>80,134</u>
Net	<u><u>\$ 204,629</u></u>

* The future minimum lease payments will be determined consistent with other similar commercial properties.

15. Professional Services

During May 2006, the Company hired M2 as a consultant. (Also see discussion in Note 7 – Related Party Transactions)

During June 2006, the Company hired a financial consultant to act as the temporary controller. The consultant's duties include assisting the Company with preparation of financial statements, financial analysis, budget preparation and other financial matters. The Company issued the consultant warrants to purchase shares of common stock at a price of \$0.35 per share. The number of warrants to be issued is based on the work performed. The warrants have a five-year term and include a cashless exercise provision. For 2007, the Company recorded warrant cost of \$51,511 for 44,634 warrants. In January 2007, a \$3,700 payable to the consultant was converted into 10,571 shares of common stock.

During September 2006, the Company hired a public relations consultant whose duties include assisting the Company in planning and executing a public relations/publicity strategy. The Company will pay a \$3,000 monthly fee, issue 24,000 shares of restricted stock for services rendered and issue an additional 70,000 shares of restricted stock upon completion of certain specified events. During 2006, the consultant earned 8,000 shares that were subsequently issued to the consultant on July 31, 2007. During 2007, the consultant earned an additional 24,000 shares, of which 16,000 shares were issued in 2007. In April 2008, the Board of Directors approved the issuance of 70,000 shares of restricted stock to the consultant as a publicity media fee. These shares were subsequently

issued in August 2008 valued at \$210,000 based on the quoted stock price on August 31, 2007.

During July 2006, the Company entered into a Manufacturers Representative Agreement with Marketing Technologies, LLC (MarketLink). The agreement required the Company to make minimum monthly payments of \$30,000. However, the Company terminated the agreement in February 2007. In June 2007, the Company was named as a defendant in a lawsuit filed by MarketLink alleging breach of contract. The Company recorded a settlement in principal for \$60,000 as an agreement has been partially executed by delivery of a payment.

During March 2007, the Company entered into a Public Relations/Marketing Services Agreement with JPR Communications, Inc. (JPR). JPR's duties include development and maintenance of editorial and special interests mailing lists, editorial discussions and meetings, and ongoing publication of news releases. The agreement requires the Company to make monthly payments of \$6,000 through July 2007 followed by monthly payments of \$9,000. In addition, the Company will issue 4,000 warrants each month throughout the first 12-months of the agreement at \$0.50 per share. The warrants have a five-year term. The Company recorded warrant cost of \$62,085 in 2007. Effective January 1, 2008, the Company and JPR agreed to discontinue this contract and it has not been renewed at this time.

16. Equity

For the year ended December 31, 2007

On January 3, 2007, the Board of Directors amended the Articles of Incorporation to change the par value per share to \$.0001. The par value designation was made retroactive to the inception of the Company. The accompanying consolidated financial statements and related notes give retroactive effect to this change.

2,395,783 shares were issued by the Company for cash. The Company received \$755,393, net of \$83,131 financing costs.

224,857 shares were issued for conversion of debt.

In April 2007, the Company issued 750,000 restricted shares to M2 for additional consulting services for the introduction of Digitiliti as a "reverse" merger candidate for Storage. The shares are restricted as to when they can be sold.

In April 2007, the Company issued 750,000 restricted shares to a consultant to assist the Company in achieving several corporate and financial goals and activities. The shares are restricted as to when they can be sold.

During September 2007, certain stockholders exercised their preemptive rights and acquired 20,612 shares of common stock at \$0.35 per share.

Effective August 17, 2007, pursuant to the Agreement and Plan of Merger, Digitiliti, just prior to the merger, completed a reverse split of its then outstanding common stock on the basis of one share for 40,000 shares with an immediate 200 for one dividend to all stockholders of record. Digitiliti issued a total of 122,262 shares just prior to the merger. Storage then had a one for one exchange of its common stock at a par value of \$.0001 per share for the Digitiliti common stock at a par value of \$.001 per share.

3,642,022 shares were issued for exercise of warrants.

For the year ended December 31, 2008

In March 2008, the Company issued 250,000 shares of common stock in connection with the TPA with StorageSwitch, LLC. (Note 4)

In March 2008, the Company issued 108,004 shares of common stock valued at \$162,006 to settle the unpaid compensation for the amount of \$37,802 with its consultant. Consequently, the \$124,204 loss on settlement was recognized.

From February to August 2008, the Company issued 219,760 shares of common stock valued at \$405,686 based upon the quoted market price of the Company's stock on the date of the issuance for exchange of consulting services.

During December 2008, several convertible debt holders converted Convertible Debt in the amount of \$261,660, net of discount of \$44,291, in principal and accrued interest, to common stock. Total shares issued in exchange for the debt were 869,562.

On December 31, 2008, 136,250 unites of warrants associated with capital lease #5 (Note 12) were exercised cashless with issuance of 136 shares of common stock.

17. Stock Options

On July 23, 2007, the Company adopted the 2007 Stock Option Plan to replace the 2006 Stock Option Plan. The 2007 plan is substantially identical to the 2006 Plan except that 4,000,000 shares of common stock were reserved for issuance. On April 17, 2008, the Company increased the shares reserved to 9,000,000 shares. The term of the options is five years and the options vest over various periods.

For the year ended December 31, 2007

During 2007, options to purchase 3,441,000 shares of common stock were granted by the Company to its employees at the exercise prices ranging from \$0.35 to \$0.385. These options have a term of 5 years, and have vesting dates that vary from either full or partial vesting at date of grant to full vesting at the first and second year anniversary of the date of grant. Fair value of \$537,325 was recorded using the Black-Scholes option-pricing model. Variables used in the Black-Scholes option-pricing model for warrants issued during the year include (1) discount rate of 5%, (2) expected life of 2.96 years (3) expected volatility of 65.6% and (4) zero expected dividends.

Stock option expense for 2007 was \$359,194.

For the year ended December 31, 2008

During 2008, options to purchase 3,900,000 shares of common stock were granted by the Company to its employees and consultants at the exercise prices ranging from \$0.35 to \$0.385. These options have a term of 5 years, and have vesting dates that vary from either full or partial vesting at date of grant to full vesting at the first and second year anniversary of the date of grant. Fair value of \$4,172,205 was recorded using the Black-Scholes option-pricing model. Variables used in the Black-Scholes option-pricing model for warrants issued during the year include (1) discount rate of 2.9%, (2) expected life of 2.5 to 3.5 years (3) expected volatility of 113% and (4) zero expected dividends.

Included in the total 3,900,000 shares of options granted were the 2,850,000 stock options issued to 5X Partners, LLC and 225,000 stock options issued to Vision to Practice, Inc.

In April 2008, the Board of Directors approved the cancellation of 525,000 shares of unvested stock options due to termination of an employee in March 2008.

During 2008, options to purchase 2,699,194 shares were forfeited. Stock option expense for 2008 was \$1,217,738.

A summary of option activities for the year of 2007 and 2008 was as follows:

	<u>Options</u>	<u>Weighted- Average Exercise Price</u>
Outstanding at December 31, 2006	-	\$ -
Granted	<u>3,441,000</u>	0.37
Outstanding at December 31, 2007	3,441,000	0.37
Granted	3,900,000	0.38
Canceled	(525,000)	0.35
Forfeited	<u>(2,699,194)</u>	0.38
Outstanding at December 31, 2008	<u>4,116,806</u>	0.37

The weighted-average remaining life of all options outstanding at December 31, 2008 and 2007 was 3.8 years and 4.55 years, respectively. The weighted-average grant date fair value of options granted in 2008 and 2007 was \$1.07 and \$0.15, respectively.

As of December 31, 2008, there was approximately \$502,463 of unrecognized cost which is expected to be recorded through May 2011.

18. Stock Warrants

For the year ended December 31, 2007

1. In connection with a private offering, the Company issued warrants to purchase 3,199,550 shares of its common stock to certain institutional and accredited investors. These warrants expire in 5 years, are exercisable at \$1.50 to \$2.25 per share immediately. These warrants are classified as equity and have a fair value of \$1,260,412.

2. The Company issued warrants to purchase 262,374 shares of its common stock to several individuals. These warrants expire in 5 to 7 years, are exercisable at \$.35 to \$.75 per share immediately. These warrants are classified as equity and have a fair value of \$480,848.

3. 3,951,260 units of warrants to purchase 3,642,022 shares of the Company's common stock were exercised.

Fair value on the warrants issued during the year ended December 31, 2007 was calculated using the Black-Scholes option-pricing model. Variables used in the Black-Scholes option-pricing model for warrants issued during the year include (1) discount rate of 5%, (2) warrant life is the contract term, (3) expected volatility of 65.6% and (4) zero expected dividends.

For the year ended December 31, 2008

1. In connection with a private offering, the Company issued warrants to purchase 2,300,450 shares of its common stock to certain institutional and accredited investors. These warrants expire in 5 to 6.5 years, are exercisable at \$1 to \$2.25 per share immediately. These warrants are classified as equity and have a fair value of \$2,935,575.

2. During the fourth quarter of 2008, warrants to purchase 500,000 shares of common stock were granted by the Company to two individuals in connection with \$500,000 borrowed under two convertible debts, at an exercise price range from \$0.35 to \$0.5. These warrants have a term of 5 years, vest immediately and have a fair value of \$162,306.

3. The Company reached an agreement with one of its creditor and modified the terms of the outstanding warrants to include a cashless exercise option. The Company recognized \$16,290 incremental compensation costs as the result of this modification. These warrants were exercised under the cashless option during the fourth quarter and

shares were issued by the Company.

Fair value on the warrants issued during the year ended December 31, 2008 and the incremental compensation costs were calculated using the Black-Scholes option-pricing model. Variables used in the Black-Scholes option-pricing model for warrants issued during the year include (1) discount rate range of 1.94% to 3.73%, (2) warrant life is the contract term, (3) expected volatility of 113% and (4) zero expected dividends.

A summary of warrant activities for the year of 2007 and 2008 was as follows:

	<u>Warrants</u>	<u>Weighted-Average Exercise Price</u>
Outstanding at December 31, 2006	4,025,484	\$ 0.35
Granted	3,461,924	1.78
Exercised	<u>(3,951,260)</u>	0.35
Outstanding at December 31, 2007	3,536,148	1.75
Granted	2,800,450	1.51
Exercised	<u>(136,250)</u>	0.75
Outstanding at December 31, 2008	<u>6,200,348</u>	1.59

All warrants were fully vested and exercisable at December 31, 2008.

The weighted-average remaining contractual life of warrants outstanding at December 31, 2008 and 2007 was 4 years and 5.12 years, respectively. The weighted-average grant date fair value of warrants granted in 2008 and 2007 was \$1.11 and \$0.51 respectively.

19. Commitments and Contingencies

Because some of our convertible note holders have not accepted our Modification Proposal, we are presently in arrears in principal and accrued interest payments in an aggregate total of \$420,000 as of December 31, 2008; and an aggregate total of \$495,826 as of March 31, 2009. Although we are continuing to discuss payment and/or conversion or extension of these notes with note holders, these outstanding obligations pose a risk to our ongoing operations.

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

20. Major Customers

The Company earned 26 percent of its revenues from one customer during the year ended December 31, 2008.

21. Subsequent Events

Settlement of Former Employee Claim

On January 8, 2009, we entered into an out-of-court settlement with a former employee who sought recovery of unpaid commissions and unused vacation compensation totaling \$44,000, of which \$34,000 was accrued by us as of December 31, 2008. The settlement was reached requiring incremental payments over a four month period ending April 10, 2009; and all payments have been made.

New Related Party Lease

In February 2009, we entered into a lease with a leasing company owned by several related parties, including Brad D. Wenzel, who recently resigned as our Chief Technical Officer and a director, and Jonathan S. Miner, a director. The lease payments are guaranteed by Mr. Wenzel and Mr. Miner. We were unable to lease the equipment covered by this lease directly, so COR Equipment Financing, which is owned by Mr. Wenzel and his father, Ronald G. Wenzel, and Mr. Miner, leased the equipment by financing a bank loan in the amount of \$10,000 that each had to personally guarantee. The outstanding lease obligation to related parties is \$8,300 as of April 9, 2009; and the terms were no less favorable than could have been obtained from non-affiliated parties.

Severance Package with Former Board Member and Acting CEO

On February 10, 2009, we accepted the resignation of Dan Herbeck, acting through his company, Continental Technologies Solutions, LLC (“Continental”), as interim CEO and one of our Board members. The severance arrangement recognized unpaid invoices owed Continental of \$105,344, payable at a rate of \$4,000 per month, commencing in April, 2009. As recognition for our delay in payment, we also granted Continental 100,000 units five year “cashless” warrants to purchase 100,000 shares of our common stock at \$0.35 per share. We have not paid the April 2009 payment as of the date of this report.

Vendor Settlement Agreement

On March 19, 2009, we executed a Settlement Agreement with a former vendor seeking recovery of \$24,000 of unpaid invoices. We originally disputed this claim, and an out-of-court settlement was reached requiring a total reimbursement of \$13,000 payable in \$3,000 monthly installment commencing April 10, 2009, and continuing thereafter until paid in full. We have paid the April 2009 installment on this obligation.

Additional Convertible Note Extensions and Conversions

Subsequent to December 31, 2008, an additional \$2,167,700 in convertible notes and accrued interest were converted pursuant to our first proposal outlined above under the heading “Bridge Loan Offering 12% Convertible Note Extension and Modification Proposal,” and an additional \$1,107,182 in convertible notes and accrued interest were extended pursuant to our second proposal. 6,622,622 shares of our common stock were issued for the principal and interest for the conversion of the \$2,167,700 in convertible notes and accrued interest.