

MITEK SYSTEMS INC  
Form 10KSB  
December 29, 2006

SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

**FORM 10-KSB**

(Mark One)

☒ Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended September 30, 2006  
or

☐ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission file number 0-15235

**MITEK SYSTEMS, INC.**  
(Name of small business issuer in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

87-0418827  
(I.R.S Employer Identification No.)

**8911 Balboa Ave., Suite B, San Diego, CA 92123**  
(Address of principal executive offices) (Zip Code)

Issuer's telephone number **(858) 503-7810**

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act:

**Common Stock, par value \$.001 per share**  
(Title of class)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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 ☐

Check if there is no disclosure of delinquent filers pursuant to Item 405 of Regulation S-B is contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act)  
Yes ☐ No ☒.

State issuer's revenues for its most recent fiscal year: \$6,021,000

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The aggregate market value of voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was sold, or the average bid and asked price of such common equity, as of December 1, 2006 (See definition of affiliate in Rule 12b-2 of the Exchange Act.) is \$13,088,154.

There were 16,751,137 shares outstanding of the registrant's Common Stock as of December 1, 2006

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**MITEK SYSTEMS, INC.**

**FORM 10-KSB**

**For The Fiscal Year Ended September 30, 2006**

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## PART I

### ITEM 1. BUSINESS

#### IMPORTANT NOTE ABOUT FORWARD-LOOKING STATEMENTS

We make forward-looking statements in this Form 10-KSB and in the documents that are incorporated by reference into this Form 10-KSB. These forward-looking statements relate to Mitek's outlook or expectations for earnings, revenues, expenses, asset quality or other future financial or business performance, strategies or expectations, or the impact of legal, regulatory or supervisory matters on Mitek's business, results of operations or financial condition. Specifically, forward looking statements used in this Form 10-KSB may include:

- statements relating to the benefits of a proposed merger between Mitek and Parascript LLC, including anticipated synergies and cost savings estimated to result from the merger;
- statements relating to the successful consummation of a proposed merger between Mitek and Parascript LLC;
- statements relating to the anticipated timing of consummation of a proposed merger between Mitek and Parascript LLC
- statements related to constitution of the Mitek's board of directors and management following a proposed merger between Mitek and Parascript LLC; and
  - statements relating to future business prospects, revenue, income and financial condition of Mitek.

Forward-looking statements can be identified by the use of words such as "estimate," "may," "plan," "project," "forecast," "intend," "expect," "anticipate," "believe," "seek," "target" or similar expressions. These statements reflect Mitek's judgment based on currently available information and involve a number of risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements.

In addition to those factors discussed under the heading "Risk Factors" in Part II, Item 6 of this Form 10-KSB, and in Mitek's other public filings with the SEC, important factors could cause actual results to differ materially from our expectations. These factors include, but are not limited to: (i) adverse economic conditions; (ii) general decreases in demand for Mitek products and services; (iii) intense competition (including entry of new competitors), including among competitors with substantially greater resources than Mitek; (iv) loss of key customers or contracts; (v) increased or adverse federal, state and local government regulation; (vi) inadequate capital; (vii) unexpected costs; (viii) lower revenues and net income than forecast; (ix) inability to raise prices; (x) the risk of litigation and administrative proceedings; (xi) higher than anticipated labor costs; (xii) the possible fluctuation and volatility of operating results and financial condition; (xiii) adverse publicity and news coverage; (xiv) inability to carry out marketing and sales plans; (xv) loss of key employees and executives; (xvi) changes in interest rates; and (xvii) inflationary factors.

You are cautioned not to place undue reliance on any forward-looking statements, which speak only as of the date hereof, or in the case of a document incorporated by reference, as of the date of that document. Except as required by law, Mitek undertakes no obligation to publicly update or release any revisions to these forward-looking statements to reflect any events or circumstances after the date of this Form 10-KSB or to reflect the occurrence of unanticipated events.

The above list is not intended to be exhaustive and there may be other factors that would preclude Mitek and Parascript from realizing the predictions made in the forward-looking statements. Mitek and Parascript operate in a continually changing business environment and new factors emerge from time to time. Mitek and Parascript cannot predict such factors or assess the impact, if any, of such factors on their respective financial positions or results of operations. Accordingly, Mitek stockholders are cautioned not to place undue reliance on such statements, which speak only as of the date of this joint proxy statement/prospectus.

## **OVERVIEW**

We were incorporated under the laws of the State of Delaware in 1986. We are primarily engaged in the development and sale of software products with particular focus on intelligent character recognition and forms processing technology, products and services for the document imaging markets.

We develop, market and support what we believe to be the most accurate Automated Document Recognition (“ADR”) products commercially available for the recognition of hand printed characters. Our unique proprietary technology recognizes hand printed and machine generated characters with a level of accuracy that renders our ADR products a viable alternative to manual data entry in certain applications. The Mitek solution allows customers that process large volumes of hand printed and machine generated documents to do so more quickly, with greater accuracy and at reduced costs.

## **PRODUCTS AND RELATED MARKETS**

During fiscal year ending 2006, we had one operating segment based on our product and service offerings: Automated Document Processing.

## **AUTOMATED DOCUMENT PROCESSING**

Since 1992 we have developed and marketed ADR products, which enable the automation of costly, labor intensive business functions such as check and remittance processing, forms processing and order entry. Our ADR products incorporate proprietary neural network software technology for the recognition and conversion of hand printed and machine generated characters into digital data. Neural networks are powerful tools for pattern recognition applications and consist of sets of coupled mathematical equations with adaptive parameters that self adjust to "learn" various forms and patterns. Our ADR products combine our neural network software technology with an extensive database of character patterns, enabling them to make fine distinctions across a wide variety of patterns with high speed, accuracy and consistency. We leverage our core technology across a family of ADR products that we believe offers the highest accuracy commercially available for the recognition of hand printed characters and the automated processing of documents. Mitek's family of ADR products is made up of the three distinct product lines: Recognition Toolkits, Document and Image Processing Solutions and Check Imaging Solutions.

## **Intelligent Recognition Toolkits**

Our Intelligent Recognition Toolkits include a suite of products that leverage our proprietary intelligent character recognition (ICR), image processing, and dynamic data extraction software engines. The suite of recognition toolkits includes QuickStrokes<sup>®</sup>, QuickFX Pro<sup>™</sup>, ImageScore<sup>™</sup>, and Dynafind<sup>™</sup>. These products are sold to original equipment manufacturers (OEMs) such as Advanced Financial Solutions, a Metavante Company; Harland Financial Solutions, a John Harland Company; Sungard; BancTec; J&B Software; and to systems integrators such as Computer Sciences Corporation.

Our products used in financial document processing, are a combination of the Legal Amount Recognition (LAR) capabilities licensed from Parascript, LLC with our proprietary QuickStrokes<sup>®</sup> API Courtesy Amount Recognition (CAR) technology. These products provide a high level of accuracy in remittance processing, proof of deposit, and lock box processing applications.

The QuickStrokes<sup>®</sup> product allows for the automatic reading of machine and hand print information found on scanned documents and forms from any structured form as well as bank documents, such as checks, deposit slips, and remittance coupons. Quickstrokes integrates technology components from the "CheckReader" product licensed from A2iA Corporation or CheckScript<sup>®</sup> product licensed from Parascript, LLC which specifically increases read rates of the courtesy and legal amounts of US and Canadian checks.

QuickFX<sup>®</sup> Pro is a software toolkit that provides automatic form ID, form registration and form/template removal. We believe it significantly improves automatic data capture (ICR/OCR), forms processing, document imaging and storage performance. QuickFX<sup>®</sup> Pro reduces the image size by removing extraneous information such as pre-printed text, lines, and boxes; leaving only the filled-in data. It repairs the characters that are left, ensuring better recognition, enhanced throughput, and higher accuracy rates.

ImageScore is Mitek's Check 21 readiness solution for any financial institution that truncates or uses check images in an accounts receivables conversion environment. Integrated solution providers for financial institutions can also buy ImageScore to enhance their products. ImageScore can quickly, accurately and comprehensively analyze check images to provide the usability and quality information needed to help financial institutions act in accordance with regulatory and industry mandates. As a result, institutions minimize their risk by ensuring the integrity of check images they process, and they eliminate costly manual processes associated with managing transactions from bad check images.

DynaFind<sup>®</sup> is a software toolkit that captures data from many types of unstructured business documents. DynaFind is used in challenging data capture applications where data must be found and extracted from documents that have no pre-determined format or layout, but share common data elements. DynaFind locates this data on documents using contextual, positional, format and keyword specific information, even if it appears in a different location on each document. We have supplied DynaFind<sup>®</sup> as a stand alone API to several important OEMs in the document processing field. DynaFind<sup>®</sup> is also available as an add-on feature that has been integrated into Doctus, which is Mitek's forms processing solution.

### **Document and Image Processing Solution**

Leveraging our core technical competency in Intelligent Recognition, we have addressed the forms processing market with our Doctus<sup>®</sup> product. Doctus<sup>®</sup> incorporates our core Intelligent Recognition technologies in an application designed for end users in a broad variety of industries that require high volume automated data entry. The Doctus<sup>®</sup> software handles both structured and unstructured forms.

### **IDENTITY VALIDATION AND FORGERY DETECTION**

Since 2001, we have applied and adapted our core competency in automatic document processes and image analytics to create a product offering Mitek's image analytics, which are built on Mitek's portfolio of innovative recognition technologies used to test, clean, read and authenticate imaged documents.

Our capabilities include:

Image analysis of signatures

Image repair and optimization

OCR/ICR

Dynamic data finding on any document or check

Distributed Capture CAR/LAR

### **Forgery Detection Toolkits**

Mitek's FraudProtect<sup>™</sup> Toolkit is an innovative product for detecting check fraud and forgery using Image analytics to uncover inconsistencies and alterations in checks as they are processed by banks. These products are sold to OEMs such as SoftPro and CSC.

Signature & Check Stock Verification API is fully automated and incorporates advanced imaging, image analysis and data extraction technologies that can help verify the authenticity of every signature on every check that passes through a bank, and analyzes paper stock for any indication that an item is a counterfeit.

Mitek's PADsafe toolkit is the first toolkit of its kind to detect fraudulent preauthorized drafts. It automatically identifies PADs from checks, then notifies the user of any potentially suspicious PADs. As a result, the withdrawal of unauthorized funds due to fraudulent PAD transactions is reduced and often prevented. Mitek's PayeeFind<sup>™</sup> prevents payee-altered checks from clearing. As a result, PayeeFind can substantially reduce losses and cut administrative costs by eliminating the need for organizations to complete and file affidavits to recover funds from checks that have cleared with fraudulent payees. With PayeeFind, this type of fraud can be stopped before recovery becomes an issue.

## **Forgery Detection Solution**

Mitek's FraudProtect™ System is a comprehensive, automated software application that allows banks to detect the most common forms of check fraud from forged signatures and counterfeit checks, as well as the detection of pre-authorized drafts and payee name alterations. Banks can significantly reduce losses due to Check Fraud by using the FraudProtect System.

## **RESEARCH AND DEVELOPMENT**

During fiscal years 2006 and 2005 research and development expense was approximately \$1,349,000 and \$1,508,000 respectively. Those amounts represented 22% and 23% respectively, of revenue in each of those years. The reduction in research and development was due to the reclassification of approximately \$938,000 in fiscal 2006 and approximately \$802,000 in fiscal 2005 from research and development to cost of goods sold for engineering services provided to our customers. The total Research and Development expense would have been approximately \$2,287,000 in fiscal 2006 and approximately \$2,310,000 in fiscal 2005 before reclassification. We plan to continue spending significant amounts for research and product development. We intend for these efforts to improve our future operating results and increase cash flow. However, we can make no assurance these efforts will result in additional new products or revenue.

Most of our software products are developed internally. We also purchase technology and license intellectual property rights. We believe that our future success depends in part on our ability to maintain and improve our core technologies, enhance our existing products and develop new products that meet an expanding range of customer requirements. We do not believe we are materially dependent upon licenses or other agreements with third parties relating to the development of our products. Internal development allows us to maintain closer technical control over our products and gives us the freedom to designate which modifications and enhancements are most important and when they should be implemented. We devise innovative solutions to automated character processing problems, such as the enhancement and improvement of degraded images, and the development of user-manipulated tools to aid in automated document processing. We intend to expand our existing product offerings and to introduce new document processing software solutions. In the development of new products and enhancements to existing products, we use our own tools extensively. We perform all quality assurance and develop documentation internally. We strive to become informed at the earliest possible time about changing usage patterns and hardware advances that may affect software design. We intend to continue to support industry standard operating environments.

Our team of specialists in recognition algorithms, software engineering, user interface design, product documentation and quality improvement is responsible for maintaining and enhancing the performance, quality and usability of all of our products. In addition to research and development, the engineering staff provides customer technical support on an as needed basis, along with technical sales support.

In order to improve the accuracy of our ADR products, we focus research and development efforts on continued enhancement of our core technology and on our database of millions of character images that is used to "train" the neural network software that forms the core of our Intelligent Character Recognition (ICR) engine. In addition, we have expanded our research and development tasks to include pre- and post-processing of data subject to automated processing.

Our research and development organization included twelve software engineers on September 30, 2006, including three with advanced degrees. We balance our engineering resources between development of ICR technology and applications development. All the software engineers are involved in applications development, including ICR research and development of the QuickStrokes<sup>®</sup> API recognition engine, Doctus<sup>®</sup>, QuickFX<sup>®</sup> Pro, and FraudProtect<sup>®</sup> products, quality assurance, and customer services and support.

## **INTELLECTUAL PROPERTY**

Our success and ability to compete is dependent in part upon our proprietary technology. We rely on a combination of patent, copyright and trade secret laws and non-disclosure agreements to protect our proprietary technology. We hold a U.S. patent for our hierarchical character recognition systems. The patent covers our multiple-pass, multiple-expert system that significantly increases the accuracy of forms processing and item processing applications. We may seek to file additional patents to expand the scope of patent coverage. We may also file future patents to cover technologies under development. There can be no assurance that patents will be issued with respect to future patent applications or that our patents will be upheld as valid or will prevent the development of competitive products.

We also seek to protect our intellectual property rights by limiting access to the distribution of our software, documentation and other proprietary information. In addition, we enter into confidentiality agreements with our employees and certain customers, vendors and strategic partners. There can be no assurance that the steps we take in this regard will be adequate to prevent misappropriation of our technology or that our competitors will not independently develop technologies that are substantially equivalent or superior to our technologies.

We are also subject to the risk of adverse claims and litigation alleging infringement on the intellectual property rights of others. In this regard, there can be no assurance that third parties will not assert infringement claims in the future with respect to our current or future products or that any such claims will not require us to enter into license arrangements or result in protracted and costly litigation, regardless of the merits of such claims. No assurance can be given that any necessary licenses will be available or that, if available, such licenses can be obtained on commercially reasonable terms.

## **SALES AND MARKETING**

We market our products and services primarily through our internal, direct sales organization. We employ a technically-oriented sales force with management assistance to identify the needs of existing and prospective customers. Our sales strategy concentrates on Original Equipment Manufacturers (OEM), distributors and companies that we believe are key users and designers of automated document processing systems for high performance, large volume applications, in addition to small and large financial institutions. We currently maintain our sales and support office in California. In addition, we sell and support our products through foreign resellers in Australia, Canada, Greece, Italy, the United Kingdom, Spain, Sweden, India, and Japan. The sales process is supported with a broad range of marketing programs which include trade shows, direct marketing, public relations and advertising.

We license our software to organizations on a perpetual basis. We also license software to organizations under enterprise agreements that allow the end-user customer to acquire multiple licenses, without having to acquire separate packaged products. These enterprise agreements are targeted at large organizations that want to acquire perpetual licenses to software products for their entire enterprise along with rights to unspecified future versions of software products over the term of the agreement.

International sales accounted for approximately 15% and 23%, of our net sales for the fiscal years ended September 30, 2006 and 2005, respectively. We believe that in addition to our international sales, a significant percentage of the products in our domestic sales are incorporated into systems that are delivered to end users outside the United States. International sales in fiscal year 2006 were made to customers in fourteen countries including Australia, Greece, Canada, United Kingdom, Spain, India, Italy, Japan, and Sweden. We sell our products in United States currency only. We recorded a significant portion of our revenues from two customers in fiscal year 2006, and from two customers in fiscal year 2005. Net sales from these customers aggregated 35% and 31% for the fiscal years 2006 and 2005, respectively.

## **MAINTENANCE AND SUPPORT**

Following the installation of Mitek's software at a customer site, we provide ongoing software support services to assist our customers in operating the systems. We have an internal customer service department that handles installation and maintenance requirements. The majority of inquiries are handled by telephone. For more complicated issues, our staff, after customer consent, can log on to our customers' systems remotely. Occasionally, visits to the customers' facilities are required to resolve support issues. We maintain our customers' software largely through releases which contain improvements and incremental additions. Nearly all of our in-house customers contract for annual support services from us. These services are a significant source of recurring revenue, and are contracted for an annual basis and are typically priced at approximately 8% to 18% of the particular software product's license fee.

We provide maintenance and support on a contractual basis after the initial product warranty has expired. We provide telephone support and on-site support. Customers with maintenance coverage receive software updates from us. Foreign distributors generally provide customer training, service and support for the products they sell. Additionally, our products are supported internationally by periodic distributor and customer visits by our management. These visits include attending imaging shows, as well as sales and training efforts. Technical support is provided by telephone as well as technical visits in addition to those previously mentioned.

We believe that as the installed base of our products grows and as customers purchase additional complementary products, the software support function will become a larger source of recurring revenues. Maintenance and support service fees are deferred and recognized into income over the contract period on a straight-line basis. Costs incurred by us to supply maintenance and support services are charged to cost of sales.

## COMPETITION

The market for our ADR products is intensely competitive, subject to rapid change and significantly affected by new product introductions and other market activities of industry participants. We face direct and indirect competition from a broad range of competitors who offer a variety of products and solutions to our current and potential customers. Our principal competition comes from (i) customer-developed solutions; (ii) direct competition from companies offering automated document processing systems; (iii) companies offering competing technologies capable of recognizing hand-printed and cursive characters; and (iv) direct competition from companies offering check imaging systems to banks.

It is also possible that we will face competition from new competitors. Moreover, as the market for automated document processing, ICR, check imaging and fraud detection software develops a number of companies with significantly greater resources than we have could attempt to enter or increase their presence in our market either independently or by acquiring or forming strategic alliances with our competitors or to otherwise increase their focus on the industry. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address the needs of our current and prospective customers.

Our QuickStrokes<sup>®</sup> API product and licensed CheckScript<sup>®</sup> product compete, to various degrees, with products produced by a number of substantial competitors such as A2iA, Parascript LLC, and Orbograph. Competition among product providers in this market generally focuses on price, accuracy, reliability and technical support. We believe our primary competitive advantages are (i) recognition accuracy with regard to hand printed characters, (ii) flexibility, since it may operate on a broad range of computer operating platforms, (iii) scalability and (iv) an architectural software design, which allows it to be more readily modified, improved with added functionality, configured for new products, and ported to new operating systems and upgrades. Despite these advantages, QuickStrokes<sup>®</sup> API and CheckScript<sup>®</sup> competitors have existed longer and have far greater financial resources and industry connections than we have.

Our Doctus<sup>®</sup> product competes against complete proprietary systems offered by software developers, such as Microsystems Technology, Readsoft, and Cardiff Software, Inc. In addition, Doctus<sup>®</sup> faces competition from providers of recognition systems that incorporate ADR technology such as Microsystems Technology, Inc., and Captiva.

Increased competition may result in price reductions, reduced gross margins, and loss of market share, any of which could have a material adverse effect on the Company's business, operating results and financial condition.

## **EMPLOYEES AND LABOR RELATIONS**

As of September 30, 2006, we employed a total of 22 persons, consisting of 3 in sales and marketing, 12 in research and development, product management and support, 1 in operations, and 6 in finance, administration and other capacities. We have never had a work stoppage. None of our employees are represented by a labor organization, and we consider our relations with our employees to be good.

## **AVAILABLE INFORMATION**

Our internet address is [www.miteksystems.com](http://www.miteksystems.com). There we make available, free of charge, our annual report on Form 10-KSB, quarterly reports on Form 10-QSB, current reports on Form 8-K and any amendments to those reports, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. Our SEC reports can be accessed through the investor relations section of our Web site. The public may also obtain such information on the operation of the SEC Public Reference Room by calling the SEC at 1-800-SEC-0330. The information found on our Web site is not part of this or any other report we file with or furnish to the SEC.

## **ITEM 2. PROPERTIES**

Our principal executive offices, as well as its principal research and development facility, is located in approximately 15,927 square feet of leased office building space in San Diego, California. The lease on this facility commenced in early December 2005 and expires in early December, 2012. The base monthly rent for our facility in fiscal 2006 under this lease was approximately \$24,687. The base monthly rent increases every twelve months by approximately 3%.

## **ITEM 3. LEGAL PROCEEDINGS**

We are not aware of any legal proceedings or claims that we believe may have, individually or in the aggregate, a material adverse effect on our business, financial condition, operating results, cash flow or liquidity.

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

There were no matters submitted to a vote of security holders during the fourth quarter ended September 30, 2006.

## ITEM 4A. EXECUTIVE OFFICERS OF THE REGISTRANT

Our executive officers as of October 16, 2006 were as follows:

| Name                 | Age | Position with Mitek                |
|----------------------|-----|------------------------------------|
| James B. DeBello     | 48  | President, Chief Executive Officer |
| John M. Thornton     | 74  | Chairman                           |
| Tesfaye Hailemichael | 57  | Chief Financial Officer            |
| Emmanuel deBoucaud   | 40  | Vice President - Sales             |

Mr. DeBello was named President and Chief Executive Officer in May 2003. He has served as a director of Mitek since 1994. Prior to being named Chief Executive Officer, he served as Chief Executive Officer of Asia Corporation Communications from 2001 to May 2003. Prior to that, he served as Chief Executive Officer of IdeaEdge Ventures from 2000 to 2001. Prior to that, he served as Chief Operating Officer of CollegeClub.com from 1999 to 2000.

Mr. Thornton served as Chairman, President, Chief Executive Officer and Chief Financial Officer from August 1998 to May 2003, when he resigned as President and Chief Executive Officer but remained as Chairman and Chief Financial Officer. Mr. Thornton resigned as Chief Financial Officer in May 2005 but remains as Chairman. He has served as Chairman since 1987.

Mr. Hailemichael joined Mitek in May 2005 as Chief Financial Officer. Prior to joining Mitek, he served as Chief Financial Officer at Maxwell Technologies from 2003 to 2005. Prior to that, he served as Chief Financial Officer at Raidtec Ltd from 2001 to 2003. Prior to that, he served as Executive Vice President of Transnational Computer Technology, Inc. from 1998 to 2001. Mr. Hailemichael served as Vice President of Finance and Chief Financial Officer of Dothill Systems, Inc. from 1990 to 1998.

Mr. deBoucaud joined Mitek in July 2004. Prior to joining Mitek, he served from September 1995 to March 2004 as Vice President of Sales for Cardiff Software, Inc.

## Part II

## ITEM 5. MARKET FOR REGISTRANT'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

### Market Information

Our common stock is traded on the OTC Bulletin Board under the symbol MITK.OB and the closing bid price on October 13, 2006 was \$1.30. As of October 13, 2006, there were 434 holders of record of Mitek Systems, Inc. Common Stock.

The following table sets forth, for the fiscal period indicated, the high and low closing bid prices for the Common Stock as reported on the Nasdaq National Market or the OTC Bulletin Board. The quotations for the Common Stock traded on the OTC Bulletin Board may reflect inter-dealer prices, without retail mark-up, markdown or commission and may not necessarily represent actual transactions.

| Quarter Ended                | Dec. 31 | Mar. 31 | Jun. 30 | Sept. 30 | Year |
|------------------------------|---------|---------|---------|----------|------|
| Fiscal 2006                  |         |         |         |          |      |
| Common stock price per share |         |         |         |          |      |
| High                         | \$ 1.60 | \$ 1.65 | \$ 1.12 | \$ 1.30  | 1.88 |
| Low                          | 1.57    | 1.64    | 1.06    | 1.25     | .70  |
| Fiscal 2005                  |         |         |         |          |      |
| Common stock price per share |         |         |         |          |      |
| High                         | \$ .56  | \$ 1.03 | \$ .88  | \$ .94   | 1.03 |
| Low                          | .33     | .36     | .55     | .55      | .33  |

## Dividends

We have not paid any dividends on our common stock. We currently intend to retain earnings for use in our business and do not anticipate paying cash dividends in the foreseeable future.

In connection with the payment of the principal related to a convertible term note of \$3,000,000, issued to Laurus Master Fund, Ltd. ("Laurus") in June 2004, we issued the following shares of our common stock with a conversion price of \$0.70 in fiscal 2006: First quarter, period ended December 31, 2005, issued 1,214,286 shares of common stock and \$850,000 applied to principal; second quarter, period ended March 31, 2006, issued 195,000 shares of common stock and \$136,500 applied to principal; third quarter, period ended June 30, 2006, issued 932,597 shares of common stock and \$652,818 applied to principal. These conversions were made pursuant to Section 4(2) of the Securities Act of 1933, as amended, as Laurus is a sophisticated investor who had access to information about Mitek.

## ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

### FORWARD LOOKING STATEMENTS

In addition to historical information, this Management's Discussion and Analysis of or Plan of Operation (the "MD&A") contains certain 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. As contained herein, the words "expects," "anticipates," "believes," "intends," "will," and similar types of expressions identify forward-looking statements, which are based on information that is currently available to Mitek, speak only as of the date hereof, and are subject to certain risks and uncertainties. To the extent that the MD&A contains forward-looking statements regarding the financial condition, operating results, business prospects or any other aspect of Mitek, please be advised that our actual financial condition, operating results and business performance may differ materially from that projected or estimated by Mitek in forward-looking statements. We have attempted to identify, in context, certain factors that we currently believe may cause actual future experiences and results to differ from our current expectations. The difference may be caused by a variety of factors, including, but not limited to, adverse economic conditions, general decreases in demand for our products and services, intense competition, including entry of new competitors, increased or adverse federal, state and local government regulation, inadequate capital, unexpected costs, lower revenues and net income than forecast, price increases for supplies, inability to raise prices, the risk of litigation and administrative proceedings involving Mitek and its employees, higher than anticipated labor costs, the possible fluctuation and volatility of our operating results and financial condition, adverse publicity and news coverage, inability to carry out marketing and sales plans, loss of key executives, changes in interest rates, inflationary factors, and other specific risks that may be alluded to in this MD&A. See "Important Note About Forward-Looking Statements" in Part I of this 10-KSB.



## RESULTS OF OPERATIONS

### NET SALES

Net sales were approximately \$6,021,000 and approximately \$6,594,000 for fiscal 2006 and 2005, respectively. Net sales decreased by approximately \$573,000, or 9%, in fiscal 2006 compared to fiscal 2005. The decrease in fiscal 2006 revenue is due primarily to one international customer who purchased less in fiscal 2006, as compared to fiscal 2005.

Revenue from Harland for engineering development services were approximately \$1,100,000 in fiscal 2006 compared to approximately \$775,000 for the same period in fiscal 2005.

### COST OF SALES

Cost of sales includes manufacturing and distribution costs for products and programs sold, operation costs related to product support, and costs associated with the delivery of consulting services. Cost of sales was approximately \$1,248,000 and \$1,130,000 for fiscal year 2006 and 2005, respectively. Cost of sales for 2006 increased by approximately \$118,000 due to product mix as the increase in engineering services results in increased cost of sales. Stated as a percentage of net sales, cost of sales for fiscal year 2006 and 2005 were 21% and 17%, respectively.

### OPERATIONS

Operations expenses for fiscal year 2006 and 2005 included payroll, employee benefits, and other headcount-related costs associated with purchasing, shipping and receiving. Operations expenses were approximately \$83,000 and \$145,000 for fiscal 2006 and 2005, respectively. Stated as a percentage of net sales, operations expenses for fiscal year 2006 and 2005 were 1% and 2%, respectively. The dollar decrease in 2006 expense compared to 2005 is primarily the result of a change in the total space devoted to operations and the resulting allocation of facilities costs in fiscal 2006 as compared to fiscal 2005.

## SELLING AND MARKETING

Selling and marketing expenses include payroll, employee benefits, and other headcount-related costs associated with sales and marketing personnel and advertising, promotions, trade shows, seminars, and other programs. Selling and marketing expenses were approximately \$1,306,000 and \$2,074,000 for fiscal 2006 and 2005, respectively. Stated as a percentage of net sales, selling and marketing expenses for fiscal year 2006 and 2005 were 22% and 31%, respectively. The dollar decrease in 2006 expense compared to 2005 is primarily attributable to the reduction of four people, reduced spending on public relations expenses and outside consulting services.

## RESEARCH AND DEVELOPMENT

Research and Development expenses include payroll, employee benefits, and other headcount-related costs associated with product development. These costs are incurred to maintain and enhance existing products. We maintain what we believe to be sufficient staff to maintain our existing product lines, including development of new, more feature-rich versions of our existing product lines, as we determine our demands by the marketplace. We also maintain research personnel, whose efforts are designed to ensure product paths from current technologies to anticipated future generations of products within our area of business.

Research and Development expenses for fiscal year 2006 were approximately \$1,349,000 after the reclassification of approximately \$938,000 from Research and Development to the cost of goods sold in relation to engineering services to our customers. Total Research and Development expenses would have been approximately \$2,287,000 if there was no reclassification. In fiscal year 2005, Research and Development expenses were approximately \$1,508,000 after the reclassification of approximately \$802,000 from Research and Development to the cost of goods sold in relation to engineering services to our customers. Total Research and Development expenses would have been approximately \$2,310,000 if there was no reclassification. Stated as a percentage of net sales, research and development expenses for fiscal year 2006 and 2005, including charges to cost of sales, were 22% and 23%, respectively. The dollar decrease in the 2006 expense is primarily due to the reduction of six people in product management and engineering services combined with the increase of expense reclassification to cost of sales as stated above.

## GENERAL AND ADMINISTRATIVE

General and administrative expenses include payroll, employee benefit, and other headcount-related costs associated with the finance, facilities, and legal and other administrative fees. General and administrative costs were approximately \$2,354,000 and approximately \$3,050,000 for fiscal year 2006 and 2005, respectively. Stated as a percentage of net sales, general and administrative expenses for fiscal year 2006 and 2005 were 39% and 46%, respectively. The dollar decrease in 2006 over 2005 was primarily due to legal expenses related to legal matters resolved in 2005.

## GAIN ON SALE OF ASSETS

In fiscal year 2005, the gain on the sale of assets of \$1,106,000 related to a contingent payment on the sale of the CheckQuest product line as discussed in Note 7 to the accompanying financial statements.

## OTHER INCOME (EXPENSE)

Other Income (Expense) for fiscal year 2006 consists of interest expense on the Convertible Note, as discussed in Note 5 of the accompanying financial statements, of which approximately \$466,000 represents amortization of the beneficial conversion feature and interest paid, and approximately \$68,000 represents interest and other income. Other Income (Expense) for fiscal year 2005 consists of interest expense on the Convertible Note, as discussed in Note 5 of the accompanying financial statements, of which \$929,000 represents amortization of the beneficial conversion feature and interest paid, \$82,000 represents the change in fair value of warrant liability, and \$25,000 represents interest and other income. Net other (expenses) were approximately \$398,000 and approximately \$822,000 for fiscal year 2006 and 2005, respectively. Stated as a percentage of net sales, net other expense for the corresponding periods were 7% and 12%, respectively.

## INCOME TAXES

For the fiscal year 2006, we recorded a tax provision of approximately \$800 for income taxes which was primarily state franchise tax. For the fiscal year 2005, we recorded a tax benefit of approximately \$714 for income taxes which was primarily franchise taxes overpaid to states in which we operated.

## LIQUIDITY AND CAPITAL RESOURCES

On September 30, 2006, we had approximately \$2,331,000 in cash as compared to approximately \$2,387,000 on September 30, 2005 which is a decrease of approximately \$56,000. Accounts receivable totaled approximately \$1,079,000, an increase of approximately \$306,000 from the September 30, 2005 balance of approximately \$773,000. This increase was primarily a result of revenue generated in the fourth quarter of the fiscal year.

Unearned revenue as of September 30, 2006 was approximately \$658,000, an increase of approximately \$230,000 from September 30, 2005, which reflects the addition of deferred license sales of \$175,000 to John H. Harland and new and anniversary product support agreements offset by continued recognition of unearned revenue from product support agreements licensed in prior periods.

During fiscal year 2006, we financed our cash needs primarily from financing activities combined with cash carried over from the prior fiscal year and the reduction in the current fiscal year loss.

Net cash used by operating activities during the year ended September 30, 2006 was approximately \$54,000. The primary use of cash from operating activities was the net loss of approximately \$717,000, and an increase in accounts receivable of approximately \$326,000. The primary sources of cash from operating activities was an increase in accounts payable of approximately \$528,000, and an increase to deferred revenue of approximately \$230,000. The primary non-cash adjustment to operating activities was depreciation and amortization expense for fixed assets and debt discount of approximately \$470,000. We used part of the cash provided from operating activities to finance the acquisition of equipment used in our business.

In fiscal 2005, net cash provided from investing activities was primarily from the transaction with Harland Financial Solutions as described in Note 7 of the accompanying financial statements and collections on the note receivable from Mitek Systems, Ltd., which were in part offset by the acquisition of fixed assets, primarily computer equipment.

In fiscal 2005, net cash from financing activities was primarily the proceeds from the convertible debt, net of debt issuance costs, described in Note 5 of the accompanying financial statements, which was offset by the borrowings of \$801,000, as well as the proceeds from the sale of common stock to John H. Harland Company.

Our working capital and current ratio was approximately \$1,905,000 and 2.12, respectively on September 30, 2006 and approximately \$1,323,000 and 1.67, respectively, on September 30, 2005. On September 30, 2006, the total liabilities to equity ratio was .86 to 1 compared to 2.36 to 1 on September 30, 2005. As of September 30, 2006, total liabilities decreased by approximately \$780,000 compared to total liabilities on September 30, 2005.

On June 11, 2004, we secured a financing arrangement with Laurus Master Fund ("Laurus"). The financing consisted of a \$3 million Secured Note that bore interest at the rate of prime (as published in the Wall Street Journal), plus one percent and had a term of three years (matures June 11, 2007).

As noted below, on June 2, 2006, Laurus converted the remaining Secured Note balance to Common Stock, leaving no principal balance due (unaudited). The Secured Note was convertible into shares of our common stock at an initial fixed price of \$0.70 per share, a premium to the 10-day average closing share price as of June 11, 2004. The effective annual interest rate of this convertible debt, after considering the total debt issue costs (discussed below), was approximately 36%.

In connection with the financing, Laurus was also issued warrants to purchase up to 860,000 shares of our common stock. The warrants are exercisable as follows: 230,000 shares at \$0.79 per share; 230,000 shares at \$0.85 per share and the balance at \$0.92 per share. The gross proceeds of the convertible debt were allocated among the debt instrument and the warrants. Then we computed the beneficial conversion feature embedded in the debt instrument using the effective conversion price in accordance with EITF 98-5 and 00-27. We have recorded a debt discount of (i) \$367,887 for the valuation of the 860,000 warrants issued with the note (computed using a Black-Scholes model with an interest rate of 2.53%, volatility of 81%, zero dividends and expected term of three years); (ii) \$522,384 for a beneficial conversion feature inherent in the Secured Note and (iii) \$151,000 for debt issue costs paid to affiliates of the lender, for a total discount of \$1,041,271. The \$1,041,271 is being amortized over the term of the Secured Note. Cumulative amortization of the debt discounts through June 30, 2006 was \$1,041,271.

A registration rights agreement was executed requiring us to register the shares of our common stock underlying the Secured Note and warrants so as to permit the public resale thereof. Liquidated damages of 2% of the Secured Note balance per month would accrue if stipulated deadlines were not met. Prior to the end of fiscal 2004, we incurred a penalty of \$208,000 to Laurus Funds for failing to register the securities underlying the Secured Notes and Warrants. On October 4, 2004, we settled this penalty with Laurus Master Fund, LLC by agreeing to issue an additional warrant for the purchase of 200,000 shares at a price of \$0.70 per share. The value of this additional warrant was calculated by us to be \$73,159, using a Black-Scholes option pricing model. We incurred additional liquidated damages, payable in cash, in the amount of \$215,000 for the period January 1, 2005 to May 13, 2005. The registration became effective on May 13, 2005.

In conjunction with raising capital through the issuance of convertible debt, we issued various warrants that have registration rights for the underlying shares. As the contracts required the company to register the shares underlying the warrants and which contained liquidating damages, which is not within the control of the Company by September 10, 2004, pursuant to EITF 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock", the net value of the warrants at the date of issuance was recorded as a warrant liability on the balance sheet (\$367,887) and the change in fair value from the date of issuance to September 30, 2004 and 2005 has been included in other (expense) income.

On June 11, 2004, to secure the payment of all obligations, we entered into a Master Security Agreement which assigned and granted to Laurus a continuing security interest in all of the following property now owned or at any time upon execution of the agreement, acquired by us or subsidiaries, or in which any assignor now have or at any time in the future may acquire any right, title or interest: all cash, cash equivalents, accounts, deposit accounts, inventory, equipment, goods, documents, instruments (including, without limitation, promissory notes), contract rights, general tangibles, chattel paper, supporting obligations, investment property, letter-of-credit rights, trademarks, trademark applications, patents, patent applications, copyrights, copyright applications, tradestyles and any other intellectual property, in each case, in which any Assignor now has or may acquire, any right, title or interest, all proceeds and products thereof (including, without limitation, proceeds of insurance) and all additions, accessions and substitutions. In the event any assignor wishes to finance an acquisition in the ordinary course of business of any hereafter-acquired equipment and have obtained a commitment from a financing source to finance such equipment from an unrelated third party, Laurus agreed to release its security interest on such hereafter-acquired equipment so financed by such third party financing source.

The Secured Note stipulated that it was to be repaid using cash payment along with an equity conversion option; the details of both methods for repayment are as follows: The cash repayments stipulated that beginning on December 1, 2004, or the first amortization date, we would make monthly payments to Laurus on each repayment date until the maturity date, each in the amount of \$90,909, together with any accrued and unpaid interest to date. The conversion repayment stated that each month by the fifth business day prior to each amortization date, Laurus would deliver to us a written notice converting the monthly amount payable on the next repayment date in either cash or shares of common stock, or a combination of both. If a repayment notice was not delivered by Laurus on or before the applicable notice date for such repayment date, then we would pay the monthly amount due in cash. Any portion of the monthly amount paid in cash would be paid to Laurus in an amount equal to 102% of the principal portion of the monthly amount due. If Laurus converted all or a portion of the monthly amount in shares of our common stock, the number of such shares to be issued by us would be the number determined by dividing the portion of the monthly amount to be paid in shares of common stock, by the applicable fixed conversion price.

During the third quarter of fiscal 2006, Laurus exercised its right to convert the outstanding principal balance of the note to common stock. On June 2, 2006, Laurus converted the remaining note balance to common stock, leaving no principal balance due. We have therefore expensed all unamortized deferred financing costs associated with this debt as of June 2, 2006.

There are no significant capital expenditures planned for the foreseeable future.

We evaluate our cash requirements on a quarterly basis. Historically, we have managed our cash requirements principally from cash generated from operations. Although our strategy for fiscal 2006 is to grow the identified markets for its new products and enhance the functionality and marketability of our character recognition technology, we have not yet observed a significant change in liquidity or future cash requirements as a result of this strategy. Anticipated cash requirements over the next twelve months are principally to fund operations, including spending on research and development. We believe that it will have sufficient liquidity to finance our operations for the next twelve months using existing cash and cash generated from operations, as discussed above.

The merger agreement we entered on July 13, 2006 with Parascript may impact our ability to satisfy our cash needs if we terminate the agreement before completion of the merger in certain circumstances. The merger agreement provides that each of Mitek and Parascript may be required to pay a termination fee to the other in an amount of \$1 million plus fees and expenses up to \$500,000.

In connection with the entry into the merger agreement on July 13, 2006, we have entered into various agreements with Plainfield relating to the financing for the transaction with Parascript. Whether or not the merger with Parascript is consummated, we may be required to pay Plainfield certain fees and expenses, which could be substantial and may impact our ability to satisfy our cash needs.

## **RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

In December 2004, the FASB issued SFAS No.123 (revised 2004), "Share-Based Payment" Statement 123(R) will provide investors and other users of financial statements with more complete and neutral financial information by requiring that the compensation cost relating to share-based payment transactions be recognized in financial statements. That compensation cost will be measured based on the fair value of the equity or liability instruments issued. Statement 123(R) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. Statement 123(R) replaces FASB Statement No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. Statement 123, as originally issued in 1995, established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that Statement permitted entities the option of continuing to apply the guidance in Opinion 25, as long as the footnotes to financial statements disclosed what net income would have been had the preferable

fair-value-based method been used. Public entities (other than those filing as small business issuers) will be required to apply Statement 123(R) as of the first interim or annual reporting period that begins after June 15, 2005. The company will adopt the modified prospective transition method under SFAS 123R effective October 1, 2006. We are continuously evaluating the impact of the adoption of SFAS 123(R), and currently believe the impact will be significant to our overall results of operations or financial position.

In March 2005, the SEC released Staff Accounting Bulletin No. 107, "Share-Based Payment" ("SAB 107"), which provides interpretive guidance related to the interaction between SFAS 123(R) and certain SEC rules and regulations. It also provides the SEC staff's views regarding valuation of share-based payment arrangements. In April 2005, the SEC amended the compliance dates for SFAS 123(R), to allow companies to implement the standard at the beginning of their next fiscal year, instead of the next reporting period beginning after June 15, 2005.

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in nondiscretionary profit-sharing payments resulting from an accounting change, should be recognized in the period of the accounting change. SFAS No. 154 also requires that a change in depreciation, amortization or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Early adoption is permitted for accounting changes and corrections of errors made in fiscal years beginning after the date this Statement is issued. Management does not expect the implementation of this new standard to have a material impact on our financial position, results of operations and cash flows.

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155 ("SFAS 155"), "Accounting for Certain Hybrid Financial Instruments" which amends Statement of Financial Accounting Standards No. 133 ("SFAS 133"), "Accounting for Derivative Instruments and Hedging Activities" and Statement of Financial Accounting Standards No. 140 ("SFAS 140"), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." SFAS 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 also clarifies and amends certain other provisions of SFAS 133 and SFAS 140. SFAS 155 is effective for all financial instruments acquired, issued or subject to a remeasurement event occurring in fiscal years beginning after September 15, 2006. Earlier adoption is permitted, provided the Company has not yet issued financial statements, including for interim periods, for that fiscal year. Since the Company has no derivative instruments or hedging activities, we do not expect the adoption of SFAS 155 to have a material impact on our financial position, results of operations or cash flows.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets" which amends SFAS No. 140. SFAS 156 requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable. The statement permits, but does not require, the subsequent measurement of servicing assets and servicing liabilities at fair value. SFAS 156 is effective for fiscal years beginning after September 15, 2006. We do not expect the adoption of SFAS 156 to have a material impact on our financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157 "Fair Value Measurements" ("SFAS 157"). SFAS 157 provides a new single authoritative definition of fair value and provides enhanced guidance for measuring the fair value of assets and liabilities and requires additional disclosures related to the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. SFAS 157 is effective for us as of January 28, 2008. We are currently assessing the impact, if any, of SFAS 157 on our financial position, results of operation, or cash flows.

In July 2006, the FASB issued FASB Interpretation No. 48 ("FIN 48"), Accounting for Uncertainty in Income Taxes, which prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Additionally, FIN 48 provides guidance on the derecognition, classification, interest and penalties, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN 48 are effective for reporting periods beginning after December 15, 2006. The Company is currently assessing the impact of the adoption of FIN 48 and its impact on our financial position, results of operations, or cash flows.

In September 2006, the SEC released Staff Accounting Bulletin No. 108 "Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements" ("SAB 108"). SAB 108 provides interpretative guidance on how public companies quantify financial statement misstatements. There have been two common approaches used to quantify such errors. Under an income statement approach, the "roll-over" method, the error is quantified as the amount by which the current year income statement is misstated. Alternatively, under a balance sheet approach, the "iron curtain" method, the error is quantified as the cumulative amount by which the current year balance sheet is misstated. In SAB 108, the SEC established an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of the company's financial statements and the related financial statement disclosures. This model is commonly referred to as a "dual approach" because it requires quantification of errors under both the roll-over and iron curtain methods. SAB 108 is effective for the us as of January 1, 2007. The adoption of SAB 108 is not expected to have a material impact on our financial position, results of operations, or cash flows.

In September 2006, the FAS issued SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, which requires employers to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity. The Company is currently analyzing the expected impact of adoption of this Statement on its financial statements.

In July 2006, the Emerging Issues Task Force Reached Consensus on Issue No. 06-03 "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)," that provides guidance on how sales tax collected from customers should be presented in the income statement. The Company will adopt this statement immediately, and will disclose the caption in which sales tax is recorded in accordance with the consensus reached in this issue when sales tax has been collected.

In July 2006, the FASB issued FASB Staff Position (FSP) No. FAS 13-2, "Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction," that provides guidance on how a change or a potential change in the timing of cash flows relating to income taxes generated by a leveraged lease transaction affects the accounting by a lessor for the lease. This staff position will be adopted by the Company on January 1, 2007. The Company is currently evaluating the impact of adopting this FSP; however, the Company does not expect the adoption of this provision to have a material effect on its financial position, results of operations or cash flows.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the American Institute of Certified Public Accountants ("AICPA") and the SEC did not or are not believed by management to have a material impact on the Company's present or future financial statements.

## **APPLICATION OF CRITICAL ACCOUNTING POLICIES**

Mitek's financial statements and accompanying notes are prepared in accordance with generally accepted accounting principles in the United States of America. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. These estimates by management are affected by management's application of accounting policies are subjective and may differ from actual results. Critical accounting policies for Mitek include revenue recognition, allowance for accounts receivable, fair value of equity instruments and accounting for income taxes.

### **Revenue Recognition**

We enter into contractual arrangements with end users that may include licensing of the our software products, product support and maintenance services, consulting services, resale of third-party hardware, or various combinations thereof, including the sale of such products or services separately. Our accounting policies regarding the recognition of revenue for these contractual arrangements is fully described in the Notes to the Financial Statements.

We consider many factors when applying generally accepted accounting principles in the United States of America to revenue recognition. These factors include, but are not limited to:

- The actual contractual terms, such as payment terms, delivery dates, and pricing of the various product and service elements of a contract
  - Availability of products to be delivered
  - Time period over which services are to be performed
  - Creditworthiness of the customer
- The complexity of customizations to our software required by service contracts
- The sales channel through which the sale is made (direct, VAR, distributor, etc.)
  - Discounts given for each element of a contract
- Any commitments made as to installation or implementation “go live” dates

Each of the relevant factors is analyzed to determine its impact, individually and collectively with other factors, on the revenue to be recognized for any particular contract with a customer. Management is required to make judgments regarding the significance of each factor in applying the revenue recognition standards, as well as whether or not each factor complies with such standards. Any misjudgment or error by management in its evaluation of the factors and the application of the standards, especially with respect to complex or new types of transactions, could have a material adverse affect on our future revenues and operating results.

#### *Accounts Receivable.*

We evaluate the creditworthiness of our customers prior to order fulfillment and we perform ongoing credit evaluations of our customers to adjust credit limits based on payment history and our assessment of the customers' current creditworthiness. We constantly monitor collections from our customers and maintain a provision for estimated credit losses that is based on historical experience and on specific customer collection issues. While such credit losses have historically been within our expectations and the provisions established, we cannot guarantee that we will continue to experience the same credit loss rates that we have in the past. Since our revenue recognition policy requires customers to be deemed creditworthy, our accounts receivable are based on customers whose payment is reasonably assured. Our accounts receivable are derived from sales to a wide variety of customers. We do not believe a change in liquidity of any one customer or our inability to collect from any one customer would have a material adverse impact on our financial position.

#### *Fair Value of Equity Instruments*

The valuation of certain items, including valuation of warrants, beneficial conversion feature related to convertible debt and compensation expense related to stock options granted, involve significant estimations with underlying assumptions judgmentally determined. The valuation of warrants and stock options are based upon a Black Scholes valuation model, which involve estimates of stock volatility, expected life of the instruments and other assumptions. As our stock is thinly traded, the estimates, which are based partly on historical pricing of our stock, may not represent fair value, but we believe it is presently the best form of estimating objective fair value.

*Deferred Income Taxes.*

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. We maintain a valuation allowance against the deferred tax asset due to uncertainty regarding the future realization based on historical taxable income, projected future taxable income, and the expected timing of the reversals of existing temporary differences. Until such time as we can demonstrate that we will no longer incur losses or if we are unable to generate sufficient future taxable income we could be required to maintain the valuation allowance against our deferred tax assets.

**RISK FACTORS**

This Annual Report on Form 10-KSB contains statements that are forward-looking. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of issues and uncertainties such as those listed below and elsewhere in this report, which, among others, should be considered in evaluating our financial outlook.

*Risks Associated With Our Business*

**If we consummate our business combination with Parascript, there will be a substantial number of shares of our common stock available for resale in the future that may increase the volume of common stock available for sale in the open market and may cause a decline in the market price of our common stock.**

The consideration to be issued in the merger with Parascript will include approximately 51 million shares of our common stock. The convertible financing with Plainfield to be used to consummate the merger will be convertible into approximately 22 million shares of our common stock. Except for a portion of the shares that will be held in an indemnification escrow, the shares issued to Parascript will be freely saleable after the consummation of the merger. The shares issuable upon conversion of the convertible debt will be freely saleable upon registration. The presence of these additional number of shares of common stock eligible for trading in the public market may have an adverse effect on the market price of our common stock.

**If we are unable to consummate our business combination with Parascript, the impact of various accrued costs and expenses associated with the transaction would remain our responsibility, which may have a material adverse effect upon our financial resources and our ability to operate in the future.**

We have expended, and continue to expend, considerable financial and other resources in connection with the proposed business combination with Parascript. We have anticipated that the cash flow from the combined businesses would be used to satisfy the costs and expenses associated with the transaction. No assurance can be made that the transaction will be consummated. If the transaction is not consummated, the payment for the various costs and expenses we have incurred would be substantial and would have a negative impact upon our financial condition and our ability to operate effectively, or at all, in the future

**Because most of our revenues are from a single type of technology, our product concentration may make us especially vulnerable to market demand and competition from other technologies, which could reduce our sales and revenues and cause us to be unable to continue our business.**

We currently derive substantially all of our product revenues from licenses and sales of software products incorporating our character recognition technology. As a result, factors adversely affecting the pricing of or demand for our products and services, such as competition from other products or technologies, any decline in the demand for automated entry of hand printed characters, negative publicity or obsolescence of the software environments in which our products operate could result in lower sales or gross margins and would have a material adverse effect on our business, operating results and financial condition.

**Competition in our market may result in pricing pressures, reduced margins or the inability of our products and services to achieve market acceptance.**

We compete against numerous other companies which address the character recognition market, many of which have greater financial, technical, marketing and other resources. Other companies could choose to enter our marketplace. We may be unable to compete successfully against our current and potential competitors, which may result in price reductions, reduced margins and the inability to achieve market acceptance for our products. Moreover, from time to time, our competitors or we may announce new products or technologies that have the potential to replace our existing product offerings. There can be no assurance that the announcement of new product offerings will not cause potential customers to defer purchases of our existing products, which could adversely affect our business, operating results and financial condition.

**We must continue extensive research and development in order to remain competitive. If our products fail to gain market acceptance, our business, operating results and financial condition would be materially adversely affected by the lower sales.**

Our ability to compete effectively with our character recognition product line will depend upon our ability to meet changing market conditions and develop enhancements to our products on a timely basis in order to maintain our competitive advantage. Rapidly advancing technology and rapidly changing user preferences characterize the markets for products incorporating character recognition technology. Our continued growth will ultimately depend upon our ability to develop additional technologies and attract strategic alliances for related or separate product lines. There can be no assurance that we will be successful in developing and marketing product enhancements and additional technologies, that we will not experience difficulties that could delay or prevent the successful development, introduction and marketing of these products, or that our new products and product enhancements will adequately meet the requirements of the marketplace, will be of acceptable quality, or will achieve market acceptance.

If our new products fail to gain market acceptance, our business, operating results and financial condition would be materially adversely affected by the lower sales. If we are unable, for technological or other reasons, to develop and introduce products in a timely manner in response to changing market conditions or customer requirements, our business, operating results and financial condition may be materially and adversely affected by lower sales.

**Our annual and quarterly results have fluctuated greatly in the past and will likely continue to do so, which may cause substantial fluctuations in our common stock price.**

Our quarterly operating results have in the past and may in the future vary significantly depending on factors including the timing of customer projects and purchase orders, new product announcements and releases by us and other companies, gain or loss of significant customers, price discounting of our products, the timing of expenditures, customer product delivery requirements, availability and cost of components or labor and economic conditions generally and in the information technology market specifically. Any unfavorable change in these or other factors could have a material adverse effect on our operating results for a particular quarter or year, which may cause downward pressure on our common stock price. We expect quarterly and annual fluctuations to continue for the foreseeable future.

**We may need to raise additional capital to fund continuing operations. If our financing efforts are not successful, we will need to explore alternatives to continue operations, which may include a merger, asset sale, joint venture, loans or further expense reductions. If these measures are not successful, we may be unable to continue our operations.**

Our efforts to reduce expenses and generate revenue may not be successful. We have funded our operations in the past by raising capital, sale of certain assets and loan from Laurus Fund. We raised \$3.0 million in gross proceeds from our June 2004 secured debt financing and a total of approximately \$2.4 million in gross proceeds ( \$1.3 million in July of 2004 and \$1.0 million in April of 2005 and a release of \$106,000 from indemnification liability withholding in the fourth quarter of fiscal 2005) from our July sale of certain assets and granting of exclusive distribution and licensing rights related to our CheckQuest® item processing and CaptureQuest® electronic document management solutions to Harland Financial Solutions, Inc. In addition we received \$1.5 million in equity investment from John H. Harland Company.

If our revenues do not increase we may expect the need to raise additional capital through equity or debt financing or through the establishment of other funding facilities in order to keep funding operations.

However, raising capital has been, and will continue to be difficult, and we may not receive sufficient funding. Any future financing that we seek may not be available in amounts or at times when needed, or, even if it is available, may not be on terms acceptable to us. Also, if we raise additional funds by selling equity or equity-based securities, the percentage ownership of our existing stockholders will be reduced and such equity securities may have rights, preferences or privileges senior to those of the holders of our common stock.

If we are unable to obtain sufficient cash either to continue to fund operations or to locate a strategic alternative, we may be forced to seek protection from creditors under the bankruptcy laws or cease operations. Any inability to obtain additional cash as needed could have a material adverse effect on our financial position, results of operations and ability to continue in existence.

Also, see the discussion of the transaction described under Subsequent Events and the credit facilities which may exist upon the consummation of such transaction.

**Our historical order flow patterns, which we expect to continue, have caused forecasting difficulties for us. If we do not meet our forecasts or analysts' forecasts for us, the price of our common stock may decline.**

Historically, a significant portion of our sales have resulted from shipments during the last few weeks of the quarter from orders received in the last month of the applicable quarter. We do, however, base our expense levels, in significant part, on our expectations of future revenue. As a result, we expect our expense levels to be relatively fixed in the short term. Any concentration of sales at the end of the quarter may limit our ability to plan or adjust operating expenses. Therefore, if anticipated shipments in any quarter do not occur or are delayed, expenditure levels could be disproportionately high as a percentage of sales, and our operating results for that quarter would be adversely affected. As a result, we believe that period-to-period comparisons of our results of operations are not and will not necessarily be meaningful, and you should not rely upon them as an indication of future performance. If our operating results for a quarter are below the expectations of public market analysts and investors, the price of our common stock may be materially adversely affected.

**Revenue recognition accounting standards and interpretations may change, causing us to recognize lower revenues.**

In October 1997, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position (SOP) No. 97-2, Software Revenue Recognition. We adopted SOP 97-2, as amended by SOP 98-4 Deferral of the Effective Date of a Provision of SOP 97-2 as of July 1, 1998. In December 1998, the AICPA issued SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions. We adopted SOP 98-9 on January 1, 2000. These standards address software revenue recognition matters primarily from a conceptual level and do not include specific implementation guidance. We believe that we are currently in compliance with SOP 97-2 and SOP 98-9. In addition, in December 1999, the Securities and Exchange Commission (SEC) staff issued Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements (SAB 101), which provides further guidance with regard to revenue recognition, presentation and disclosure. We adopted SAB 101 during the fourth quarter of fiscal 2000.

The accounting profession and the SEC continue to discuss certain provisions of SOP 97-2, SAB 101 and other revenue recognition standards and related interpretations with the objective of providing additional guidance on potential application of the standards and interpretations. These discussions could lead to unanticipated changes in revenue recognition standards and, as a result, in our current revenue accounting practices, which could cause us to recognize lower revenues and lead to a decrease in our stock price.

**If our products have product defects, it could damage our reputation, sales, profitability and result in other costs, any of which could adversely affect our operating results which could cause our common stock price to go down.**

Our products are extremely complex and are constantly being modified and improved, and as such they may contain undetected defects or errors when first introduced or as new versions are released. As a result, we have in the past and could in the future face loss or delay in recognition of revenues as a result of software errors or defects. In addition, our products are typically intended for use in applications that are critical to a customer's business. As a result, we believe that our customers and potential customers have a greater sensitivity to product defects than the market for software products generally.

There can be no assurance that, despite our testing, errors will not be found in new products or releases after commencement of commercial shipments, resulting in loss of revenues or delay in market acceptance, diversion of development resources, damage to our reputation, adverse litigation, or increased service and warranty costs, any of which would have a material adverse effect upon our business, operating results and financial condition.

**Our success and our ability to compete are dependent, in part, upon protection of our proprietary technology. If we are unable to protect our proprietary technology, our revenues and operating results would be materially adversely affected.**

We generally rely on trademark, trade secret, copyright and patent law to protect our intellectual property. We may also rely on creative skills of our personnel, new product developments, frequent product enhancements and reliable product maintenance as means of protecting our proprietary technologies. There can be no assurance, however, that such means will be successful in protecting our intellectual property. There can be no assurance that others will not develop technologies that are similar or superior to our technology.

The source code for our proprietary software is protected both as a trade secret and as a copyrighted work. Despite these precautions, it may be possible for a third party to copy or otherwise obtain and use our products or technology without authorization, or to develop similar technology independently.

**We may have difficulty protecting our proprietary technology in countries other than the United States. If we are unable to protect our proprietary technology, our revenues and operating results would be materially adversely affected.**

We operate in a number of countries other than the United States. Effective copyright and trade secret protection may be unavailable or limited in certain countries. Moreover, there can be no assurance that the protection provided to our proprietary technology by the laws and courts of foreign nations against piracy and infringement will be substantially similar to the remedies available under United States law. Any of the foregoing considerations could result in a loss or diminution in value of our intellectual property, which could have a material adverse effect on our business, financial condition, and results of operations.

**Companies may claim that we infringe their intellectual property or proprietary rights, which could cause us to incur significant expenses or prevent us from selling our products.**

We have in the past had companies claim that certain technologies incorporated in our products infringe their patent rights. Although we have resolved the past claims and there are currently no claims of infringement pending against us, there can be no assurance that we will not receive notices in the future from parties asserting that our products infringe, or may infringe, those parties' intellectual property rights. There can be no assurance that licenses to disputed technology or intellectual property rights would be available on reasonable commercial terms, if at all.

Furthermore, we may initiate claims or litigation against parties for infringement of our proprietary rights or to establish the validity of our proprietary rights. Litigation, either as plaintiff or defendant, could result in significant expense to us and divert the efforts of our technical and management personnel from operations, whether or not such litigation is resolved in our favor. In the event of an adverse ruling in any such litigation, we might be required to pay substantial damages, discontinue the use and sale of infringing products, expend significant resources to develop non-infringing technology or obtain licenses to infringing technology. In the event of a successful claim against us and our failure to develop or license a substitute technology, our business, financial condition and results of operations would be materially and adversely affected.

**We depend upon our key personnel.**

Our future success depends in large part on the continued service of our key technical and management personnel. We do not have employment contracts with, or "key person" life insurance policies on, any of our employees, including Mr. James B. DeBello, our President and Chief Executive Officer, Mr. John M. Thornton, our Chairman and Mr. Tesfaye Hailemichael, our Chief Financial Officer. Loss of services of key employees could have a material adverse effect on our operations and financial condition. We are also dependent on our ability to identify, hire, train, retain and motivate high quality personnel, especially highly skilled engineers involved in the ongoing developments required to refine our technologies and to introduce future applications. The high technology industry is characterized by a high level of employee mobility and aggressive recruiting of skilled personnel.

We cannot assure you that we will be successful in attracting, assimilating and retaining additional qualified personnel in the future. If we were to lose the services of one or more of our key personnel, or if we failed to attract and retain additional qualified personnel, it could materially and adversely affect our customer relationships, competitive position and revenues.

**We do not have a current credit facility.**

While we believe that our current cash on hand and cash generated from operations, to finance our operations for the next twelve months, we can make no assurance that we will not need additional financing during the next twelve months or beyond. Actual sales, expenses, market conditions or other factors which could have a material affect upon us could require us to obtain additional financing. If such financing is not available, or if available, is not available on reasonable terms, it could have a material adverse effect upon our results of operations and financial condition.

Also, see the discussion of the transaction described under Subsequent Events and the credit facilities which may exist upon the consummation of such transaction.

**The liability of our officers and directors is limited pursuant to Delaware law.**

Pursuant to our Certificate of Incorporation, and as authorized under applicable Delaware Law, our directors and officers are not liable for monetary damages for breach of fiduciary duty, except for liability (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law, (iii) under Section 174 of the Delaware General Corporation Law or (iv) for any transaction from which the director derived an improper personal benefit.

***Risks Related to Our Stock***

**A few of our stockholders have significant control over our voting stock which may make it difficult to complete some corporate transactions without their support and may prevent a change in control.**

As of September 30, 2006, John M. Thornton, who is our Chairman of the Board and his spouse, Director Sally B. Thornton, beneficially owned 2,699,959 shares of common stock or approximately 17% of our outstanding common stock. Our directors and executive officers as a whole, own approximately 17% of our outstanding common stock, or approximately 26% including outstanding options (vested and unvested) to acquire common stock, but not including options to be issued pursuant to employment agreements with certain Mitek officers which become effective upon consummation of the merger with Parascript. Laurus may acquire up to 1,060,000 shares upon exercise of its warrant or approximately 5% of the outstanding common stock.

The above-described significant stockholders may have considerable influence over the outcome of all matters submitted to our stockholders for approval, including the election of directors. In addition, this ownership could discourage the acquisition of our common stock by potential investors and could have an anti-takeover effect, possibly depressing the trading price of our common stock.

**Our common stock is listed on the Over-The-Counter Bulletin Board.**

Our common stock is currently listed on the Over-The-Counter Bulletin Board (the "OTCBB"). If our common stock became ineligible to be listed on the OTCBB, it would likely continue to be listed on the "pink sheets." Securities traded on the OTCBB or the "pink sheets" are subject to certain securities regulations. These regulations may limit, in certain circumstances, certain trading activities in our common stock, which could reduce the volume of trading in our common stock or the market price of our common stock. The OTC market and the "pink sheets" also typically exhibit extreme price and volume fluctuations. These broad market factors may materially adversely affect the market price of our common stock, regardless of our actual operating performance. In the past, individual companies whose securities have exhibited periods of volatility in their market price have had securities class action litigation instituted against that company. This type of litigation, if instituted, could result in substantial costs and a diversion of management's attention and resources.

**We may issue preferred stock, which could adversely affect the rights of common stock holders.**

The Board of Directors is authorized to issue up to 1,000,000 shares of preferred stock and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by the stockholders. The rights of the holders of common stock will be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. The issuance of preferred stock, while providing desirable flexibility in connection with possible acquisitions and other corporate purposes, could have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock. We have no current plans to issue shares of preferred stock. In addition, Section 203 of the Delaware General Corporation Law restricts certain business combinations with any "interested stockholder" as defined by such statute. The statute may have the effect of delaying, deferring or preventing a change in our control.

**Our common stock price has been volatile. You may not be able to sell your shares of our common stock for an amount equal to or greater than the price at which you acquire your shares of common stock.**

The market price of our common stock has been, and is likely to continue to be, highly volatile. Future announcements concerning us or our competitors, quarterly variations in operating results, announcements of technological innovations, the introduction of new products or changes in the product pricing policies of Mitek or its competitors, claims of infringement of proprietary rights or other litigation, changes in earnings estimates by analysts or other factors could cause the market price of our common stock to fluctuate substantially. In addition, the stock market has from time-to-time experienced significant price and volume fluctuations that have particularly affected the market prices for the common stocks of technology companies and that have often been unrelated to the operating performance of particular companies. These broad market fluctuations may adversely affect the market price of our common stock. During the fiscal year ended September 30, 2006, our common stock price ranged from \$0.70 to \$1.88.

**Future sales of our common stock may cause our stock price to decline.**

The sale of a large number of shares of our common stock in the market or the belief that such sales could occur, could cause a drop in the market price of our common stock. The shares registered in this offering will be freely tradable without restriction or further registration under the Securities Act, unless the shares are purchased by our affiliates.

**Applicable SEC Rules governing the trading of “penny stocks” limit the trading and liquidity of our common stock which may adversely affect the trading price of our common stock.**

Our common stock currently trades on the OTC Bulletin Board. Since our common stock continues to trade below \$5.00 per share, our common stock is considered a “penny stock” and is subject to SEC rules and regulations that impose limitations upon the manner in which our shares can be publicly traded. These regulations require the delivery, prior to any transaction involving a penny stock, of a disclosure document explaining the penny stock market and the associated risks. Under these regulations, brokers who recommend penny stocks to persons other than established customers or certain accredited investors must make a special written suitability determination for the purchaser and receive the purchaser’s written agreement to a transaction prior to sale. These regulations have the effect of limiting the trading activity of our common stock and reducing the liquidity of an investment in our common stock.

**We do not intend to pay dividends in the foreseeable future.**

We have never declared or paid a dividend on our common stock. We intend to retain earnings, if any, for use in the operation and expansion of our business and, therefore, do not anticipate paying any dividends in the foreseeable future.

**ITEM 7. FINANCIAL STATEMENTS**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of Mitek Systems, Inc.  
San Diego, California

We have audited the accompanying balance sheet of Mitek Systems, Inc. (the "Company") as of September 30, 2006, and the related statements of operations, stockholders' equity (deficit), and cash flows for the years ended September 30, 2006 and 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company at September 30, 2006, and the results of its operations and its cash flows for the years ended September 30, 2006 and 2005, in conformity with accounting principles generally accepted in the United States of America.

/s/ Stonefield Josephson, Inc.  
CERTIFIED PUBLIC ACCOUNTANTS

Los Angeles, California  
December 19, 2006

MITEK SYSTEMS, INC.  
BALANCE SHEET  
September 30, 2006

## ASSETS

## CURRENT ASSETS

|                                                                                                                |             |
|----------------------------------------------------------------------------------------------------------------|-------------|
| Cash and cash equivalents                                                                                      | \$2,331,011 |
| Accounts receivable including related party of \$372,498-net of allowance<br>for doubtful accounts of \$69,631 | 1,078,576   |
| Inventory, prepaid expenses and other current assets                                                           | 198,620     |
| Total current assets                                                                                           | 3,608,207   |

|                              |        |
|------------------------------|--------|
| PROPERTY AND EQUIPMENT - net | 83,530 |
|------------------------------|--------|

|              |        |
|--------------|--------|
| OTHER ASSETS | 52,022 |
|--------------|--------|

|              |              |
|--------------|--------------|
| TOTAL ASSETS | \$ 3,743,759 |
|--------------|--------------|

## LIABILITIES AND STOCKHOLDERS' EQUITY

## CURRENT LIABILITIES:

|                                   |            |
|-----------------------------------|------------|
| Accounts payable                  | \$ 734,707 |
| Accrued payroll and related taxes | 280,400    |
| Deferred revenue                  | 657,505    |
| Other accrued liabilities         | 30,927     |
| Total current liabilities         | 1,703,539  |

|               |        |
|---------------|--------|
| Deferred rent | 23,890 |
|---------------|--------|

|                   |              |
|-------------------|--------------|
| TOTAL LIABILITIES | \$ 1,727,429 |
|-------------------|--------------|

## COMMITMENTS AND CONTINGENCIES (Note 4)

## STOCKHOLDERS' EQUITY:

|                                                                                                     |              |
|-----------------------------------------------------------------------------------------------------|--------------|
| Preferred Stock, Par \$0.001, 1,000,000 shares authorized, none issued and outstanding              |              |
| Common stock - \$.001 par value; 40,000,000 shares authorized, 16,745,609 issued<br>and outstanding | 16,746       |
| Additional paid-in capital                                                                          | 14,357,042   |
| Accumulated deficit                                                                                 | (12,357,458) |
| Total stockholders' equity                                                                          | 2,016,330    |

|                                            |              |
|--------------------------------------------|--------------|
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 3,743,759 |
|--------------------------------------------|--------------|

The accompanying notes form an integral part of these financial statements.

MITEK SYSTEMS, INC.  
STATEMENTS OF OPERATIONS  
FOR THE YEARS ENDED SEPTEMBER 30, 2006 and 2005

|                                                                                                                                  | 2006         | 2005           |
|----------------------------------------------------------------------------------------------------------------------------------|--------------|----------------|
| <b>NET SALES</b>                                                                                                                 |              |                |
| Software, including approximately \$83,000 in 2006 and approximately \$196,000 in 2005 to a related party                        | \$ 3,029,597 | \$ 4,432,043   |
| Professional Services, education and other, including approximately \$1,330,000 in 2006 and \$775,000 in 2005 to a related party | 2,991,509    | 2,161,802      |
|                                                                                                                                  | 6,021,106    | 6,593,845      |
| <b>COSTS AND EXPENSES:</b>                                                                                                       |              |                |
| Cost of Sales-Software                                                                                                           | 276,971      | 300,606        |
| Cost of Sales-Professional Services, education and other                                                                         | 970,575      | 829,088        |
| Operations                                                                                                                       | 83,017       | 145,223        |
| Selling and marketing                                                                                                            | 1,306,157    | 2,073,977      |
| Research and development                                                                                                         | 1,348,721    | 1,507,510      |
| General and administrative                                                                                                       | 2,354,274    | 3,050,037      |
| Gain on disposition of assets                                                                                                    | 0            | (1,106,129)    |
| Total costs and expenses                                                                                                         | 6,339,715    | 6,800,312      |
| <b>OPERATING LOSS</b>                                                                                                            | (318,609)    | (206,467)      |
| <b>OTHER INCOME (EXPENSE):</b>                                                                                                   |              |                |
| Interest expense                                                                                                                 | (465,753)    | (929,066)      |
| Change in fair value of warrant liability                                                                                        | 0            | 81,993         |
| Interest and other income                                                                                                        | 67,836       | 25,470         |
| Total other income (expense)                                                                                                     | (397,917)    | (821,603)      |
| <b>LOSS BEFORE TAXES</b>                                                                                                         | (716,526)    | (1,028,070)    |
| <b>PROVISION (BENEFIT) FOR TAXES</b>                                                                                             | 800          | (714)          |
| <b>NET LOSS</b>                                                                                                                  | \$ (717,326) | \$ (1,027,356) |
| <b>NET LOSS PER SHARE - BASIC AND DILUTED</b>                                                                                    | \$ (0.05)    | \$ (0.08)      |
| <b>WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING - BASIC AND DILUTED</b>                                                  | 15,905,157   | 12,569,617     |

The accompanying notes form an integral part of these financial statements.

MITEK SYSTEMS, INC.  
STATEMENTS OF CASH FLOWS  
FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

|                                                                 | 2006                | 2005                |
|-----------------------------------------------------------------|---------------------|---------------------|
| <b>OPERATING ACTIVITIES</b>                                     |                     |                     |
| Net loss                                                        | \$ (717,326)        | \$ (1,027,356)      |
| Adjustments to reconcile net loss used in operating activities: |                     |                     |
| Depreciation and amortization                                   | 51,815              | 92,320              |
| Provision (recoveries) for bad debts                            | 21,000              | (31,000)            |
| Gain on disposal of property and equipment                      | (2,551)             | 0                   |
| Gain on sale of checkquest assets                               | 0                   | (1,106,129)         |
| Change in fair value of warrant liability                       | 0                   | (81,993)            |
| Amortization of debt discount                                   | 418,085             | 526,938             |
| Provision for sales returns & allowances                        | (85,068)            | (14,583)            |
| Fair value of stock options issued to non-employees             | 0                   | 2,580               |
| Gain on sale of equity investment                               | 0                   | (16,159)            |
| Changes in assets and liabilities:                              |                     |                     |
| Accounts receivable                                             | (326,366)           | (172,056)           |
| Inventory, prepaid expenses, and other assets                   | 60,276              | (126,434)           |
| Accounts payable                                                | 527,771             | (81,973)            |
| Accrued payroll and related taxes                               | (70,705)            | 111,105             |
| Deferred revenue                                                | 229,998             | 29,783              |
| Deferred rent                                                   | 23,890              | (13,215)            |
| Other accrued liabilities                                       | (184,346)           | (114,002)           |
| Net cash used in operating activities                           | (53,527)            | (2,022,174)         |
| <b>INVESTING ACTIVITIES</b>                                     |                     |                     |
| Purchases of property and equipment                             | (54,319)            | (48,932)            |
| Proceeds from sale of property and equipment                    | 4,150               | 569                 |
| Proceeds from sale of assets, related party                     | 0                   | 1,000,000           |
| Payment on related party note receivable-net                    | 0                   | 150,000             |
| Net cash provided by (used in) investing activities             | (50,169)            | 1,101,637           |
| <b>FINANCING ACTIVITIES</b>                                     |                     |                     |
| Repayment of borrowings                                         | 0                   | (800,682)           |
| Proceeds from sale of common stock                              | 0                   | 1,501,250           |
| Proceeds from exercise of stock options                         | 47,503              | 0                   |
| Net cash provided by financing activities                       | 47,503              | 700,568             |
| <b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>                | <b>(56,193)</b>     | <b>(219,969)</b>    |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR</b>           | <b>2,387,204</b>    | <b>2,607,173</b>    |
| <b>CASH AND CASH EQUIVALENTS AT END OF YEAR</b>                 | <b>\$ 2,331,011</b> | <b>\$ 2,387,204</b> |
| <b>SUPPLEMENTAL DISCLOSURE<br/>OF CASH FLOW INFORMATION</b>     |                     |                     |
| Cash paid for interest                                          | \$ 47,668           | \$ 402,127          |

|                            |    |     |    |       |
|----------------------------|----|-----|----|-------|
| Cash paid for income taxes | \$ | 700 | \$ | 1,056 |
|----------------------------|----|-----|----|-------|

**SUPPLEMENTAL DISCLOSURE OF NON-CASH FINANCING  
AND INVESTING ACTIVITIES**

|                                                                                     |    |           |    |         |
|-------------------------------------------------------------------------------------|----|-----------|----|---------|
| Options issued in exchange for services                                             | \$ | -         | \$ | 2,580   |
| Warrants issued in connection with financing                                        | \$ | -         | \$ | 73,159  |
| Conversion of debt to equity                                                        | \$ | 1,639,318 | \$ | 560,000 |
| Statement of indemnification liability                                              | \$ | -         | \$ | 106,129 |
| Settlement of registration penalty through issuance of warrants                     | \$ | -         | \$ | 208,000 |
| Reclassification of warrants with registration obligation to liability              | \$ | -         | \$ | 73,159  |
| Reclassification of warrants upon fulfillment of registration obligations to equity | \$ | -         | \$ | 407,074 |

The accompanying notes form an integral part of these financial statements.

MITEK SYSTEMS, INC.  
 STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)  
 FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

|                                                                                     | <b>Common<br/>Stock<br/>Outstanding</b> | <b>Common<br/>Stock</b> | <b>Additional<br/>Paid-In<br/>Capital</b> | <b>Accumulated<br/>Deficit</b> | <b>Total<br/>Stockholders<br/>Equity<br/>(Deficit)</b> |
|-------------------------------------------------------------------------------------|-----------------------------------------|-------------------------|-------------------------------------------|--------------------------------|--------------------------------------------------------|
| Balance, October 1, 2004                                                            | 11,389,481 \$                           | 11,389 \$               | 10,069,833 \$                             | (10,612,776)\$                 | (531,554)                                              |
| Fair value of stock options issued to non-employees                                 |                                         |                         | 2,580                                     |                                | 2,580                                                  |
| Proceeds from issuance of common stock                                              | 2,142,856                               | 2,143                   | 1,499,107                                 |                                | 1,501,250                                              |
| Common stock issued in exchange for convertible debt                                | 800,000                                 | 800                     | 559,200                                   |                                | 560,000                                                |
| Settlement of registration penalty through issuance of warrants                     |                                         |                         | 208,000                                   |                                | 208,000                                                |
| Reclassification of warrants with registration obligation to liability              |                                         |                         | (73,159)                                  |                                | (73,159)                                               |
| Reclassification of warrants upon fulfillment of registration obligations to equity |                                         |                         | 407,074                                   |                                | 407,074                                                |
| Net loss                                                                            |                                         |                         |                                           | (1,027,356)                    | (1,027,356)                                            |
| Balance, September 30, 2005                                                         | 14,332,337                              | 14,332                  | 12,672,635                                | (11,640,132)                   | 1,046,835                                              |
| Exercise of stock options                                                           | 71,389                                  | 71                      | 47,432                                    |                                | 47,503                                                 |
| Common stock issued in exchange for convertible debt                                | 2,341,883                               | 2,343                   | 1,636,975                                 |                                | 1,639,318                                              |
| Net loss                                                                            |                                         |                         |                                           | (717,326)                      | (717,326)                                              |
| Balance, September 30, 2006                                                         | 16,745,609 \$                           | 16,746 \$               | 14,357,042 \$                             | (12,357,458)\$                 | 2,016,330                                              |

The accompanying notes form an integral part of these financial statements.

**MITEK SYSTEMS, INC.**  
**NOTES TO FINANCIAL STATEMENTS**  
**FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005**

**NOTE 1 - NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Nature of Operations - Mitek Systems, Inc. (the "Company") is a designer, manufacturer and marketer of advanced character recognition products for intelligent forms processing applications ("Character Recognition") with an emphasis in document imaging system products and solutions systems integration services.

During the years ended September 30, 2006 and 2005, the Company has incurred losses of \$717,326 and \$1,027,356, respectively. Cash used for operations improved from \$2,022,174 in 2005 to \$53,527 in 2006. The Company has a cash balance of approximately \$2.3 million as of September 30, 2006. Management believes that the current cash balance and cash expected to be generated from operations for the next twelve months will be adequate to satisfy its working capital needs for the next twelve months. In 2004, the Company addressed its cash requirements by issuing Convertible Debt (see Note 5 of the accompanying financial statements). In 2005, the Company received equity investments of \$1.5 million from J.H. Harland & Co. As discussed in Note 7 of the accompany notes, the Company received an additional \$1 million arising from the sale of the checkquest assets in 2004 and resolution of the BSM legal matter in 2005. Should additional losses occur, the Company may need to raise significant additional funds to continue its activities. In the absence of positive cash flows from operations, the Company may be dependent on its ability to secure additional funding through the issuance of debt or equity instruments. If adequate funds are not available, the Company may be forced to significantly curtail its operations or to obtain funds through entering into additional collaborative agreements or other arrangements that may be on unfavorable terms. The Company's failure to raise sufficient additional funds on favorable terms, or at all, would have a material adverse effect on its business, results of operations and financial position.

Also, see the discussion of the pending acquisition transaction of Parascript, LLC, as more fully described under Note 10 and the related credit facilities, which may exist upon the consummation of such transaction.

Basis of Accounting - The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.

Reclassification - Certain prior year balances have been reclassified to conform to the current year presentation

Accounting Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include estimates of loss contingencies and product life cycles, and assumptions such as the elements comprising a software arrangement, including the distinction between upgrades/enhancements and new products; and when technological feasibility is achieved for our products. The Balance Sheet items that are significantly impacted by estimates include the contingencies related to the collectability of accounts receivable, the useful lives of fixed assets and the associated depreciation expense thereupon, the valuation of tax losses and credits. In addition, we use assumptions to estimate the fair value of stock-based compensation. Actual results may differ from management's estimates and assumptions.

**Fair Value of Financial Instruments** - The carrying amount of cash, cash equivalents, accounts receivable, notes receivable, accounts payable, and accrued liabilities are considered representative of their respective fair values because of the short-term nature of those instruments.

**Revenue Recognition** - Revenue from sales of software licenses sold through direct and indirect channels, which do not contain multiple elements, are recognized upon shipment of the related product, if the requirements of Statement of Position ("SOP") 97-2, as amended, are met. If the requirements of SOP 97-2, including evidence of an arrangement, delivery, fixed or determinable fee, collectability or vendor specific evidence about the fair value of an element are not met at the date of shipment, revenue is not recognized until such elements are known or resolved. Software license revenue for arrangements to deliver unspecified additional software products in the future is recognized ratably over the term of the arrangement, beginning with the initial shipment. Revenue from post-contract customer support is recognized ratably over the term of the contract. Revenue from professional services is recognized when such services are delivered and accepted by the customer.

**Deferred Revenue** - Deferred revenue represents customer billings, paid either upfront or annually at the beginning of each billing period, which are accounted for as subscriptions with revenue recognized ratably over the billing coverage period. For certain other licensing arrangements revenue attributable to undelivered elements, including free post-delivery telephone support and the right to receive unspecified upgrades/enhancements on our software on a when-and-if-available basis, is based upon the sales price of those elements when sold separately and is recognized ratably on a straight-line basis over the term of the agreement. Historically, the percentage of revenue recorded as unearned due to undelivered elements generally ranged from approximately 8% to 18% of the sales price of the software.

**Advertising expense** -Advertising costs are expensed as incurred and totaled approximately \$24,000 and approximately \$45,000 during the years ended September 30, 2006, and 2005, respectively.

**Cash and Cash Equivalents** - Cash equivalents are defined as highly liquid financial instruments with original maturities of three months or less. A substantial portion of our cash is deposited with one financial institution. We monitor the financial condition of the financial institution and we do not believe that the deposit is subject to a significant degree of risk. However, the bank has FDIC insurance of up to \$100,000, and any financial problems with the bank may impact the company.

**Allowance for Doubtful Accounts** - The allowance for doubtful accounts reflects our best estimate for probable losses inherent in the accounts receivable balance. We determine the allowance based on known troubled accounts, historical experience, and other currently available evidence.

**Inventories, prepaid expenses and other current assets consisted of the following at September 30, 2006.**

|                           |            |
|---------------------------|------------|
| Inventories               | \$ 6,833   |
| Prepaid insurance         | 29,277     |
| Deposits and prepaid rent | 63,515     |
| Financing costs (Note 10) | 39,750     |
| Prepaid expenses          | 59,245     |
| Total                     | \$ 198,620 |

Inventories - Inventories consisting of finished goods are recorded at the lower of cost or market.

Property and equipment - Property and Equipment are carried at cost. Following is a summary of property and equipment as of September 30, 2006.

|                                                 |            |
|-------------------------------------------------|------------|
| Property and equipment - at cost:               |            |
| Equipment                                       | \$ 669,026 |
| Furniture and fixtures                          | 132,015    |
| Leasehold improvements                          | 49,299     |
|                                                 | \$ 850,340 |
| Less: accumulated depreciation and amortization | (766,810)  |
| Total                                           | \$ 83,530  |

Property and equipment are carried at cost. Depreciation and amortization of property and equipment are provided using the straight-line method over estimated useful lives ranging from three to five years. Leasehold improvements are amortized over the shorter of the life of the lease or 7 years. Expenditures for repairs and maintenance are charged to operations while renewals and betterments are capitalized. Total repairs and maintenance expenses for the year ended September 30, 2006 amounted to approximately \$56,000. Depreciation and amortization of property and equipment totaled approximately \$52,000 and \$92,000 for the years ended September 30, 2006 and 2005, respectively.

Other Assets - Other assets consisted of the following at September 30, 2006:

|               |           |
|---------------|-----------|
| Prepaid rent  | \$ 29,465 |
| Prepaid other | 22,557    |
| Total         | \$ 52,022 |

Long-Lived Assets - We periodically evaluate the carrying value of license agreements and other intangible assets to determine whether any impairment of these assets has occurred or whether any revision to the related amortization periods should be made. This evaluation is based on management's projections of the undiscounted future cash flows associated with each product or asset. If management's evaluation were to indicate that the carrying values of these intangible assets were impaired, the impairment to be recognized is measured by the amount the carrying amount of the assets exceeds the fair value of the assets. We did not record any impairment for the years ended September 30, 2006 and 2005.

Investment in Mitek Systems Ltd. - Between September 1, 2000 and fiscal 2001, we acquired an investment in Itech Business Solutions Ltd., who subsequently changed their name to Mitek Systems Ltd. In fiscal year 2002, we made an interest bearing loan to Mitek Systems Ltd. which was later converted to equity. In the first quarter of fiscal 2005, our entire interest in Mitek Systems Ltd. was repurchased by the principal stockholder of Mitek Systems Ltd., which resulted in net proceeds of \$150,000. Included in fiscal 2005 Other Income (Expenses) is \$15,710 related to the gain in equity investment in Mitek Systems Ltd.

Research and Development - Research and development costs are expensed in the period incurred.

Income Taxes - The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*. Deferred tax assets and liabilities arise from temporary differences between the tax bases of assets and liabilities and their reported amounts in the financial statements that will result in taxable or deductible amounts in future years.

Management evaluates the available evidence about future taxable income and other possible sources of realization of deferred tax assets. The valuation allowance reduces deferred tax assets to an amount that represents management's best estimate of the amount of such deferred tax assets that more likely than not will be realized. - see Note 3.

Net Loss Per Share - We calculate net loss per share in accordance with Statement of Financial Accounting Standards ("SFAS") No. 128, *Earnings per Share*. Basic net loss per share is based on the weighted average number of common shares outstanding during the period. Diluted net income per share also gives effect to all potential dilutive common shares outstanding during the period, such as convertible debt, options and warrants, if dilutive. Outstanding stock options for fiscal 2006 and 2005 of 2,616,246 and 2,006,719, respectively, were excluded from this calculation, as they would have been antidilutive. In addition, 1,060,000 Laurus warrants and 321,428 Harland warrants were excluded from this calculation in fiscal 2006, as they would reduce net loss per share. In fiscal 2005, 2,341,883 shares issuable upon conversion of debt to equity and exercise of 1,060,000 Laurus warrants and 321,428 Harland warrants were excluded from this calculation, as they would reduce net loss per share.

Segment Reporting - SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*, results in the use of a management approach in identifying segments of an enterprise. Management has determined that we operate in only one segment.

Comprehensive Income (Loss) - There are no differences between net income and comprehensive income and, accordingly, no amounts have been reflected in the accompanying financial statements and a statement of comprehensive loss is not presented.

### **Recent Accounting Pronouncements**

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" Statement 123(R) will provide investors and other users of financial statements with more complete and neutral financial information by requiring that the compensation cost relating to share-based payment transactions be recognized in financial statements. That compensation cost will be measured based on the fair value of the equity or liability instruments issued. Statement 123(R) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. Statement 123(R) replaces FASB Statement No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. Statement 123, as originally issued in 1995, established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that Statement permitted entities the option of continuing to apply the guidance in Opinion 25, as long as the footnotes to financial statements disclosed what net income would have been had the preferable fair-value-based method been used. Public entities (other than those filing as small business issuers) will be required to apply Statement 123(R) as of the first interim or annual reporting period that begins after June 15, 2005. The company will adopt the modified prospective transition method under SFAS 123R effective October 1, 2006. We are continuously evaluating the impact of the adoption of SFAS 123(R), and currently believe the impact will be significant to our overall results of operations or financial position.

In March 2005, the SEC released Staff Accounting Bulletin No. 107, "Share-Based Payment" ("SAB 107"), which provides interpretive guidance related to the interaction between SFAS 123(R) and certain SEC rules and regulations. It also provides the SEC staff's views regarding valuation of share-based payment arrangements. In April 2005, the SEC amended the compliance dates for SFAS 123(R), to allow companies to implement the standard at the beginning of their next fiscal year, instead of the next reporting period beginning after June 15, 2005.

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in nondiscretionary profit-sharing payments resulting from an accounting change, should be recognized in the period of the accounting change. SFAS No. 154 also requires that a change in depreciation, amortization or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Early adoption is permitted for accounting changes and corrections of errors made in fiscal years beginning after the date this Statement is issued. Management does not expect the implementation of this new standard to have a material impact on our financial position, results of operations and cash flows.

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155 (“SFAS 155”), “Accounting for Certain Hybrid Financial Instruments” which amends Statement of Financial Accounting Standards No. 133 (“SFAS 133”), “Accounting for Derivative Instruments and Hedging Activities” and Statement of Financial Accounting Standards No. 140 (“SFAS 140”), “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.” SFAS 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 also clarifies and amends certain other provisions of SFAS 133 and SFAS 140. SFAS 155 is effective for all financial instruments acquired, issued or subject to a remeasurement event occurring in fiscal years beginning after September 15, 2006. Earlier adoption is permitted, provided the Company has not yet issued financial statements, including for interim periods, for that fiscal year. Since the Company has no derivative instruments or hedging activities, we do not expect the adoption of SFAS 155 to have a material impact on our financial position, results of operations or cash flows.

In March 2006, the FASB issued SFAS No. 156, “Accounting for Servicing of Financial Assets” which amends SFAS No. 140. SFAS 156 requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable. The statement permits, but does not require, the subsequent measurement of servicing assets and servicing liabilities at fair value. SFAS 156 is effective for fiscal years beginning after September 15, 2006. We do not expect the adoption of SFAS 156 to have a material impact on our financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157 “Fair Value Measurements” (“SFAS 157”). SFAS 157 provides a new single authoritative definition of fair value and provides enhanced guidance for measuring the fair value of assets and liabilities and requires additional disclosures related to the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. SFAS 157 is effective for us as of January 28, 2008. We are currently assessing the impact, if any, of SFAS 157 on our financial position, results of operation, or cash flows.

In July 2006, the FASB issued FASB Interpretation No. 48 (“FIN 48”), Accounting for Uncertainty in Income Taxes, which prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Additionally, FIN 48 provides guidance on the derecognition, classification, interest and penalties, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN 48 are effective for reporting periods beginning after December 15, 2006. The Company is currently assessing the impact of the adoption of FIN 48 and its impact on our financial position, results of operations, or cash flows.

In September 2006, the SEC released Staff Accounting Bulletin No. 108 “Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements” (“SAB 108”). SAB 108 provides interpretative guidance on how public companies quantify financial statement misstatements. There have been two common approaches used to quantify such errors. Under an income statement approach, the “roll-over” method, the error is quantified as the amount by which the current year income statement is misstated. Alternatively, under a balance sheet approach, the “iron curtain” method, the error is quantified as the cumulative amount by which the current year balance sheet is misstated. In SAB 108, the SEC established an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of the company’s financial statements and the related financial statement disclosures. This model is commonly referred to as a “dual approach” because it requires quantification of errors under both the roll-over and iron curtain methods. SAB 108 is effective for the us as of January 1, 2007. The adoption of SAB 108 is not expected to have a material impact on our financial position, results of operations, or cash flows.

In September 2006, the FAS issued SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, which requires employers to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity. The Company is currently analyzing the expected impact of adoption of this Statement on its financial statements.

In July 2006, the Emerging Issues Task Force Reached Consensus on Issue No. 06-03 "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)," that provides guidance on how sales tax collected from customers should be presented in the income statement. The Company will adopt this statement immediately, and will disclose the caption in which sales tax is recorded in accordance with the consensus reached in this issue when sales tax has been collected.

In July 2006, the FASB issued FASB Staff Position (FSP) No. FAS 13-2, "Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction," that provides guidance on how a change or a potential change in the timing of cash flows relating to income taxes generated by a leveraged lease transaction affects the accounting by a lessor for the lease. This staff position will be adopted by the Company on January 1, 2007. The Company is currently evaluating the impact of adopting this FSP; however, the Company does not expect the adoption of this provision to have a material effect on its financial position, results of operations or cash flows.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the American Institute of Certified Public Accountants ("AICPA") and the SEC did not or are not believed by management to have a material impact on the Company's present or future financial statements.

**NOTE 2 - STOCK BASED COMPENSATION**

As permitted by SFAS No. 123, *Accounting for Stock-Based Compensation*, we account for costs of stock-based compensation to employees in accordance with Accounting Principles Board (“APB”) Opinion No. 25, *Accounting for Stock Issued to Employees* and related interpretations, and accordingly, discloses the pro forma effect on net income (loss) and related per-share amounts assuming the fair value based method to account for stock-based compensation (Note 2) had been used. The fair value of stock compensation issued to non-employees is determined using the Black-Scholes option pricing model and compensation expense is recorded pursuant to the provisions of EITF 96-18.

We account for stock options granted to our employees and members of our board of directors under the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25 (APB No. 25) *Accounting for Stock Issued to Employees*, and related interpretations, and with the disclosure requirements of SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure*. Pursuant to APB No. 25, no compensation cost is recognized for options granted to employees and non-employee directors at fair value on the grant date (measurement date).

The following table illustrates the effect on net loss and net loss per share if we had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation.

(rounded)

|                                                                                                                            | Year Ended<br>September 30,<br>2006 | Year Ended<br>September 30,<br>2005 |
|----------------------------------------------------------------------------------------------------------------------------|-------------------------------------|-------------------------------------|
| Net loss, as reported                                                                                                      | (\$717,000)                         | (\$1,027,000)                       |
| Add: Stock-based employee compensation expense included in reported net (loss) income, net of related tax effects          | 0                                   | 0                                   |
| Deduct; Total stock-based employee compensation expense determined under the fair value method, net of related tax effects | (406,000)                           | (322,000)                           |
| Pro Forma net loss                                                                                                         | (\$1,123,000)                       | (\$1,349,000)                       |
| Net loss per share - basic and diluted, as reported                                                                        | \$                                  |                                     |