UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

(Mark One)

x **QUARTERLY REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2007.

¨ **TRANSITION REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE TRANSITION PERIOD FROM _____ TO _____.

Commission File Number 000-50813

St. Bernard Software, Inc.

(Exact Name of Small Business Issuer as Specified in Its Charter)

Delaware	**20-0996152**
(State or other Jurisdiction of incorporation)	**(I.R.S. Employer Identification No.)**

15015 Avenue of Science

San Diego, California

(Address of Principal Executive Office)

(858) 676-2277

(Issuer s Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Securities Exchange Act of 1934. (Check one):

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

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

As of November 14, 2007 there were 14,760,052 shares of the registrant s common stock outstanding.

Table of Contents

ST. BERNARD SOFTWARE, INC.

For the Quarter Ended September 30, 2007

Form 10-QSB

INDEX

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

St. Bernard Software, Inc.

Consolidated Balance Sheets

	September 30, 2007 (Unaudited)	December 31, 2006
Assets		
Current Assets		
Cash and cash equivalents	$ **2,806,551**	$ 4,841,871
Accounts receivable - net of allowance for doubtful accounts of $422,000 and $678,000 at September 30, 2007, and December 31, 2006, respectively	**2,869,205**	3,964,403
Inventories	**788,469**	729,739
Prepaid expenses and other current assets	**671,849**	483,840
Total current assets	**7,136,074**	10,019,853
Fixed Assets - Net	**1,732,781**	1,726,050
Other Assets	**276,329**	3,937,848
Goodwill	**7,567,975**	7,709,212
	$ **16,713,159**	$ 23,392,963
Liabilities and Stockholders Deficit		
Current Liabilities		
Line of credit	$ **1,000,000**	$ 296,410
Accounts payable	**3,138,467**	4,559,323
Accrued compensation expenses	**953,603**	1,525,821
Accrued expenses and other current liabilities	**294,613**	291,718
Current portion of capitalized lease obligations	**148,623**	75,087
Deferred revenue	**9,342,996**	11,873,376
Total current liabilities	**14,878,302**	18,621,735
Capitalized Lease Obligations, Less Current Portion	**210,445**	141,617
Deferred Revenue	**5,601,801**	5,842,809
Total liabilities	**20,690,548**	24,606,161
Commitments and Contingencies		
Stockholders Deficit		
Preferred stock, $0.01 par value; 5,000,000 shares authorized and 0 shares issued and outstanding		
Common stock, $0.01 par value; 50,000,000 shares authorized and 14,760,052 and 14,764,251 shares issued and outstanding at September 30, 2007 and December 31, 2006, respectively	**147,600**	147,643
Additional paid-in capital	**39,032,394**	38,304,771
Accumulated deficit	**(43,157,383)**	(39,665,612)
Total stockholders deficit	**(3,977,389)**	(1,213,198)

	$	**16,713,159**	$	23,392,963

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

3

Table of Contents

St. Bernard Software, Inc.

Unaudited Consolidated Statements of Operations

	Three months ended September 30, 2007	2006	*Nine months ended September 30,* 2007	2006
Sales				
License	**$ 252,619**	$ 969,311	**$ 1,667,742**	$ 2,829,693
Appliance	**621,758**	805,356	**2,248,998**	2,233,284
Subscription	**3,582,479**	3,884,338	**10,954,835**	11,476,575
Total Sales	**4,456,856**	5,659,005	**14,871,575**	16,539,552
Cost of Sales				
License	**4,571**	53,168	**54,825**	74,983
Appliance	**399,675**	594,038	**1,736,267**	1,571,926
Subscription	**901,899**	1,084,267	**2,967,280**	3,015,500
Total Cost of Sales	**1,306,145**	1,731,473	**4,758,372**	4,662,409
Gross Profit	**3,150,711**	3,927,532	**10,113,203**	11,877,143
Sales and marketing expenses	**2,847,717**	2,550,500	**10,321,735**	7,827,189
Research and development expenses	**1,167,597**	1,571,969	**4,850,468**	4,599,780
General and administrative expenses	**1,689,534**	2,204,573	**6,549,648**	4,116,777
Impairment of intangible assets related to the acquisition of AgaveOne	**3,261,667**		**3,261,667**	
Total Operating Expenses	**8,966,515**	6,327,042	**24,983,518**	16,543,746
Loss from Operations	**(5,815,804)**	(2,399,510)	**(14,870,315)**	(4,666,603)
Other (Income) Expense				
Interest expense - net	**72,914**	51,812	**144,975**	220,113
Gain on sale of assets	**(7,967,025)**		**(11,430,440)**	
Other income	**(97,314)**		**(97,314)**	
Warrant income		(2,630,400)		(2,630,400)
Total Other Income	**(7,991,425)**	(2,578,588)	**(11,382,779)**	(2,410,287)
Income (Loss) Before Income Taxes	**2,175,621**	179,078	**(3,487,536)**	(2,256,316)
Income tax expense		(1,059,000)	**(4,235)**	(1,059,000)
Net Income (Loss)	**$ 2,175,621**	$ (879,922)	**$ (3,491,771)**	$ (3,315,316)
Income (Loss) Per Common Share - Basic	**$ 0.15**	$ (0.08)	**$ (0.24)**	$ (0.31)
Income (Loss) Per Common Share - Diluted	**$ 0.15**	$ (0.08)	**$ (0.24)**	$ (0.31)
Weighted Average Shares Outstanding - Basic	**14,759,671**	11,582,535	**14,772,774**	10,785,781
Weighted Average Shares Outstanding - Diluted	**14,804,689**	11,582,535	**14,772,774**	10,785,781

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

Table of Contents

St. Bernard Software, Inc.

Unaudited Consolidated Statements of Stockholders' Deficit

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Deficit	Total
Balance at December 31, 2006	14,764,251	$ 147,643	$ 38,304,771	$ (39,665,612)	$ (1,213,198)
Common stock issued for exercise of employee options	44,950	449	29,595		30,044
Common stock issued under the employee stock purchase plan	17,518	175	14,365		14,540
Stock-based compensation expense			841,257		841,257
Common stock cancelled as a result of an indemnification claim	(66,667)	(667)	(249,335)		(250,002)
Value of warrants issued			91,741		91,741
Net loss				(3,491,771)	(3,491,771)
Balance at September 30, 2007	14,760,052	$ 147,600	$ 39,032,394	$ (43,157,383)	$ (3,977,389)

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

5

Table of Contents

St. Bernard Software, Inc.

Unaudited Consolidated Statements of Cash Flows

	Nine months ended September 30,	
	2007	**2006**
Cash Flows From Operating Activities		
Net loss	**$ (3,491,771)**	$ (3,315,316)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	**926,635**	447,958
Provision for bad debts	**(255,893)**	34,388
Gain on sale of assets	**(11,430,440)**	
Impairment of intangible assets related to the acquisition of AgaveOne	**3,261,667**	
Compensation expense	**841,257**	486,628
Noncash interest expense	**6,905**	
Noncash warrant income		(2,630,400)
Change in valuation allowance of deferred tax asset		1,059,000
Increase (decrease) in cash resulting from changes in:		
Accounts receivable	**1,351,091**	814,372
Inventories	**(58,730)**	183,550
Prepaid expenses and other current assets	**(218,029)**	(517,533)
Accounts payable	**(1,420,856)**	(779,678)
Accrued expenses and other current liabilities	**(481,429)**	(402,056)
Deferred revenue	**1,253,522**	1,095,116
Net cash used in operating activities	**(9,716,071)**	(3,523,971)
Cash Flows From Investing Activities		
Additional costs related to purchase of business	**(108,764)**	
Purchases of fixed assets	**(285,989)**	(91,266)
Proceeds from the sale of assets	**7,413,025**	
Net cash provided by (used in) investing activities	**7,018,272**	(91,266)
Cash Flows From Financing Activities		
Net proceeds from issuance of common stock related to merger		17,519,732
Proceeds from note payable		483,333
Proceeds from stock option and warrant exercises	**30,044**	97,900
Proceeds from the sales of stock under the employee stock purchase plan	**14,540**	
Principal payments on capitalized lease obligations	**(85,695)**	(38,854)
Principal payments on notes payable		(743,955)
Net increase (decrease) in line of credit	**703,590**	(669,849)
Net cash provided by financing activities	**662,479**	16,648,307
Net Increase (Decrease) in Cash and Cash Equivalents	**(2,035,320)**	13,033,070
Cash and Cash Equivalents at Beginning of Period	**4,841,871**	9,211
Cash and Cash Equivalents at End of Period	**$ 2,806,551**	$ 13,042,281
Cash paid during the period for:		
Interest	**$ 205,026**	$ 257,655
Income taxes	**$ 1,677**	$ 10,000

During the nine months ended September 30, 2007, the Company entered into capitalized lease obligations for the purchase of $218,542 in fixed assets.

In April 2007, the shares issued in conjunction with the purchase of AgaveOne were reduced by 66,667 shares, or $250,000, as a result of indemnification claims.

In May 2007, the Company issued 100,000 warrants in conjunction with a loan agreement with a bank. See Note 3.

In September 2007, the Company recorded an impairment charge of $3,261,667 to write-down the intangible assets related to the acquisition of AgaveOne. See Notes 1 and 2.

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

Table of Contents

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements

(Unaudited)

1. Summary of Significant Accounting Policies

St. Bernard Software, Inc., a Delaware corporation (the Company or St. Bernard), formerly known as Old St. Bernard Software, Inc. is a software development firm specializing in the design and production of innovative network systems management security software. The Company sells its products through distributors, dealers and original equipment manufacturers (OEM), and directly to network managers and administrators worldwide.

Merger and accounting treatment

On October 26, 2005 the Company entered into an Agreement and Plan of Merger (Merger Agreement), as amended, with Sand Hill IT Security Acquisition Corp. (Sand Hill or Parent), a publicly held Delaware corporation. On July 27, 2006 stockholders of Sand Hill voted to approve the Merger Agreement and the transactions set forth therein (the Merger) in which St. Bernard Software, Inc. became the Parent s wholly-owned subsidiary. Sand Hill then changed its name to St. Bernard Software, Inc.

The shares of common stock held by the former stockholders of Old St. Bernard, Inc. were converted into a total of 9,733,771 shares of Sand Hill common stock, or approximately 69.2% of the subsequently outstanding common stock of the combined company.

Upon consummation of the Merger, approximately $22.3 million was released from trust to be used by the combined company. With respect to the business combination, any public stockholder who voted against the Merger could demand that the Company redeem their shares. The per share redemption price was equal to $5.40 per share. After payments of redeemed shares of approximately $4.2 million and costs related to the Merger of approximately $1.3 million, the net proceeds received by the Company was approximately $16.8 million. The costs incurred in connection with the Merger were reflected as a reduction to the proceeds as of the effective date of the Merger.

For accounting purposes the Merger was accounted for as a reverse acquisition. Under this method of accounting, Sand Hill was treated as the acquired company. Accordingly, for accounting purposes, the Merger was treated as the equivalent of St. Bernard issuing stock for the net monetary assets of Sand Hill. The historical financial statements prior to July 27, 2006, are those of St. Bernard Software. All historical share and per share amounts have been retroactively adjusted, using a conversion factor of 0.419612277 to give effect to the reverse acquisition of Sand Hill.

These consolidated financial statements are issued under the name of the Parent, but are a continuation of the financial statements of the Company and the comparative information presented is that of the Company. The assets and liabilities of the Company are recognized and measured in these consolidated financial statements at their pre-combination carrying amounts. The retained earnings and other equity balances recognized are the retained earnings and other equity balances of the Company immediately before the business combination. The amount recognized as issued equity instruments in these consolidated financial statements was determined by adding to the issued equity of the Company immediately before the business combination. However, the equity structure appearing in these consolidated financial statements reflects the equity structure of the Parent, including the equity instruments issued by the legal Parent to affect the combination.

Effective October 17, 2006, the Company acquired AgaveOne, Inc., a Nevada corporation doing business as Singlefin. Singlefin provided on-demand security and business services to small and medium sized companies, including email filtering, web filtering and instant messaging management as a hosted or on demand service. In connection with the Singlefin acquisition, the Company paid Singlefin stockholders and option holders $0.47 million in cash, issued 471,288 shares of common stock and assumed certain stock options granted by Singlefin and converted them into options to acquire 47,423

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

shares of our common stock. During the nine months ended September 30, 2007, the shares issued in conjunction with the purchase were reduced by 66,667 as a result of indemnification claims. The Company also satisfied $5.5 million in Singlefin indebtedness and certain Singlefin employees received bonuses totaling $0.25 million. The aggregate value of the transaction was approximately $8.0 million.

The following pro forma consolidated information is presented as if the October 2006 acquisition of AgaveOne, Inc. occurred on January 1, 2006. The unaudited pro forma consolidated results have been prepared for comparative purposes only and do not purport to be indicative of the results of operations that would have actually resulted had the acquisition been in effect in the periods indicated above, or of the future results of operations. The unaudited pro forma consolidated results for the quarter ended September 30, 2006, are as follows (in thousands):

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Net sales	$ 5,753	$ 16,822
Net loss	$ (1,295)	$ (4,559)
Basic and Diluted Loss per Common Share	(0.10)	(0.41)
Weighted Average Shares Outstanding	13,178	11,203

Basis of presentation

The accompanying consolidated financial statements have been prepared by us without audit and reflect all adjustments (consisting of normal and recurring adjustments and accruals) which are, in our opinion, necessary to present a fair statement of the results for the interim periods presented. The consolidated financial statements include our accounts and those of our subsidiary. All inter-company balances and transactions have been eliminated in consolidation. The statements have been prepared in accordance with the regulations of the Securities and Exchange Commission, but omit certain information and footnote disclosures necessary to present the statements in accordance with U.S. generally accepted accounting principles. The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the full fiscal year. The information included in this form 10-QSB should be read in conjunction with the Company s financial statements and footnotes that are included in the most recent 10-KSB.

Use of estimates

The preparation of the consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates. Significant estimates used in preparing the consolidated financial statements include those assumed in computing the allowance for uncollectible accounts receivable, the valuation allowance on deferred tax assets, in testing goodwill and other intangible assets for impairment, and assumptions used to determine the fair value of stock options under SFAS 123R.

Liquidity

As of September 30, 2007, the Company had $2.8 million of cash and a working capital deficit of $7.8 million. Operating losses for the three and nine months ended September 30, 2007 were $5.8 million and $14.9 million, respectively. As of September 30, 2007, we do not expect sufficient cash flows from operations during the next twelve months, along with our available line of credit financing and cash on hand, to cover our anticipated operating expenses plus continued development of our on-demand software as a service solution package. Although the Company had a net income of $2.2 million for the current quarter as a result of the gain from the sale of the assets of Open File Manager on August 14,

8

Table of Contents

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

2007, it has incurred a net loss of $3.5 million for the nine months ended September 30, 2007. The net cash proceeds from the sale of Open File Manager were $6.2 million. There may be additional cash received by the company for transition services provided to the acquirer and the release of $0.5 million from an indemnification escrow. Billings from our on demand service have been lower than expected due to a several month delay in developing the new product line to effectively compete in the medium and large customer market space. In addition, the Company continued to invest in our on-demand service which includes the staffing of technical support personnel, as well as advertising expenses. If the on-demand business continues to require cash investment and does not begin to meet sales expectations, we may need to raise additional funds on acceptable terms. If we cannot do so, we will not be able to develop or enhance our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements. Furthermore, the increased costs associated with being a public company has caused an increase in the use of cash, which includes accounting, legal, and insurance fees; and a combination of SOX 404, Board of Director, and IT consulting fees.

At September 30, 2007, our current liabilities exceeded our current assets by approximately $7.8 million and the Company had a stockholders deficit of approximately $4.0 million. Our expenses consist primarily of variable costs such as payroll and related expenses that can be modified to meet our operating needs. In addition, approximately $9.3 million of the current liability balance at September 30, 2007 consists of deferred revenues, which represents amounts that will be amortized into revenue over time, as they are earned. While there are costs that will be incurred as these revenues are earned, management believes these costs are significantly less than the approximately $9.3 million recorded as a current liability or the approximately $14.9 million recorded as a liability in total.

These circumstances raise substantial doubt about our ability to continue as a going concern as of September 30, 2007. Consequently, we are actively seeking additional debt and/or equity financing. To the extent we raise additional capital by issuing equity securities, our stockholders may experience substantial dilution. A material shortage of capital will require us to take drastic steps such as reducing our level of operations or seeking an acquisition partner. In addition, the Company anticipates experiencing cash shortages mid-way through the first quarter of 2008 which could result in a breach of the Silicon Valley Bank covenant. If the Company is not able to develop new and enhanced products that achieve widespread market acceptance, it may be unable to recover product development costs, and its earnings and revenue may decline.

Table of Contents

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

The accompanying financial statements have been prepared assuming the Company will continue as a going concern.

Cash and cash equivalents

The Company considers all highly liquid investments with original maturities of 90 days or less at the time of purchase to be cash equivalents.

Research and development and capitalized software costs

The Company s research and development expenses include payroll, employee benefits, stock-based compensation, offshore development and other head-count related costs associated with product development and are expensed as incurred. In accordance with *Statement of Financial Accounting Standards (SFAS) No. 86, Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed,* capitalization of costs begins when technological feasibility has been established and ends when the product is available for general release to customers. The Company has determined that technological feasibility for its products is reached after beta testing which is shortly before the products are released to manufacturing/operations. Costs incurred after technological feasibility is established are not material, and accordingly, the Company expenses all research and development costs when incurred. The technological feasibility of significant intellectual property that is purchased has been established prior to the acquisition and therefore the cost is capitalized.

Goodwill

The Company accounts for goodwill in accordance with the provisions of *Statement of Financial Accounting Standards (SFAS) No. 142*. The Company subjects the goodwill to an annual impairment test or when events indicate that an impairment has occurred. The impairment test consists of a comparison of the estimated fair value of the reporting unit to which the goodwill has been assigned to the sum of the carrying value of the assets and liabilities of that reporting unit. The fair value used in this evaluation is based upon discounted future cash flow projections for the reporting unit. As a result of our significant underperformance relative to the expected operating results, we tested our goodwill for impairment as of September 30, 2007. Based upon the results of the impairment test, management of the Company has concluded there was no impairment of goodwill at September 30, 2007. The Company is one reporting unit for purposes of testing goodwill.

Goodwill totaled $7.6 million and $7.7 million at September 30, 2007 and December 31, 2006, respectively that arose through business acquisitions made in 2000 and 2006. The decrease in goodwill was equivalent to the fair value of 66,667 shares withheld from a stockholder as a result of indemnification claims in relation to the acquisition of AgaveOne.

Intangible assets

The Company accounts for intangible assets in accordance with *Statement of Financial Accounting Standards (SFAS) No. 144*, Accounting for the Impairment or Disposal of Long-Lived Assets , management reviews our long-lived asset groups, including property and equipment and other intangibles, for impairment and whenever events indicate that their carrying amount may not be recoverable. When management determines that one or more impairment indicators are present for an asset group, the Company compares the carrying amount of the asset group to net future undiscounted cash flows that

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

the asset group is expected to generate. If the carrying amount of the asset group is greater than the net future undiscounted cash flows that the asset group is expected to generate, the Company compares the fair value to the book value of the asset group. If the fair value is less than the book value, the Company would recognize an impairment loss. The impairment loss would be the excess of the carrying amount of the asset group over its fair value. As a result of our significant underperformance relative to the expected operating results and current-period operating and cash flow losses coupled with a history of such losses, the Company tested its intangible assets for impairment during the nine months ended September 30, 2007. Based upon the results of the test, management has concluded that the intangible assets related to the acquisition of AgaveOne was impaired at September 30, 2007. Per the analysis, the Company has determined that the carrying value of the long-lived intangible assets exceeded the sum of the undiscounted cash flow, over a five year projection period, expected to result from the use and eventual disposition of the asset group. As a result, an impairment charge of $3.3 million was recorded at September 30, 2007 to write-down the intangible asset to zero. See Note 2.

Stock options

Effective January 1, 2006, the Company adopted the fair value recognition provisions of Statement of *Financial Accounting Standards (SFAS) No. 123R (revised 2004), Share-based Payment* , using the modified prospective method and therefore has not restated results for prior periods. Under this transition method, stock-based compensation expense includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based upon the grant date fair value estimated in accordance with *SFAS No. 123*, *Accounting for Stock-Based Compensation*. Stock-based compensation expense for all stock-based compensation awards granted after January 1, 2006 is based upon the grant date fair value estimated in accordance with SFAS 123R. Prior to the adoption of SFAS 123R on January 1, 2006, the Company recognized stock-based compensation expense in accordance with Accounting Principles Board (APB) *Opinion No. 25, Accounting for Stock Issued to Employees* , and provided pro forma disclosure amounts in accordance with SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure* , as if the fair value method defined by SFAS 123 had been applied to its stock-based compensation.

The Company has non-qualified and incentive stock option plans (together, the Plans) providing for the issuance of options to employees, directors, and consultants as deemed appropriate by the Board of Directors. Terms of options issued under the Plans include an exercise price equal to the fair market value at the date of grant, vesting periods generally between three to five years, and expiration dates not to exceed ten years from date of grant. The determination of the fair market value of the Company s stock is derived using the closing sale price on the grant date.

The Company granted options during the nine months ended September 30, 2007 and 2006, therefore all fair value calculations were done using the Black-Sholes model under the guidance of SFAS 123R. The weighted average fair value of options granted during the nine months ended September 30, 2007 and 2006, respectively, was calculated using the Black-Scholes option pricing model with the following valuation assumptions:

	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Average expected life (years)	6.5	6.5
Average expected volatility factor	75.0%	66.0%
Average risk-free interest rate	4.54 to 5.14%	4.72 to 5.09 %
Average expected dividend yield	0	0

Table of Contents

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

Total stock-based compensation expense was approximately $260,000 and $487,000 for the three months ended September 30, 2007 and 2006, respectively, and $841,000 and $487,000 for the nine months ended September 30, 2007 and 2006, respectively. The stock-based compensation expenses were charged to general and administrative expenses. The earnings per share effect as a result of the stock based compensation expense was approximately $0.02 and $0.04 for the three months ended September 30, 2007 and 2006, respectively, and $0.06 and $0.05 for the nine months ended September 30, 2007 and 2006, respectively. The tax effect was immaterial.

The following is a summary of stock option activity under the Plans as of September 30, 2007, and changes during the nine months ended September 30, 2007:

	Number of Shares Outstanding	Weighted Average Exercise Price
Options outstanding at December 31, 2006	2,260,643	$ 3.12
Granted	1,294,364	$ 1.82
Exercised	(44,950)	$ 0.67
Forfeited/Expired	(1,534,292)	$ 3.47
Options outstanding at September 30, 2007	1,975,765	$ 2.03

Additional information regarding options outstanding as of September 30, 2007, is as follows:

Range of Exercise Prices		Number of Shares Outstanding	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$0.59	to $0.82	278,572	8.04	$ 0.73	158,572	$ 0.71
$1.15	to $1.19	76,279	3.18	$ 1.18	61,279	$ 1.19
$1.79	to $1.79	3,000	9.45	$ 1.79		$ 0.00
$1.80	to $1.80	60,000	5.47	$ 1.80		$ 0.00
$1.90	to $1.90	400,000	9.22	$ 1.90		$ 0.00
$1.95	to $1.95	831,128	8.75	$ 1.95	243,119	$ 1.95
$2.30	to $2.30	50,000	9.25	$ 2.30		$ 0.00
$3.71	to $3.71	200,000	8.94	$ 3.71	66,000	$ 3.71
$4.75	to $4.75	60,000	2.29	$ 4.75	60,000	$ 4.75
$5.20	to $5.20	16,786	8.79	$ 5.20	16,786	$ 5.20
$0.59	to $5.20	1,975,765	8.27	$ 2.03	605,756	$ 2.11

Table of Contents

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

Consistent with the adoption of the fair value recognition provisions of SFAS 123R and based upon the Company s historical experience, the Company has estimated that 231,000 outstanding options under the Plans that are currently unvested will be forfeited.

The aggregate intrinsic value of options outstanding and exercisable at September 30, 2007 was approximately $39,000 and $25,000, respectively. The aggregate intrinsic value represents the total intrinsic value, based upon the stock price of $0.87 at September 30, 2007. The intrinsic value of option exercises for the three and nine months ended September 30, 2007 was approximately $0 and $69,000, respectively.

As of September 30, 2007, there was approximately $4.0 million of total unrecognized compensation expense related to unvested share-based compensation arrangements granted under the Plans. The cost is expected to be recognized over a weighted average period of 2.13 years.

Amendment to recent stock option grants

On January 3, 2007, the Board of Directors of St. Bernard approved an amendment to certain stock option grants made by St. Bernard to certain St. Bernard employees and directors between July 14, 2006 and December 4, 2006, reducing the exercise price of the amended option grants to the closing fair market price of St. Bernard common stock on January 11, 2007. The intention of St. Bernard s Board of Directors in approving the amendment is to reestablish the incentive and retentive value of the amended stock options for the affected employees and directors, as the relevant options had been left significantly out-of-the-money due to declines in the price of St. Bernard common stock. A substantial majority of the options that were amended were granted to new executives and employees that joined St. Bernard after the merger with Sand Hill IT Security Acquisition Corp. in July 2006. The reason for delaying the determination of the new grant date for the amended option grants until January 11, 2007 was to enable the market to absorb the information before setting the new exercise price. The amendment affects options to purchase a total of up to 1,055,064 shares of the Company s common stock, including options granted to the executive officers and directors of the Company. The Company expects incremental compensation expenses in relation to the amended stock option grants to total approximately $283,000.

The following table represents the St. Bernard Software employees and directors whose option grants were amended:

Name	Position	Original Option Grant Date	Shares Underlying the Option
Vincent Rossi	Chief Executive Officer	July 28, 2006	480,000
Al Riedler	Chief Financial Officer	July 14, 2006	20,980
Bradford Weller	Chief Legal Officer	July 28, 2006	50,000
Louis Ryan	Director	September 7, 2006	50,000
Richard Arnold	Director	September 7, 2006	50,000
Troy Sexton-Getty	General Manager	November 15, 2006	150,000
			800,980

Employee stock purchase plan

The Company s Employee Stock Purchase Plan, or ESPP, was adopted by our board of directors in December 2006, and approved by our shareholders in June 2007 at the annual shareholders meeting.

Table of Contents

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

The ESPP provides a means by which employees of the Company (and any parent or subsidiary of the Company designated by the Board of Directors to participate in the Purchase Plan) may be given an opportunity to purchase Common Stock of the Company at semi-annual intervals through payroll deductions, to assist the Company in retaining the services of its employees, to secure and retain the services of new employees, and to provide incentives for such persons to exert maximum efforts for the success of the Company. 400,000 shares have been initially reserved for issuance pursuant to purchase rights under the ESPP. A participant may contribute up to 15% of his or her compensation through payroll deductions, and the accumulated deductions will be applied to the purchase of shares on the purchase date, which is the last trading day of the offering period. The purchase price per share will be equal to 85% of the fair market value per share on the start date of the offering period in which the participant is enrolled or, if lower, 85% of the fair market value per share on the purchase date. In addition, the number of shares available for issuance under the Purchase Plan may be increased annually on the first day of each Company fiscal year, beginning in 2008 and ending in (and including) 2016, by an amount equal to the least of: (i) the difference between four hundred thousand (400,000) and the number of shares remaining authorized for issuance after the last purchase of shares, (ii) four hundred thousand (400,000) shares of Common Stock, or (iii) an amount determined by the Board of Directors or a committee of the Board of Directors appointed to administer the Purchase Plan. If rights granted under the Purchase Plan expire, lapse or otherwise terminate without being exercised, the shares of Common Stock not purchased under such rights again become available for issuance under the Purchase Plan.

For the initial offering period of March 1, 2007 to June 30, 2007, $14,540 was withheld from employee earnings for the stock purchases of 17,518 shares of Common Stock. At September 30, 2007, $17,700 has been withheld from employee earnings for stock purchases of Common Stock under the ESPP for the offering period of July 1, 2007 to December 31, 2007. Compensation expense was immaterial for the three and nine months ended September 30, 2007.

Shares available for issuance under the Company s Employee Stock Purchase Plan are as follows:

	Number of Shares
Shares reserved for issuance at December 31, 2006	400,000
Shares issued during nine months ended September 30, 2007	(17,518)
Shares reserved for issuance at September 30, 2007	382,482

The Company used the following assumptions to estimate the fair value of the semi-annual employee stock purchase plan share grants during the nine months ended September 30, 2007:

	Nine Months Ended September 30, 2007
Average expected life (years)	0.5
Average expected volatility factor	75.0%
Average risk-free interest rate	5.0%
Average expected dividend yield	0

Income/Loss per share

Basic income/loss per share is calculated by dividing net income/loss by the weighted-average number of shares of common stock outstanding. Diluted income/loss per share includes the components of basic

14

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

income/loss per share and also gives effect to dilutive common stock equivalents. Potentially dilutive common stock equivalents include stock options and warrants. A dilutive effect was calculated for the three months ended September 30, 2007 as the Company report a net income. Conversely, there was no dilutive effect calculated for the three months ended September 30, 2006 and for the nine months ended September 30, 2007 and 2006, as the Company reported a net loss in each period.

Income taxes

Deferred income taxes are recognized for the tax consequences in future years of differences between the tax basis of assets and liabilities and their financial reporting amounts at each year end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. Income tax expense is the combination of the tax payable for the period and the change during the period in deferred tax assets and liabilities.

New accounting standards

In June 2007, the Financial Accounting Standards Board (FASB) ratified the consensus reached by the *Emerging Issues Task Force (EITF) No. 07-3, Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities.* EITF 07-3 requires that nonrefundable advance payments for future research and development activities should be deferred and capitalized. Such amounts should be recognized as an expense as the goods are delivered or the related services are performed. It also states that entities should continue to evaluate whether they expect the goods to be delivered or services to be rendered. If an entity does not expect the goods to be delivered or services to be rendered, the capitalized advance payment should be charged to expense. EITF 07-3 is effective for financial statements issued for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. Early adoption is not permitted. The Company is currently evaluating the impact, if any, this pronouncement will have on its financial statements.

In June 2007, the Financial Accounting Standards Board (FASB) ratified the consensus reached by the *Emerging Issues Task Force (EITF) No. 06-11, Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards* . EITF 06-11 requires that the tax benefit with respect to dividends or dividend equivalents for non-vested restricted shares or restricted share units that are paid to employees be recorded as an increase to additional paid-in capital. EITF 06-11 is to be applied prospectively for tax benefits on dividends declared in fiscal years beginning after December 15, 2007, with early adoption permitted. The Company is currently evaluating the impact, if any, this pronouncement will have on its financial statements.

On February 15, 2007 the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (*SFAS) No. 159*, *The Fair Value Option for Financial Assets and Financial Liabilities* . SFAS No. 159 permits all entities to choose, at specified election dates, to measure eligible items at fair value (the fair value option). A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings (or another performance indicator if the business entity does not report earnings) at each subsequent reporting date. Upfront costs and fees related to items for which the fair value option is elected shall be recognized in earnings as incurred and not deferred. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted. The Company is currently evaluating whether SFAS No. 159 will have a material effect on its financial position, results of operations or cash flows.

Table of Contents

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

In September 2006, the Financial Accounting Standards Board (FASB) issued *Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This statement applies in those instances where other accounting pronouncements require or permit fair value measurements, the board of directors having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. The Company is required to adopt SFAS 157 no later than the fiscal year beginning after November 15, 2007. The Company is currently evaluating the impact, if any, this pronouncement will have on its financial statements.

On July 13, 2006, the Financial Accounting Standards Board (FASB) issued *FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*. Interpretation 48 clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with Statement 109 and prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Additionally, Interpretation 48 provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. Interpretation 48 is effective for fiscal years beginning after December 15, 2006, with early adoption permitted. The Company adopted Interpretation 48 during fiscal year 2007. The Company did not record, and does not anticipate any adjustments resulting from the adoption of Interpretation 48.

Reclassifications

Certain amounts in the 2006 financial statements have been reclassified to conform to the 2007 classifications. These reclassifications have no effect on reported net income (loss).

2. Other Assets

Other assets consisted of the following:

	September 30, 2007	December 31, 2006
Capitalized software costs, net of amortization	**$ 54,790**	$ 2,500,496
Customer-related intangible, net of amortization		1,245,833
Security deposits	**221,539**	191,519
Total other assets	**$ 276,329**	$ 3,937,848

Amortization for the capitalized software costs are computed on an individual-product basis using the

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

straight-line method over a useful life ranging from three to six years. Amortization expense related to capitalized software was approximately $17,000 and $22,000 for the three months ended September 30, 2007 and 2006 and $300,000 and $75,000 for nine months ended September 30, 2007 and 2006, respectively. Amortization for the customer related intangible is computed using the straight-line method over a useful life of five years. Amortization expense for the customer related intangible was approximately $0 for the three months ended September 30, 2007 and 2006, respectively, and $130,000 and $0 for the nine months ended September 30, 2007 and 2006, respectively.

At September 30, 2007, the management of the Company tested the intangible assets related to the acquisition of AgaveOne for impairment and concluded that an impairment charge of approximately $3.3 million was necessary per the guidance provided by FAS 144. The impairment charge consisted of approximately $3.8 million in intangible assets, offset by the related amortization of approximately $0.5 million. As a result, the net capitalized software costs and the customer-related intangibles were $2.2 million and $1.1 million, respectively. See Note 1 Intangible Assets.

Table of Contents

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

3. Debt

Line of Credit

The Company had a $1,250,000 line of credit with a finance company that automatically renewed every six months. The line of credit provided for advances of up to 80% of eligible accounts receivable. Interest was payable monthly at 1.5% per month (18% per annum). The agreement included a provision for a 1% annual renewal fee and a 1% per annum charge for the average daily unused portion of the line. The agreement allowed for termination without penalty but required thirty days notice. The line of credit was secured by all of the assets of the Company and all assets acquired by the Company during the term of the agreement. The Company was required to deliver all accounts receivable proceeds to the finance company upon receipt by the Company. In May 2007, the Company terminated the above detailed agreement. At September 30, 2007, the balance was zero on the line of credit with this finance company.

On May 15, 2007, the Company (***St. Bernard***), entered into a Loan and Security Agreement (the ***Loan Agreement***) with Silicon Valley Bank, a California corporation (***SVB***). Pursuant to the terms of the Loan Agreement, SVB has agreed to provide St. Bernard with a two year revolving line of credit equal to the lesser of (i) $4,000,000 or (ii) the amount of the Borrowing Base , or eligible accounts receivable, as described in the Loan Agreement. The Loan Agreement also provides for term loans up to $2,000,000 pursuant to which St. Bernard may request up to a maximum of six term loan advances, the first of which was made available after May 15, 2007, in the amount of $1,000,000. The Loan Agreement further provides for letters of credit, advances in connection with SVB cash management services and a special reserve for foreign currency exchange contracts with SVB which in the aggregate may not exceed $250,000. The borrowing availability on the revolving line of credit is reduced by the amount of outstanding principal of any term loans, any outstanding letters of credit, any advances in connection with SVB cash management services and the amount of the reserve for foreign currency exchange contracts with SVB and is subject to the other terms and conditions described in the Loan Agreement. Advances under the revolving line of credit and the term loans shall accrue interest at a per annum rate equal to 2% above the greater of (i) SVB s announced prime rate or (ii) 7.50%.

The obligations under the Loan Agreement are secured by substantially all of St. Bernard s assets other than certain stock of St. Bernard s foreign subsidiary and certain intellectual property rights.

The Loan Agreement contains customary affirmative and negative covenants and other restrictions. The affirmative covenants include, among others, the delivery of financial statements and accounts receivables schedules to SVB, the maintenance of insurance and the maintenance of a minimum level of

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

tangible net worth. St. Bernard has also agreed that without the consent of SVB, it shall refrain from activities such as engaging in a merger or acquisition, incurring indebtedness, paying dividends or making distributions to its stockholders, repurchasing capital stock or making payments on subordinated debt. At September 30, 2007 the Company was in compliance with the above stated covenants and restrictions.

The Loan Agreement states that the Company will pay interest only for the first six months on Term Loan Advances outstanding. Thereafter, each Term Loan Advance will be payable in equal monthly installments of principal, plus interest, based on a 36 month amortization schedule, commencing in November 2007 and continuing on the same date of each month thereafter until the Term Loan Maturity Date of May 2009, on which date all remaining principal and accrued interest shall be paid in full.

Additionally, the Loan Agreement contains customary events of default including the following: nonpayment of principle or interest; the violation of a Loan Agreement covenant; the occurrence of a material adverse change; the attachment of a material portion of St. Bernard s assets; insolvency; default by St. Bernard of any third party agreement pursuant to which the acceleration of $50,000 in principal may result; entry of a judgment equal to or greater than $50,000 against St. Bernard; material misrepresentations by St. Bernard; and the default by St. Bernard under any subordinated debt. Upon the occurrence of an event of default by St. Bernard, the applicable interest rate shall become 5% above the rate that would otherwise be applicable.

In connection with the execution of the Loan Agreement, St. Bernard issued warrants to SVB on May 16, 2007, which allows SVB to purchase up to 100,000 shares of St. Bernard common stock at an exercise price of $1.60 per share. The warrants expire on the fifth anniversary of the warrant s issue date. Accordingly, the Company recorded prepaid interest expense in the amount of $91,000, based on the estimated fair value allocated to the warrants using the following assumptions; 73.56% volatility, risk free interest rate of 4.71%, an expected life of five years and no dividends. Amortization of the interest expense for the three and nine months ended September 30, 2007 was approximately $2,000 and $7,000, respectively. Furthermore, St. Bernard has agreed to grant SVB certain piggyback registration rights with respect to the shares of common stock underlying the warrants. As of September 30, 2007, the balance on the line of credit with SVB was $1.0 million.

4. Stockholders Deficit

Warrants

As of September 30, 2007 and 2006, a total of 8,750,104 and 8,650,104 shares of common stock, respectively, were reserved for issuance for the exercise of warrants at an exercise price of $1.60, $1.85, $2.98 and $5.00 per share.

5. Related Party Transactions

During July 2007, the chief executive officer loaned the Company $15,000 pursuant to the terms of a promissory note. The note was unsecured, bore no interest, and was repaid in August 2007.

A stockholder and former member of the Board of Directors provides legal services to the Company in the ordinary course of business. Therefore, amounts due to this related party s firm exist throughout the year. Billings from the firm totaled $4,000 and $91,000 for the three months ended September 30, 2007 and 2006, respectively, and $641,000 and $659,000 for the nine months ended September 30, 2007 and 2006. Amounts due at September 30, 2007 and 2006 were $425,000 and $36,000, respectively.

The Company presently occupies office space provided by an affiliate of certain officers and directors

Table of Contents

St. Bernard Software, Inc.

Notes to Consolidated Financial Statements-(Continued)

(Unaudited)

of the Company. Such affiliate has agreed that it will make such office space, as well as certain office and secretarial services, available to the Company, as may be required by the Company from time to time. The Company has agreed to pay such affiliate $7,500 per month for such services.

6. Commitment and Contingencies

Litigation

In the normal course of business, the Company is occasionally named as a defendant in various lawsuits. On March 14, 2007, Arthur Budman filed an action against the Company in the San Diego Superior Court for the County of San Diego, asserting claims of intentional misrepresentation, negligent misrepresentation, fraudulent concealment, and negligence. A trial date has been scheduled for February 22, 2008. The