NIGHTHAWK SYSTEMS INC
Form 10-Q
May 15, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

X **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended: March 31, 2008

Or

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

For the transition period from: _____________ to _____________

NIGHTHAWK SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Nevada	**0-30786**	**87-0627349**
(State or Other Jurisdiction of Incorporation)	(Commission File Number)	(I.R.S. Employer Identification No.)

10715 Gulfdale, Suite 200 San Antonio, TX 78216

(Address of Principal Executive Office) (Zip Code)

210 341-481

(Registrant s telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

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. X Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company X

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date. As of May 14, 2008, there were 135,913,727 shares of common stock, par value $.001 per share, of the registrant issued and outstanding.

APPLICABLE ONLY TO REGISTRANTS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

Yes No

NIGHTHAWK SYSTEMS, INC.

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Nighthawk Systems, Inc.

Condensed Consolidated Balance Sheets

	March 31, 2008 (unaudited)	December 31, 2007
ASSETS		
Current assets:		
Cash	$ 74,694	$ 428,484
Accounts receivable, net	217,417	313,644
Inventories	431,402	359,636
Other current assets	64,754	93,683
Total current assets	788,267	1,195,447
Furniture, fixtures and equipment, net	260,434	269,619
Debt issuance costs, net	283,955	310,428
Intangible assets, net	1,126,017	1,218,677
Goodwill	3,397,537	3,397,537
	5,067,943	5,196,261
	$ 5,856,210	$ 6,391,708
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 422,805	$ 327,668
Accrued expenses	570,669	502,822
Deposits and other	263,978	218,148
Line of credit and notes payable:		
Line of credit	18,692	18,892
Convertible notes, net of discount of $808,446 (March 31, 2008) and $883,117 (December 31, 2007)	1,209,732	1,135,061
Other notes	502,568	558,320
Total liabilities (all current)	2,988,444	2,760,911
Commitments		
Stockholders' equity:		
Series A Preferred stock; $0.001 par value; 5,000,000 shares authorized; no shares issued and outstanding	-	-
Series B Preferred stock ; $0.001 par value; 1,000,000 shares authorized; 600,000 shares issued and outstanding at		

March 31, 2008 and December 31, 2007; liquidation				
preference of $6,000,000		5,597,206		5,417,699
Common stock; $0.001 par value; 200,000,000				
shares authorized; 134,433,060 issued and outstanding at				
March 31, 2008 and December 31, 2007		134,433		134,433
Additional paid-in capital		12,919,373		13,091,713
Accumulated deficit		(15,783,246)		(15,013,048)
Total stockholders' equity		2,867,766		3,630,797
	$	5,856,210	$	6,391,708

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

Nighthawk Systems, Inc.

Condensed Consolidated Statements of Operations

Three Months Ended March 31,

(unaudited)

		2008		2007
Revenue	$	826,321	$	212,021
Cost of revenue		668,497		126,104
Gross profit		157,824		85,917
Selling, general and administrative expenses		629,289		708,799
Depreciation and amortization		107,388		2,535
		736,677		711,334
Loss from operations		(578,853)		(625,417)
Interest expense:				
Related parties		-		480
Other		191,344		491,405
		191,344		491,885
Net loss		(770,198)		(1,117,302)
Accumulated dividends on preferred stock		(179,507)		-
Net loss applicable to common stockholders	$	(949,705)	$	(1,117,302)
Net loss per basic and diluted common share	$	(0.01)	$	(0.01)
Weighted average number of common shares outstanding, basic and diluted		141,789,726		90,083,937

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

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Nighthawk Systems, Inc.

Condensed Consolidated Statements of Stockholders' Equity

Three Months Ended March 31, 2008

(unaudited)

	Series B Preferred Stock		Common Stock		Additional Paid-in	Accumulated	
	Shares	Amount	Shares	Amount	Capital	Deficit	Total
Balances, January 1, 2008	600,000	$ 5,417,699	134,433,060	$ 134,433	$ 13,091,713	$ (15,013,048)	$ 3,630,797
Stock-based compensation, vesting of options					7,167		7,167
Accumulated dividends on Series B preferred stock		179,507			(179,507)		
Net loss						(770,198)	(770,198)
Balances, March 31, 2008	600,000	$ 5,597,206	134,433,060	$ 134,433	$ 12,919,373	$ (15,783,246)	$ 2,867,766

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

Nighthawk Systems, Inc.

Condensed Consolidated Statements of Cash Flows

Three Months Ended March 31,

(unaudited)

	2008	2007
Cash flows from operating activities:		
Net loss	$ (770,198)	$ (1,117,302)
Adjustments to reconcile net loss to net cash used in operating activities:		
Bad debt expense	874	-
Depreciation and amortization	107,388	2,535
Stock-based compensation	7,167	68,266
Consulting services expense	-	120,000
Amortization of debt issuance costs and discounts on debt	101,144	351,932
Change in assets and liabilities:		
Decrease in accounts receivable	95,353	83,857
(Increase) decrease in inventories	(71,766)	444
Decrease in other current assets	28,929	31,227
Increase (decrease) in accounts payable	95,137	(7,334)
Increase in accrued expenses	67,847	186,242
Decrease in deposits and other	45,830	-
Total adjustments	477,903	837,169
Net cash used in operating activities	(292,295)	(280,133)
Cash flows from investing activities:		
Purchases of furniture, fixtures and equipment	(5,543)	(959)
Net cash used in investing activities	(5,543)	(959)
Cash flows from financing activities:		
Payments on notes payable	(55,752)	(152,435)
Payments on line of credit	(200)	(100)
Net proceeds from issuance of common stock	-	251,261
Net cash (used in) provided by financing activities	(55,952)	98,726
Net decrease in cash	(353,790)	(182,366)
Cash, beginning	428,484	270,910

Cash, ending	$	74,694	$	88,544
Supplemental disclosure of cash flow information:				
Cash paid for interest	$	1,930	$	7,024
Supplemental disclosure of non-cash investing and financing activities:				
Common shares issued as payment on notes payable, including commissions	$	-	$	398,373
Conversion of notes payable to common stock	$	-	$	27,744

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

NIGHTHAWK SYSTEMS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTH PERIODS ENDED MARCH 31, 2008 AND 2007

1. ORGANIZATION, GOING CONCERN AND MANAGEMENT'S PLANS

INTERIM FINANCIAL STATEMENTS

The accompanying unaudited condensed consolidated financial statements of Nighthawk Systems, Inc. (the Company or Nighthawk) have been prepared in accordance with the instructions to quarterly reports on Form 10-Q. In the opinion of Management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations and changes in financial position at March 31, 2008, and for all periods presented have been made. Certain information and footnote data necessary for fair presentation of financial position and results of operations in conformity with accounting principles generally accepted in the United States of America have been condensed or omitted. It is therefore suggested that these unaudited condensed consolidated financial statements be read in conjunction with the summary of significant accounting policies and notes to financial statements included in the Company s Annual Report on Form 10-KSB. The results of operations for the three month period ended March 31, 2008, are not necessarily an indication of operating results for the full year.

ORGANIZATION

The Company is a provider of intelligent devices and systems that allow for the centralized, on-demand management of assets and processes. Nighthawk products are used throughout the United States in a variety of mission-critical applications, including remotely turning on and off and rebooting devices, activating alarms, and emergency notification, including the display of custom messages. In October 2007, the Company purchased a Set-Top Box business. Nighthawk s IPTV set top boxes are utilized by the hospitality industry to provide in-room standard and high definition television and video on demand.

The unaudited condensed consolidated financial statements of the Company also include its non-operating subsidiary, Peregrine Control Technologies, Inc. Intercompany accounts and transactions have been eliminated in consolidation.

GOING CONCERN AND MANAGEMENT'S PLANS

The Company incurred a net loss of approximately $770,000 during the three month period ended March 31, 2008 (a net loss applicable to common stockholders of approximately $950,000), and had a working capital deficiency of approximately $2.2 million as of March 31, 2008. The Company s ability to continue as a going concern depends on the success of management s plans to overcome these conditions and ultimately achieve profitability and positive cash flows from operations

Since 2004, the Company has relied on an investment agreement with Dutchess Private Equities, II, L.P. (Dutchess) to obtain funds to cover its operating cash flows and deficits. This arrangement expired in December 2007. The Company remains in discussions with Dutchess about the Company s operating cash requirements, but presently has no formal agreement with Dutchess to receive additional funding.

In October 2007, the Company acquired the assets and assumed certain liabilities of the business known as Set-Top Box from Eagle Broadband, Inc. (Eagle , a publicly-traded company) for cash of $4,750,000 (Note 3). This acquisition was funded by a $6.0 million sale of Series B convertible preferred stock and warrants to Dutchess. This acquisition was made primarily to reduce or eliminate the Company s monthly operating cash flow deficits. Although no assurance may be given that it will be able to do so, management believes that this operation may be able to generate sufficient cash flows during 2008 to cover the Company s overall operating cash flow requirements, and eliminate the requirement for additional funding from third parties.

In January 2008, the Company engaged a third party to act as its exclusive financial advisor in connection with a potential offering of securities to a financial or strategic partner. Although management believes that the recently acquired Set-Top Box operations may eliminate its need for outside funding, management believes that enhanced operating results may allow the Company to attract more favorable financing options than those utilized in the past. The Company, with the assistance of the financial advisor, is currently exploring opportunities to raise sufficient funds to meet its operating requirements, as well as to redeem some or all of its outstanding obligations to Dutchess, and some portion of the Series B preferred stock as well, in an effort to reduce monthly interest costs and further dilution of its current shareholder base.

The accompanying financial statements do not include any adjustments relating to the recoverability and classification of assets or the amounts of liabilities that might be necessary should the Company be unsuccessful in implementing these plans, or otherwise be unable to continue as a going concern.

2. SIGNIFICANT ACCOUNTING POLICIES

CONCENTRATIONS

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of trade accounts receivable. Receivables arising from sales to customers are not collateralized and, as a result, management continually monitors the financial condition and its relationships with its customers to reduce the risk of loss. The maximum loss that might be sustained if customer receivables are not collected is limited to the carrying amount of the accounts receivable, net of the allowance for doubtful accounts. Approximately $171,519 of the March 31, 2008 balance, or 79%, was from three customers, $104,380 of which was collected subsequent to March 31, 2008.

During the three months ended March 31, 2008, two customers accounted for approximately 58% and 14% of total revenue, respectively, and during the three months ended March 31, 2007, two customers accounted for approximately 29% and 11% of total revenue, respectively.

During the three months ended March 31, 2008, the Company's three largest suppliers accounted for approximately 51%, 12%, and 11% respectively, of the Company's purchases of pre-manufactured component materials, and during the three months ended March 31, 2007, the Company s two largest suppliers accounted for approximately 58% and 12% of the Company s purchases of pre-manufactured component materials. As the pre-manufactured components are a crucial integral component of the Company's product, the loss of one or more of the Company's major suppliers could have an adverse effect on the Company's ability to maintain production of its products on a cost effective basis in the future.

INVENTORIES

Inventories consist of parts and pre-manufactured component materials ($380,276 at March 31, 2008 and $314,036 at December 31, 2007) and finished goods ($51,126 at March 31, 2008 and $45,600 at December 31, 2007). Inventories are valued at the lower of cost using the first-in, first-out (FIFO) method, or market. The elements of cost in inventories include materials, labor and overhead.

INCOME TAXES

For the three month periods ended March 31, 2008 and 2007, the Company did not record any income tax benefit, because management does not believe realization of such related deferred income tax assets is more likely than not.

NET LOSS PER SHARE

Basic net loss per share is computed by dividing the net loss applicable to common stockholders by the weighted-average number of shares of common stock outstanding (which includes warrants exercisable into 7,356,666 shares of common stock at $0.001 per share), for the period. Diluted net loss per share reflects the potential dilution that could occur if dilutive securities were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Company, unless the effect of such inclusion would reduce a loss or increase earnings per share. For each of the periods presented in the accompanying financial statements, the effect of the inclusion of dilutive shares would have resulted in a decrease in loss per share. Common stock options and warrants aggregating 18,514,638 and 18,491,666 as of March 31, 2008 and 2007, respectively, have been excluded from the calculation of diluted net loss per common share.

RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment to FASB Statement No. 115.* This statement permits companies to choose to measure many financial instruments and other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The fair value option established by this statement permits all entities to measure eligible items at fair value at specified election dates. This statement was effective for the Company on January 1, 2008. The Company did not apply the fair value option to any of its outstanding instruments and therefore, SFAS No. 159 did not have an impact on the Company s consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurement*. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement applies under other accounting pronouncements that require or permit fair value measurements. SFAS No. 157 was effective for the Company on January 1, 2008 for all financial assets and liabilities. For non-financial assets and liabilities, SFAS No. 157 is effective for the Company on January 1, 2009. Management is currently assessing the impact the adoption of SFAS No. 157 may have on the Company s financial statements beyond it s current fiscal year.

3. NOTES PAYABLE

The Company has $18,692 outstanding at March 31, 2008 under a $20,000 unsecured line of credit with a bank. Borrowings under the line of credit bear interest at 9% at March 31, 2008 (10.25% at December 31, 2007). Interest is due monthly. The line of credit is guaranteed by ex-officers and affiliates of the Company.

At March 31, 2008 and December 31, 2007, notes payable consist of the following:

	March 31, 2008		December 31, 2007	
Unsecured note with a financial institution; 15.99% interest rate (17.49% at December 31, 2007); interest and principal due monthly through November 2008	$	3,883	$	4,635
Note payable to a financial institution; 12.75% interest rate; unsecured; due on demand		8,685		8,685
Convertible notes payable to an unrelated minority stockholder; 8% interest rate; in default and due on demand; collateralized by all assets of the Company		75,000		75,000
Note payable to Dutchess; collateralized by accounts receivable; 36% interest rate; in default and due on demand		415,000		470,000
	$	502,568	$	558,320
	$		$	
Convertible notes payable to Dutchess: 10% interest rate; maturities between December 2009 and June 2012; net of discount of $808,446 at March 31, 2008 ($883,117 at December 31, 2007)				

		709,732		635,061
Convertible, 5% note payable to Dutchess; due December 2010		500,000		500,000
	$	1,209,732	$	1,135,061

Total interest expense during the three months ended March 31, 2008 related to the Dutchess debentures, including amortization of the discount, was $141,239, which represented an effective interest rate of 28%. Total interest expense during the three months ended March 31, 2007 related to the Dutchess debentures, including amortization of the discount and $80,998 in early redemption penalties, was $489,022, which represented an effective interest rate of 68%.

All of the convertible notes payable to Dutchess at March 31, 2008, contain a clause calling for an early redemption penalty of 20%. In addition, although Dutchess has not provided any indication it will do so, each of the convertible debenture agreements contain a provision under which Dutchess may request the Company to make amortizing payments on a monthly basis in an amount to be determined by the Company and Dutchess. As such, the total amount of debentures outstanding is classified as a current liability. The total amount of discount amortized to interest expense during the three months ended March 31, 2008 and 2007 was $74,671 and $278,066, respectively.

Subsequent to March 31, 2008, Dutchess converted an additional $53,304 of debentures into 1,480,667 shares of the Company s common stock.

4. STOCKHOLDERS' DEFICIT

No shares of common stock or preferred stock were issued during the three month period ending March 31, 2008. Subsequent to March 31, 2008, the Company issued 1,480,667 shares of common stock to Dutchess upon the conversion of $53,304 in outstanding debentures. The Company recorded $179,507 in accumulated dividends on the outstanding Series B Preferred Stock for the period ending March 31, 2008. No warrants were issued by the Company or exercised by their holder, nor did any expire, during the period ending March 31, 2008.

OPTIONS

Most of the options granted by the Company to employees vest over three years, which is considered to be the requisite service period. Stock options issued in exchange for consultant services vest over the period defined in each contract. During the three month period ended March 31, 2008, no options were awarded and no options were exercised or forfeited. During the three month period ended March 31, 2007, the Company awarded 4,450,000 options to employees and a director with a weighted average exercise price of $0.07 per option, and no options were exercised or forfeited. The weighted average grant date fair value of these options awarded was $0.067 per option. The estimated fair value of the options granted in 2007 were calculated using the following assumptions:

Expected volatility	1.66%
Expected term (in years)	5-6.5 years
Risk-free interest rate	4.46-4.55%
Dividend yield	0%

The total fair value of options vesting during the three months ending March 31, 2008 and 2007 was $16,750 and $106,600, respectively.

As of March 31, 2008, the Company had 10,735,000 shares under option with a weighted average exercise price of $0.09 per share, a weighted average remaining contractual life of 5.5 years and an aggregate intrinsic value of $7,500. The aggregate intrinsic value represents the total intrinsic value (the difference between the closing stock price on March 31, 2008 of $0.05 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders, had all option holders been able to and in fact, had exercised their options on March 31, 2008.

As of March 31, 2008, the Company had 750,000 un