

ST. BERNARD SOFTWARE, INC.
Form 10QSB
May 15, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 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
(State or other Jurisdiction)

of incorporation)

15015 Avenue of Science

San Diego, California

(Address of Principal Executive Office)

20-0996152
(I.R.S. Employer

Identification No.)

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(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 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

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

As of May 11, 2007 there were 14,809,201 shares of the registrant's common stock outstanding.

ST. BERNARD SOFTWARE, INC.

For the Quarter Ended March 31, 2007

Form 10-QSB

INDEX

<u>PART I</u>	<u>Financial Information</u>	3
Item 1.	<u>Consolidated Financial Statements</u>	3
Item 2.	<u>Management's Discussion and Analysis and Results of Operation</u>	16
Item 3.	<u>Controls and Procedures</u>	29
<u>PART II</u>	<u>Other Information</u>	29
Item 1.	<u>Legal Proceedings</u>	29
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	29
Item 3.	<u>Defaults Upon Senior Securities</u>	29
Item 4.	<u>Submission of Matters to A Vote of Security Holders</u>	30
Item 5.	<u>Other Information</u>	30
Item 6.	<u>Exhibits</u>	31
	<u>Signatures</u>	33

PART I FINANCIAL INFORMATION**Item 1. Consolidated Financial Statements**

	St. Bernard Software, Inc.	
	and Subsidiaries	
	Consolidated Balance Sheets	
	March 31,	December 31,
	2007	2006
	(Unaudited)	
Assets		
Current Assets		
Cash and cash equivalents	\$ 1,157,819	\$ 4,841,871
Accounts receivable - net of allowance for doubtful accounts of \$747,000 and \$678,000 at March 31, 2007 and December 31, 2006, respectively	3,330,492	3,964,403
Inventories	655,357	729,739
Prepaid expenses and other current assets	450,021	483,840
Total current assets	5,593,689	10,019,853
Fixed Assets - Net	1,870,682	1,726,050
Other Assets	3,736,732	3,937,848
Goodwill	7,775,027	7,709,212
Deferred Income Taxes		
	\$ 18,976,130	\$ 23,392,963
Liabilities and Stockholders Deficit		
Current Liabilities		
Line of credit	\$ 227,185	\$ 296,410
Accounts payable	3,256,748	4,559,323
Accrued compensation expenses	1,542,764	1,525,821
Accrued expenses and other current liabilities	323,537	291,718
Current portion of capitalized lease obligations	119,262	75,087
Deferred revenue	10,005,068	11,873,376
Total current liabilities	15,474,564	18,621,735
Capitalized Lease Obligations, Less Current Portion	232,236	141,617
Deferred Revenue	5,127,012	5,842,809
Total liabilities	20,833,812	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 14,809,201 and 14,764,251 shares issued and outstanding in 2007 and 2006, respectively	148,092	147,643
Additional paid-in capital	38,594,477	38,304,771

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Accumulated deficit	(40,600,251)	(39,665,612)
Total stockholders' deficit	(1,857,682)	(1,213,198)
	\$ 18,976,130	\$ 23,392,963

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

St Bernard Software, Inc.

and Subsidiaries

Unaudited Consolidated Statements of Operations

	<i>Three months ended March 31,</i>	
	2007	2006
Sales		
License	\$ 855,645	\$ 884,395
Appliance	745,271	623,200
Subscription	3,772,317	3,761,009
Total Sales	5,373,233	5,268,604
Cost of Sales		
License	32,317	8,693
Appliance	558,009	380,205
Subscription	1,057,639	963,144
Total Cost of Sales	1,647,965	1,352,042
Gross Profit	3,725,268	3,916,562
Sales and marketing expenses	4,059,605	2,564,330
Research and development expenses	1,877,602	1,595,364
General and administrative expenses	2,419,991	927,775
Loss from Operations	(4,631,930)	(1,170,907)
Other Expense (Income)		
Interest expense - net	12,899	80,464
Gain on sale of UpdateExpert	(3,714,425)	
Total Other Expense (Income)	(3,701,526)	80,464
Loss Before Income Taxes	(930,404)	(1,251,371)
Income tax expense	(4,235)	
Net Loss	\$ (934,639)	\$ (1,251,371)
Basic and Diluted Loss Per Common Share	\$ (0.06)	\$ (0.13)
Weighted Average Shares Outstanding	14,794,863	9,747,760

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

St. Bernard Software, Inc.

and Subsidiaries

Unaudited Consolidated Statements of Stockholders Deficit

	Common Stock		Additional	Accumulated	Total
	Shares	Amount	Paid-in Capital	Deficit	
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
Compensation expense on stock options			260,111		260,111
Net loss				(934,639)	(934,639)
Balance at March 31, 2007	14,809,201	\$ 148,092	\$ 38,594,477	\$ (40,600,251)	\$ (1,857,682)

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

St Bernard Software, Inc.

and Subsidiaries

Unaudited Consolidated Statements of Cash Flows

	<i>Three months ended March 31,</i>	
	2007	2006
Cash Flows From Operating Activities		
Net loss	\$ (934,639)	\$ (1,251,371)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	365,318	152,036
Provision for bad debts	68,364	(46,808)
Gain on sale of UpdateExpert	(3,714,425)	
Compensation expense	260,111	
Increase (decrease) in cash resulting from changes in:		
Accounts receivable	565,547	1,172,152
Inventories	74,382	23,079
Prepaid expenses and other current assets	28,311	64,678
Accounts payable	(1,302,575)	420,995
Accrued expenses and other current liabilities	48,764	(61,089)
Deferred revenue	(69,680)	(450,870)
Net cash provided (used) in operating activities	(4,610,522)	22,802
Cash Flows From Investing Activities		
Additional costs related to purchase of business	(65,816)	
Purchases of fixed assets	(145,103)	(28,909)
Proceeds from the sale of UpdateExpert	1,200,000	
Net cash provided (used) in investing activities	989,081	(28,909)
Cash Flows From Financing Activities		
Principal payments on note payable		(182,335)
Proceeds from stock option and warrant exercises	30,044	14,066
Principal payments on capitalized lease obligations	(23,430)	(11,460)
Net increase (decrease) in line of credit	(69,225)	178,880
Net cash used in financing activities	(62,611)	(849)
Net Decrease in Cash and Cash Equivalents	(3,684,052)	(6,956)
Cash and Cash Equivalents at Beginning of Period	4,841,871	9,211
Cash and Cash Equivalents at End of Period	\$ 1,157,819	\$ 2,255
Cash paid during the period for:		
Interest	\$ 56,769	\$ 77,789
Income taxes	\$ 1,041	\$

During the three months ended March 31, 2007, the Company entered into capitalized lease obligations for the purchase of \$158,224 in fixed assets.

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

St. Bernard Software, Inc.

and Subsidiaries

Notes to Consolidated Financial Statements

1. Summary of Significant Accounting Policies

Merger and accounting treatment

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.

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, we 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, we 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 shares of our common stock. We 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 \$8.3 million.

St. Bernard Software, Inc.

and Subsidiaries

Notes to Consolidated Financial Statements-(Continued)

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 March 31, 2006, are as follows (in thousands):

	Amount
Net sales	\$ 5,362
Net loss	\$ (1,666)
Basic and Diluted Loss per Common Share	(0.16)
Weighted Average Shares Outstanding	10,219

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 subsidiaries. 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 for impairment, and assumptions used to determine the fair value of stock options under SFAS 123R.

Liquidity

At March 31, 2007, our current liabilities exceeded our current assets by approximately \$9.9 million and we had a stockholders' deficit of approximately \$1.9 million. We expect sufficient cash flows from operations during the next twelve months, along with our available line of credit financing, to cover our anticipated operating expenses. 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 \$10.0 million of the current liability balance at March 31, 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 \$10.0 million recorded as a current liability or the approximately \$15.1 million recorded as a liability in total.

St. Bernard Software, Inc.

and Subsidiaries

Notes to Consolidated Financial Statements-(Continued)

However, while the likelihood of a liquidity crisis is considered remote, should one occur there are no guarantees that the Company would obtain sufficient cash from outside sources on a timely basis. Management does not believe the situation represents a significant risk to the Company.

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. Based upon the results of the impairment test, management of the Company has concluded there was no impairment of goodwill at either March 31, 2007 or at December 31, 2006.

Goodwill totaled \$7.8 million and \$7.7 million at March 31, 2007 and December 31, 2006, respectively that arose through business acquisitions made in 2000 and 2006. Goodwill that arose in 2006 was not subject to an impairment test. In accordance with SFAS No. 142, it will be tested for the first time during 2007, and then annually unless events indicate that an impairment test is warranted sooner.

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 for fiscal year 2006 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.

St. Bernard Software, Inc.

and Subsidiaries

Notes to Consolidated Financial Statements-(Continued)

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 three months ended March 31, 2007, 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 three months ended March 31, 2007, was calculated using the Black-Scholes option pricing model with the following valuation assumptions: expected volatility 72%; dividend yield 0%; risk free interest rates ranging from 4.54 to 4.75%; expected life 6.5 years.

For the three months ended March 31, 2007, total stock-based compensation expense was approximately \$260,000, and was charged to general and administrative expenses. The earnings per share effect as a result of the stock based compensation expense was approximately \$0.02 for the three months ended March 31, 2007. The tax effect was immaterial.

The following is a summary of stock option activity under the Plans as of March 31, 2007 and changes during the three months ended March 31, 2007:

	Number of Shares Outstanding	Weighted Average Exercise Price
Options outstanding at December 31, 2006	2,260,643	\$ 3.12
Granted	1,134,364	\$ 1.97
Exercised	(44,950)	\$ 0.67
Forfeited/Expired	(1,064,651)	\$ 4.19
Options outstanding at March 31, 2007	2,285,406	\$ 2.08

Additional information regarding options outstanding as of March 31, 2007 is as follows:

Range of Exercise Prices	Number of Shares Outstanding	Weighted Average		Number Exercisable	Weighted Average Exercise Price
		Remaining Contractual Life in Years	Weighted Average Exercise Price		
\$0.59 to \$1.19	305,714	4.84	\$ 0.97	305,714	\$ \$0.97
\$1.79 to \$1.80	73,000	9.72	\$ 1.80		\$ 0.00
\$1.90 to \$1.90	450,000	9.72	\$ 1.90		\$ 0.00

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\$1.95 to \$1.95	1,079,964	8.35	\$ 1.95	79,546	\$ 1.95
\$2.30 to \$2.30	50,000	9.76	\$ 2.30		\$ 0.00
\$2.55 to \$2.55	47,423	0.16	\$ 2.55	47,423	\$ 2.55
\$2.98 to \$2.98	420	0.07	\$ 2.98	420	\$ 2.98
\$3.71 to \$3.71	200,000	9.44	\$ 3.71		\$ 0.00
\$4.75 to \$4.75	60,000	2.79	\$ 4.75	60,000	\$ 4.75
\$5.20 to \$5.20	18,885	8.29	\$ 5.20	18,885	\$ 5.20
\$0.59 to \$5.20	2,285,406	8.00	\$ 2.08	511,988	\$ 1.87

St. Bernard Software, Inc.

and Subsidiaries

Notes to Consolidated Financial Statements-(Continued)

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 399,000 outstanding options under the Plans that are currently unvested will be forfeited.

The aggregate intrinsic value of options outstanding and exercisable at March 31, 2007 was \$238,000. The aggregate intrinsic value represents the total intrinsic value, based upon the stock price of \$1.75 at March 31, 2007. The intrinsic value of option exercises for the three months ended March 31, 2007 was approximately \$69,000.

As of March 31, 2007, there was \$3,843,000 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 2.54 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 recent 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

Loss per share

Basic loss per share is calculated by dividing net loss by the weighted-average number of shares of common stock outstanding. Diluted loss per share includes the components of basic loss per share and also gives effect to dilutive common stock equivalents. Potentially dilutive common stock equivalents include stock options and warrants. No dilutive effect was calculated for the three months ended March 31, 2007 and March 31, 2006, respectively, as the Company reported a net loss in each period.

St. Bernard Software, Inc.

and Subsidiaries

Notes to Consolidated Financial Statements-(Continued)

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

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.

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.

In June 2006, the Financial Accounting Standards Board (FASB) ratified *Emerging Issues Task Force (EITF) No. 06-2, Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, Accounting for Compensated Absences (SFAS No. 43)*. EITF 06-2 provides guidelines under which sabbatical leave or other similar benefits provided to an employee are considered to accumulate, as defined in SFAS 43. If such benefits are deemed to accumulate, then the compensation cost associated with a sabbatical or other similar benefit arrangement should be accrued over the requisite service period. The provisions of the EITF are effective for fiscal years beginning after December 15, 2006

St. Bernard Software, Inc.

and Subsidiaries

Notes to Consolidated Financial Statements-(Continued)

and allow for either retrospective application or a cumulative effect adjustment approach upon adoption. The Company adopted EITF 06-2 during fiscal year 2007. The Company did not record, and does not anticipate any adjustments resulting from the adoption of EITF 06-2.

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

2. Other Assets

Other assets consisted of the following:

	March 31, 2007	December 31, 2006
Capitalized software costs, net of amortization	\$ 2,358,872	\$ 2,500,496
Customer-related intangible, net of amortization	1,180,833	1,245,833
Security deposits	197,027	191,519
	\$ 3,736,732	\$ 3,937,848

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 \$65,000 and \$0 for the three months ended March 31, 2007 and 2006, respectively.

Amortization for the capitalized software costs are computed on an individual-product basis using the straight-line method over a useful life ranging from three to six years. Amortization expense related to capitalized software was approximately \$142,000 and \$31,000 for March 31, 2007 and 2006, respectively.

3. Debt*Line of Credit*

The Company has a \$1,250,000 line of credit with a finance company that automatically renews every six months. The line of credit provides for advances of up to 80% of eligible accounts receivable. Interest is payable monthly at 1.5% per month (18% per annum). The agreement includes 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 may be terminated without penalty but requires thirty days notice. The line of credit is secured by all of the assets of the Company and all assets acquired by the Company during the term of the agreement. The Company is required to deliver all accounts receivable proceeds to the finance company upon receipt by the Company. As of March 31, 2007, the balance on the line of credit was approximately \$227,000.

4. Stockholders Deficit*Warrants*

As of March 31, 2007 and 2006, a total of 8,650,104 and 8,708,850 shares of common stock, respectively, were reserved for issuance for the exercise of warrants at an exercise price of \$1.85, \$2.98 and \$5.00 per share.

5. Related Party Transactions

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 \$622,000 and \$603,000 for the three months ended March 31, 2007 and 2006, respectively. Amounts due at March 31, 2007 and 2006 were \$617,000 and \$361,000, respectively.

St. Bernard Software, Inc.

and Subsidiaries

Notes to Consolidated Financial Statements-(Continued)

The Company presently occupies office space provided by an affiliate of certain officers and directors 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 April 13, 2006, eSoft, Inc. filed Civil Action No. 00697-EWN-MJW in the U.S. District Court in Denver, Colorado alleging infringement of U.S. Patent No. 6,961,773 by St. Bernard Software, Inc. In connection with this proceeding, the Company filed a counter claim against the plaintiff alleging infringement of U.S. Patent No. 5,557,747. In February 2007, the Company paid a settlement for an undisclosed amount in the lawsuit with eSoft, Inc. In addition, the Company has agreed to a cross license of patent rights.

In March 2007, Arthur Budman, a stockholder of the Company, filed a lawsuit against the Company and the Chief Financial Officer (CFO) in the Superior Court of the State of California, San Diego County, seeking monetary damages arising from the alleged negligence of the CFO in connection with communications regarding the terms of the merger of Old St. Bernard Software, Inc. and Sand Hill. It is the opinion of management that the outcome of this pending lawsuit will not materially affect the operations, the financial position or cash flows of the Company.

Miscellaneous contingency

In January of 2006, an enterprise wide review of job descriptions and employee classifications was conducted by the Company. Based upon current responsibilities, certain exempt /non exempt classifications were updated. Any changes in classifications will be implemented going forward.

As a result of the update in employee classifications, there could be potential assertions from current and former employees that they were entitled to certain benefits under a non exempt classification pursuant to the Fair Labor Standards Act and state law.

In accordance with SFAS No. 5, Accounting for Contingencies, the Company has not recorded a provision since there are no pending claims and it is not probable that a claim will be asserted. The amount of any potential loss cannot be reasonably estimated.

7. Concentrations

Sales and revenue

The Company considers itself to operate within one business segment, Secure Content Management (SCM). For the quarters ended March 31, 2007 and 2006, approximately 91% and 96% of the Company's revenue was in North America, the remaining 9% and 4%, respectively, were disbursed over the rest of the world.

8. Asset Sale and License Agreement

On January 29, 2007, pursuant to the terms of an Asset Sale and License Agreement signed and effective as of January 4, 2007 (the *Agreement*), by and between St. Bernard Software, Inc., a Delaware

St. Bernard Software, Inc.

and Subsidiaries

Notes to Consolidated Financial Statements-(Continued)

corporation (*St. Bernard*), and Shavlik Technologies, LLC (*Shavlik*), St. Bernard assigned and sold to Shavlik St. Bernard s UpdateEXPERT and Update EXPERT Premium software applications and related customer and end user license agreements, software, programming interfaces and other intellectual property rights and contracts for an aggregate purchase price of \$1.2 million plus 45% of any maintenance renewal fees collected by Shavlik in excess of \$1.2 million for renewals invoiced by Shavlik between February 1, 2007 and January 31, 2008 (the *Asset Sale*). As a result of the sale, the Company realized a gain of approximately \$3.7 million in January 2007, primarily due to the immediate recognition of previously unrecognized deferred revenue.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation

This Form 10-QSB contains forward-looking statements concerning St. Bernard's anticipated future revenues and earnings, adequacy of future cash flow and related matters for the three months ended March 31, 2007. These forward-looking statements include, but are not limited to, statements or phrases such as believe, will, expect, anticipate, estimate, intend, plan, and would and similar expressions, and the net thereof. Forward-looking statements are not guarantees of performance. We assume no obligation to update any such forward-looking statements, and these statements involve risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements. For a summary of such risks and uncertainties, please see Risk Factors located in our Annual Report on Form 10-KSB for the year ended December 31, 2006 filed with the Securities and Exchange Commission on April 2, 2007.

OVERVIEW

Our Business

We design, develop, and market network security and data protection solutions that enable our customers to efficiently and effectively maintain secure network environments. Our solutions are delivered as software, dedicated appliances, and as an on-demand software as a service (SaaS) solution package. Our core offerings provide network protection and efficiency through content filtering and policy enforcement across multiple internet protocols, including web traffic, email, and instant message. Additional capabilities in business continuity and collaboration are enabled via hosted archiving and sharing of electronic transactions associated with these internet activities.

Our customers, primarily small and mid-sized enterprises including more than 8,000 business, education, and government institutions purchase our solutions directly from us, through our 1-tier and 2-tier reseller network, and through OEM, original equipment manufacturers, (OEMs). Each purchase consists of a software license and recurring subscription to data and/or service updates and in the case of our on-premises solutions, a maintenance fee. Our primary users are IT managers, directors, and administrators.

We invested significantly in research and development activities and for the three months ended March 31, 2007 and 2006 we spent \$1.9 million and \$1.6 million, respectively, on research and development. Our research and development efforts have been directed toward developing new products for Linux, NetWare, UNIX and Windows, developing new features and functionality for existing products, integrating products across our existing product lines, porting new and existing products to different operating systems and expanding our product portfolio into new markets, such as Software as a Service, and additional secure content management markets, such as messaging security, business continuity and data collaboration, and consolidating these products under a common console.

Our Strategy

During 2005, we undertook an evaluation of the appropriate long-term strategy for our business. As a result of that process, we determined that we should continue to build on our existing small and medium enterprise security business by increasing our penetration of the secure content management security business, and also seek to expand into broader security segments; such as messaging security. We also believed that the software industry was undergoing a trend towards consolidation, and that the areas of security, and content management were beginning to converge. Commencing in the first half of 2005 and continuing through the third quarter of 2006, we began to investigate business combinations and other strategic transactions that would allow us to expand our security products and service offerings into one or more other key areas of the small and medium size enterprise secure content management market. We focused on acquiring anti-phishing, instant messaging management, anti-spy ware and e-mail filtering technologies in our initial pursuit of the expansion of our security business with our adjacent secure content management software products.

Our Business Growth

We have historically grown internally and through acquisitions. On October 26, 2005 we entered into a merger agreement 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 in which we 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 the private company in the merger were converted into a total of 9,733,771 shares of our stock, or approximately 69.2% of our outstanding common stock following the merger.

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 we 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 us were 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 the private company in the merger issuing stock for the net monetary assets of Sand Hill. Our historical financial statements prior to July 27, 2006, are those of the private company in the merger. 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.

Effective October 17, 2006, we 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, we 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 shares of our common stock. We 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 \$8.3 million.

Our Financial Results

For the three months ended March 31, 2007, net revenue was \$5.4 million, an increase of 1.9% over the same period in 2006. The net loss for the quarter ended March 31, 2007 was \$0.9 million, a decrease from the first quarter of 2006 of 30.8%. Basic and diluted net loss per share was \$0.06 for the quarter ended March 31, 2007, a reduction from a net loss per share of \$0.13 for the quarter ended March 31, 2006, primarily as a result of a gain from the sale of our UpdateExpert product offset by operating expenses. The increase in operating expenses was mainly attributable to an increase of \$1.5 million, or 57.7%, for sales and marketing expenses due to additional channel sales staff, which lead to an increase in base wages and commissions, and an increase in advertising expenses related to the launch of our LivePrism on-demand service. In addition, an increase of \$1.5 million or 166.7% for general and administrative expenses for the three months ended March 31, 2007 over the same period in 2006 was largely due to the costs associated with being a public company, which included an increase in compensation expenses and bonuses, an increase in legal costs, an increase in accounting costs, an increase in contract labor and consulting services, and an increase in insurance expenses.

Cash used by operations for the quarter ended March 31, 2007 was \$4.6 million compared to cash provided during the quarter ended March 31, 2006 of \$23,000. The increased use of cash was due primarily

to an increased investment in sales and marketing of \$1.5 million, an increased investment in research and development of \$0.3 million, an increased investment in general and administrative expenses due to being a public company of \$1.5 million, and a reduction of accounts payable of \$1.3 million. We utilize cash in ways that management believes provide an optimal return on investment. Principal uses of our cash for investing and financing activities include new product development, acquisition of technologies, and purchases of property and equipment.

During the three months ended March 31, 2007, we continued to invest in product development. Three product extension efforts were underway during the quarter to enhance the features of iPrism version 4.0, Open File Manager, and LivePrism.

Critical Accounting Policies and Estimates

There are several accounting policies that are critical to understanding our historical and future performance, because these policies affect the reported amounts of revenue and other significant areas in our reported financial statements and involve management's judgments and estimates. These critical accounting policies and estimates include:

revenue recognition;

allowance for doubtful accounts;

impairment of goodwill and long-lived assets;

accounting for income taxes; and

accounting for stock options.

These policies and estimates and our procedures related to these policies and estimates are described in detail below and under specific areas within the discussion and analysis of our financial condition and results of operations. Please refer to Note 1, Summary of Significant Accounting Policies in the Notes to Consolidated Financial Statements of St. Bernard for the quarter ended March 31, 2007 included herein for further discussion of our accounting policies and estimates. There have been no material changes to these accounting policies during the three months ended March 31, 2007.

Revenue Recognition

We make significant judgments related to revenue recognition. For each arrangement, we make significant judgments regarding the fair value of multiple elements contained in our arrangements, judgments regarding whether our fees are fixed or determinable and judgments regarding whether collection is probable. We also make significant judgments when accounting for potential product returns. These judgments, and their effect on revenue recognition, are discussed below.

Multiple Element Arrangements

We typically enter into arrangements with customers that include perpetual software licenses, database subscriptions, hardware appliances, maintenance and technical support. Software licenses are on a per copy basis. Per copy licenses give customers the right to use a single copy of licensed software. We make judgments regarding the fair value of each element in the arrangement and generally account for each element separately.

Assuming all other revenue recognition criteria are met, license and appliance and product revenue is recognized upon delivery in accordance with Statement of Position, or SOP, 97-2 *Software Revenue Recognition*. Under 97-2, we have established vendor specific objective evidence, or VSOE, on each element of multiple element arrangements using the price charged when the same element is sold separately. Undelivered elements typically include subscription, maintenance and technical support and are recognized ratably over the term.

If we cannot establish fair value for any undelivered element, we would be required to recognize revenue for the whole arrangement at the time revenue recognition criteria for the undelivered element is met using Statement of Position (SOP) No. 98-9, Modification of SOP No. 97-2

Software Revenue Recognition, with respect to Certain Transactions.

The Fee is Fixed or Determinable

Management makes judgments, at the outset of an arrangement, regarding whether the fees are fixed or determinable. Our customary payment terms generally require payment within 30 days after the invoice date. Arrangements with payment terms extending beyond 120 days after the effective date of the license agreement are not considered to be fixed or determinable, in which case revenue is recognized as the fees become due and payable.

Collection is Probable

Management also makes judgments at the outset of an arrangement regarding whether collection is probable. Probability of collection is assessed on a customer-by-customer basis. We typically sell to customers with whom we have a history of successful collections. New customers can be subjected to a credit review process to evaluate the customer's financial position and ability to pay. If it is determined at the outset of an arrangement that collection is not probable, then revenue is recognized upon receipt of payment.

Indirect Channel Sales

We generally recognize revenue from licensing of software products through our indirect sales channel upon sell-through or when evidence of an end-user exists. For certain types of customers, such as distributors, we recognize revenue upon receipt of a point of sales report, which is our evidence that the products have been sold through to an end-user. For resellers, we recognize revenue when we obtain evidence that an end-user exists, which is usually when the software is delivered. For licensing of our software to original equipment manufacturers, or OEMs, royalty revenue is recognized when the OEM reports the sale of software to an end-user customer, in some instances, on a quarterly basis.

Delivery of Software Products

Our software may be physically delivered to our customers with title transferred upon shipment to the customer. We primarily deliver our software electronically, by making it available for download by our customers or by installation at the customer site. Delivery is considered complete when the software products have been shipped and the customer has access to license keys. If an arrangement includes an acceptance provision, we generally defer the revenue and recognize it upon the earlier of receipt of written customer acceptance or expiration of the acceptance period.

Product Returns and Exchanges

Our license arrangements do not typically provide customers a contractual right of return. Some of our sales programs allow customers limited product exchange rights. Management estimates potential future product returns and exchanges and reduces current period product revenue in accordance with *Statement of Financial Accounting Standards (SFAS) No. 48, Revenue Recognition When Right of Return Exists*. The estimate is based on an analysis of historical returns and exchanges. Actual returns may vary from estimates if we experience a change in actual sales, returns or exchange patterns due to unanticipated changes in products, competitive or economic conditions.

Allowance for Doubtful Accounts

Management estimates potential future uncollectible accounts and recognizes expense as appropriate. The estimate is based on an analysis of historical uncollectible accounts and on a review of all significant outstanding invoices. Actual bad debts may vary from estimates if we experience a change in actual sales, returns or exchange patterns due to unanticipated changes in products, competitive or economic conditions.

Impairment of Goodwill and Long-Lived Assets

In accordance with the *Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets*, management tests our goodwill for impairment annually and whenever events or changes in circumstances suggest that the carrying amount may not be recoverable.

We compare the implied fair value of our reporting unit's goodwill to its carrying amount. If the carrying amount of our reporting unit's goodwill exceeds its fair value, an impairment loss will be recognized in an amount equal to that excess.

Goodwill arose through business acquisitions made in 2000 and 2006. We completed the test for the goodwill that arose in 2000 during the fourth quarter of 2006, and we were not required to record an impairment loss on that goodwill. Goodwill that arose in 2006 was not subject to an impairment test. In accordance with SFAS No. 142, it will be tested for the first time during 2007, and then annually unless events indicate that an impairment test is warranted sooner.

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, we compare the carrying amount of the asset group to net future undiscounted cash flows that 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, we compare the fair value to the book value of the asset group. If the fair value is less than the book value, we would recognize an impairment loss. The impairment loss would be the excess of the carrying amount of the asset group over its fair value.

Some of the events that we consider as impairment indicators for our long-lived assets, including goodwill, are:

our significant underperformance relative to expected operating results;

significant adverse change in legal factors or in the business climate;

an adverse action or assessment by a regulator;

unanticipated competition;

a loss of key personnel;

significant decrease in the market value of a long-lived asset; and

significant adverse change in the extent or manner in which a long-lived asset is being used or its physical condition.

Significant assumptions and estimates are made when determining if our goodwill or other long-lived assets have been impaired or if there are indicators of impairment. Management bases its estimates on assumptions that it believes to be reasonable, but actual future results may differ from those estimates as our assumptions are inherently unpredictable and uncertain. Management's estimates include estimates of future market growth and trends, forecasted revenue and costs, expected periods of asset utilization, appropriate discount rates and other variables.

Accounting for Income Taxes

We are required to estimate our income taxes in each federal, state and international jurisdiction in which we operate. This process requires that management estimate the current tax exposure as well as assess temporary differences between the accounting and tax treatment of assets and liabilities, including items such as accruals and allowances not currently deductible for tax purposes. The income tax effects of the differences identified are classified as current or long-term deferred tax assets and liabilities in our consolidated balance sheets. Management's judgments, assumptions and estimates relative to the current provision for income tax take into account current tax laws, our interpretation of current tax laws and possible outcomes of current and future audits conducted by foreign and domestic tax authorities. Changes in tax laws or management's interpretation of tax laws, including the provisions of the American Jobs Creation Act of 2004, and the resolution of current and future tax audits could significantly impact the amounts provided for income taxes in our balance sheet and results of operations. We must also assess the likelihood that deferred tax assets will be realized from future taxable income and, based on this

assessment, establish a valuation allowance if required. As of March 31, 2007, the deferred tax assets were fully reserved. The deferred tax assets include net operating losses and may be subject to significant annual limitation under certain provisions of the Internal Revenue Code of 1986, as amended. Management's determination of valuation allowance is based upon a number of assumptions, judgments and estimates, including forecasted earnings, future taxable income and the relative proportions of revenue and income before taxes in the various domestic and international jurisdictions in which we operate.

Commitments and Contingencies

Effective October 1, 2006, we adopted the provisions of FASB Staff Position (FSP) *Emerging Issue Task Force (EITF) 00-19-2, Accounting for Registration Payment Arrangements* . As a result we changed the manner in which we account for the warrants that were issued subject to a registration payment arrangement by Sand Hill during 2004. Pursuant to the FSP which was posted December 21, 2006, we now account for the registration rights contained in the warrants separately and measures the liability under *FASB SFAS No. 5, Accounting for Contingencies* and *FASB Interpretation (FIN) No. 14, Reasonable Estimation of the Amount of a Loss* . As a result of the application of transition guidance in the FSP, we reported a change in accounting principle through a cumulative-effect adjustment. The warrant liability originally recorded of approximately \$8.1 million was transferred to additional paid in capital and retained earnings was adjusted for approximately \$2.6 million, which is the difference in the carrying amount of the instrument recorded as a liability immediately prior to the adoption of the FSP and the amount reclassified to equity. We have chosen early adoption of this FSP. Pursuant to *FASB SFAS No. 5*, a loss contingency is to be accrued only if it is probable and can be reasonably estimated. We have determined that a loss contingency related to the registration requirements in the warrants is not probable.

In January 2006, we conducted an enterprise wide review of job descriptions and employee classifications. Based upon current responsibilities, certain exempt/nonexempt classifications were updated. Changes in classifications were implemented going forward.

As a result of the update in employee classifications, there could be potential assertions from current and former employees that they were entitled to certain benefits under a non exempt classification pursuant to the Fair Labor Standards Act and state law.

In accordance with *SFAS No. 5, Accounting for Contingencies* , we have not recorded a provision since there are no pending claims and it is not probable that a claim will be asserted. The amount of any potential loss cannot be reasonably estimated.

In the normal course of business, we are occasionally named as a defendant in various lawsuits. On April 13, 2006, eSoft, Inc. filed Civil Action No. 00697-EWN-MJW in the U.S. District Court in Denver, Colorado alleging infringement of U.S. Patent No. 6,961,773 by our Company. In connection with this proceeding, we filed a counter claim against the plaintiff alleging infringement of U.S. Patent No. 5,557,747. In February 2007, we paid a settlement for an undisclosed amount in the lawsuit with eSoft, Inc. In addition, we agreed to a cross license of patent rights.

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Results of Operations of St. Bernard**Comparison of the Three Months Ended March 31, 2007 and 2006***Net Revenues*

	For the		
	Three Months Ended		
	March 31,	2006	% Change
	2007		
	(In millions, except percentages)		
Total net revenue	\$ 5.4	\$ 5.3	1.9%

Net revenues increased \$0.1 million for the three months ended March 31, 2007 compared to the same period in the prior year due to an increase of appliance hardware revenue of approximately \$0.1.

Net License Revenues

	For the		
	Three Months Ended		
	March 31,	2006	% Change
	2007		
	(In millions, except percentages)		
Net license revenue	\$ 0.9	\$ 0.9	0.0%
As a percentage of net revenue	16.7%	17.0%	

For the three months ended March 31, 2007, our net license revenue remained unchanged as compared to the same period in 2006. Net license revenue was approximately \$0.9 million for both periods.

Net Appliance Revenues

	For the		
	Three Months Ended		
	March 31,	2006	% Change
	2007		
	(In millions, except percentages)		
Net appliance revenue	\$ 0.7	\$ 0.6	16.7%
As a percentage of net revenue	13.0%	11.3%	

For the three months ended March 31, 2007, appliance hardware sales increased by \$0.1 million due primarily to more appliance units shipped as compared to the same period in 2006. Total units shipped for the three months ended March 31, 2007 and 2006 were 607 and 462, respectively.

Net Subscription Revenues

	For the		
	Three Months Ended		
	March 31,		% Change
	2007	2006	
	(In millions, except percentages)		
Net subscription revenue	\$ 3.8	\$ 3.8	0.0%
As a percentage of net revenue	70.4%	71.7%	

For the three months ended March 31, 2007, our subscription revenue remained unchanged over the same period in 2006. Renewal rates for our products range from 75% to 95%.

Cost of Revenue