ST. BERNARD SOFTWARE, INC.
Form 10KSB
March 20, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-KSB

(Mark One)

x **ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2007

OR

¨ **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Transition Period From to

Commission File Number 0-50813

St. Bernard Software, Inc.

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

Delaware	**20-0996152**
(State or other Jurisdiction	**(I.R.S. Employer**
of incorporation)	**Identification No.)**
15015 Avenue of Science, San Diego, California	**92128**
(Address of Principal Executive Office)	**(Zip Code)**

(858) 676-2277

(Issuer s Telephone Number, Including Area Code)

Securities registered under Section 12(b) of the Act: None

Securities registered under Section 12(g) of the Act:

Common Stock, $0.01 Par Value

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. ¨

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

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

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

Revenues for the fiscal year ended December 31, 2007 were $19,076,000.

APPLICABLE TO CORPORATE REGISTRANTS

As of March 14, 2008, 14,772,367 shares of Common Stock, $0.01 par value, were issued and outstanding, and no shares of Preferred Stock, $0.01 par value were issued.

The approximate aggregate market value and total number of shares of Common Stock held by non-affiliates at June 29, 2007 was $9,374,317 and 9,565,630, respectively. The total number of non-affiliate shares of Common Stock was multiplied by $0.98 per share (the closing price of such shares of Common Stock on June 29, 2007) to determine the aggregate market value of non-affiliate shares of Common Stock set forth above. (The assumption is made, solely for purposes of the above computation, that all officers, directors and holders of more than 5% of the outstanding Common Stock of registrant are affiliates.) The approximate total aggregate market value of Common Stock, including affiliates, is $14,447,683.

DOCUMENTS INCORPORATED BY REFERENCE

Refer to Exhibits set forth in Item 13 of this Form 10-KSB. Refer to Items 9, 10, 11, 12 and 14 of this Form 10-KSB for information incorporated by reference to the registrant s proxy statement for its 2008 annual stockholders meeting.

Transitional Small Business Disclosure Format (check one): Yes ¨; No x.

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St. Bernard Software, Inc.

FOR FISCAL YEAR ENDED December 31, 2007

FORM 10-KSB ANNUAL REPORT

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PART I

Item 1. DESCRIPTION OF BUSINESS

St. Bernard Software, Inc. (the Company or St. Bernard), a Delaware corporation incorporated in 1986, designs, develops, and markets secure content management (SCM) and policy compliance solutions to small, medium and enterprise class customers. These SCM solutions enable our customers to manage their employee usage policy across multiple messaging protocols, which include internet access, e-mail, and instant messaging (IM). These solutions are delivered in a unique Hybrid packaging of appliances and on-demand software as a service (SaaS) services. We also provide an on-demand archiving solution for internet usage, e-mail, and IM that supports our customers policy requirements for message retention and discovery.

Our customers include more than 5,000 business, education, and government institutions. Customers can purchase our solutions directly from us, through our 1-tier and 2-tier reseller network, and through original equipment manufacturers (OEMs). All of the company s software is sold as a single or multi-year subscription. These subscriptions represent the majority of the company s annual sales. Appliance purchases typically consist of an initial hardware purchase and maintenance subscription. Our primary customers are IT managers, directors, and administrators.

In July 2006, St. Bernard merged with Sand Hill IT Security Acquisition Corp. creating the current St. Bernard Software entity. The strategy of the newly merged company resulted in the following actions regarding the company s products:

- the acquisition of AgaveOne, Inc. (dba Singlefin) in October 2006 which established the foundation of our SaaS solution, LivePrism;
- the divestiture of the legacy UpdateEXPERT product line in January 2007 to Shavlik Technologies, LLC (Shavlik); and
- the divestiture of the legacy OFM product line in August 2007 to EVault, Inc., a wholly owned subsidiary of Seagate Technology, Inc. (EVault).

During 2007, the Company was focused on the development of the industry s first Hybrid SCM solution, combining the advantages of an appliance platform and SaaS services infrastructure. These products are scheduled to be announced in early 2008.

Our corporate headquarters is located at 15015 Avenue of Science, San Diego, California, 92128.

St. Bernard s Business Growth

St. Bernard has historically grown organically and through acquisitions. On October 26, 2005 the Company 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 St. Bernard Software, Inc. became the Parent s wholly-owned subsidiary. Sand Hill then changed its name to St. Bernard Software, Inc. Except where context requires otherwise, pre-merger St. Bernard Software, Inc. shall hereinafter be referred to as Old St. Bernard Software, Inc.

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.

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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 shares of common stock of the Company. The Company also satisfied $5.7 million in Singlefin indebtedness and certain Singlefin employees received bonuses totaling $0.25 million. The aggregate value of the transaction was approximately $8.1 million.

Products

iPrism Dedicated Web Content Filtering Appliance

iPrism, our flagship product, is a dedicated and optimized network appliance that enables organizations to enforce their acceptable internet use policies by providing multi-protocol web filtering and access control. The appliance, first under development in 1997, is a specialized firewall that packages the operating system, application software, and user interface, thereby delivering a cohesive, simple to install and maintain solution. At the core of iPrism is our industry-exclusive, 100% human-reviewed URL database, iGuard. Updates to the iGuard database are automatically delivered to iPrism customers as frequently as hourly.

iPrism is offered in 5 different models which vary by technical specification thereby delivering varying degrees of performance, storage, through-put, and component redundancy. All models run the same software, both application and operating system. All models receive common iGuard data updates. Models offer different features by design. Each appliance offers support for faster Internet speeds and more features as one progresses up the product line. The 10h is the entry-level appliance and supports 10 Mbs throughput. The 20h appliance supports 20 Mbs plus offers a failover capability. The 30h appliance support 30 Mbs, offers a full 1U chassis with RAID array storage and dual power. The 50h supports Internet speeds of 50 Mbs in addition to the features of the 30h. Finally, the 100h supports speeds in excess of 100 Mbs and offers more storage capacity. Today, the M-Series appliances from the last five years continue to be supported and can accept the latest software releases. As the iPrism appliances are designed to work together, concurrent box deployments enable scaling in larger networks and can also be deployed in a redundant fashion. All boxes can be centrally managed, remotely managed, or locally managed.

To support dynamic deployments of large enterprises and diverse locales, St. Bernard offers remote consolidation of reporting data in two solutions. The on-premises solution is the iPrism Enterprise Reporting Server (ERS). The ERS is a non-filtering server that enables organizations to establish common user activity reporting and archiving across multiple iPrism appliance deployments. In a typical deployment, a customer will deploy 2 or more iPrism filtering appliances in 1 or more data centers and use the ERS to aggregate filtering activity data into an enterprise-wide view. For customers who wish to use St. Bernard Software s data centers in lieu of purchasing an appliance like ERS, they can take advantage of the iPrism Managed Enterprise Reporting Service (MERS). The MERS offers the same features as the on-premises ERS. Since MERS is an on-demand service hosted by St. Bernard Software, the customer requires no upfront purchase of hardware and does not need to use precious rack-space in its server room.

Version 6.0 of iPrism is scheduled to release in March 2008. This release will offer existing and new customers malware defense as an enhancement to the Web filtering technology. This is essential for securing Web content as companies employees surf the Web. In addition, version 6.0 will offer the optional service of filtering public instant messaging (IM). Most iPrism customers filter IM conversations in some way. For an additional subscription fee, customers can capture these conversations, add a disclaimer for all parties to any conversation and ensure that malware is thwarted.

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LivePrism On Demand Internet Security, Continuity, and Collaboration Suite

LivePrism is an on-demand multi-tenant, software-as-a-service (SaaS) offering that delivers three primary services: email filtering, instant message filtering and transaction archive. Designed specifically for the small and midsized business, LivePrism offers enterprise-class IT solutions without the need to install and maintain hardware and software. Rather, LivePrism applications are hosted at third party data centers contracted by St. Bernard. Those applications are accessed by our customers via the Internet. The product strategy for the coming year will produce integration of LivePrism services into the iPrism product suite. The functional components of LivePrism include:

Email Filtering	Through redirection of inbound email to St. Bernard s servers, email is filtered for spam, viruses, and other unwanted email content prior to the traffic arriving at the customers network. Also through redirection to our servers, outbound email is scanned for content violations and viruses.
Instant Message Filtering	Similar to email, through redirection of Instant Message traffic to our servers, customers can monitor, filter, and enforce acceptable use of instant messaging services. Following the release of iPrism version 6.0, this IM filtering service will be provisioned from iPrism appliances.
Messaging Archive	LivePrism customers can also take advantage of archiving services whereby email and IM transactions are stored at our data centers, eliminating the need for customers to deploy in-house storage capability.

LivePrism components are sold for a license service fee typically based on the number of users. The broader strategy is designed to provide these services via the iPrism appliance, thus taking advantage of the best features from both on-premises and on-demand services. This strategy also leverages existing customers for whom adoption of these services via their iPrism appliances produces low barriers and reduced acquisition costs.

ePrism, licensed through an OEM agreement, is a dedicated email filtering and content inspection appliance that protects against spam, viruses, and other unwanted email content and protects against outbound data leakage through message content and attachment inspection and policy enforcement. ePrism is offered in 3 different models which vary by technical specification thereby delivering varying degrees of performance, storage, through-put, and component redundancy. The M1000 is a mini-1U rack mounted appliance targeted for smaller or lower email volume environments. The M2000 is a 1U rack mounted appliance targeted for use in mid-sized or medium email volume environments. And the M3000 is a 2U rack mounted appliance targeted for use in larger installations. Multiple appliances can be deployed in a stateful failover configuration.

Marketing, Sales and Distribution

St. Bernard sells and markets its products and related services both directly to end-users and through a variety of indirect sales channels, which include value-added resellers (VARs), distributors, system integrators (SIs) and original equipment manufacturers (OEMs).

Direct Sales to End-Users, and VARs. St. Bernard s direct sales sells products and software subscription services primarily in North America. Many of St. Bernard s products involve a consultative, solution-oriented tele-sales model that uses the collaboration of technical and sales personnel to demonstrate how our solutions fit specific customer requirements. St. Bernard focuses its initial sales effort on network administrators and IT department personnel who are responsible for a customer s IT initiatives and data center management. St. Bernard complements its direct sales efforts with indirect sales channels such as resellers, VARs, and distributors. St. Bernard will continue to invest in programs that train and enable its channel partners to market its technologies. St. Bernard provides its products to its channel partners and customers under non-exclusive reseller license agreements, including shrink-wrap or click-wrap licenses for some products, without transferring title of our software products.

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System Integrators (SIs) and Managed Services Providers. St. Bernard collaborates with SIs, who may refer its customers to St. Bernard, utilize St. Bernard as a subcontractor in some situations, build standard and customized solutions with their products or use products to deliver hosted services as well as outsourced services. SIs use St. Bernard s products and services in conjunction with optimizing their client s investment in transactional applications and related hardware. Some SIs are authorized resellers of our products and some use St. Bernard products and services to deliver consultative services or managed services to their customers. Under these arrangements, SIs and managed services providers are not obligated to use or sell St. Bernard s products or services. In general, St. Bernard receives a fee for each sublicense of its products granted by its partners. In some cases, St. Bernard grants rights to distribute promotional versions of its products, which have limited functionality or limited use periods, on a non-fee basis. St. Bernard enters into both object-code only licenses and, when appropriate, source-code licenses of its products. St. Bernard does not transfer title of software products to its customers.

Original Equipment Manufacturers. Another important element of our sales and marketing strategy involves strategic relationships with OEM partners. These OEM partners may incorporate St. Bernard s products into their products, bundle our products with their products, endorse St. Bernard s products in the marketplace or serve as authorized resellers of our products. In general, the OEM partners are not obligated to sell St. Bernard s products or services under these arrangements and are not obligated to continue to include its products in future versions of their products.

Marketing efforts are primarily focused on end-user awareness and demand generation through multiple media and venues. Typical efforts include public relations, analyst relations, online search, online advertising, print advertising, third party promotions, email campaigns, events, and tradeshows. Paid media are selected which target technical business buyers with little reliance on broader non-trade media.

Software as a Service (SaaS) and Deferred Revenue

A typical sale of a St. Bernard product consists of a software license or an appliance accompanied by a subscription component. The subscription component includes traditional maintenance support (telephone support, product upgrades, bug fixes) as well as database updates, some as frequent as hourly. The subscription component percentage of the original sale varies from 25% to 100% depending on the product line. The subscriptions are generally available for one to three years. Renewal of the subscriptions is an important and growing part of St. Bernard s business. Due to historically high customer satisfaction and high product value, St. Bernard currently enjoys renewal rates of 85% to 95%, depending on the product line, which results in recurring revenues. Even though the full payment for a subscription or renewal, as the case may be, is received at the time of renewal, the revenue is recognized over the subscription or renewal period resulting in deferred revenue on the balance sheet. Deferred revenue was approximately $15.5 million and $17.7 million at December 31, 2007 and 2006, respectively. Deferred revenue represents subscription and product maintenance orders for St. Bernard s software products that have been billed to and paid by its customers and for which revenue will generally be earned within the next few years. Deferred revenue also includes subscription and maintenance orders that have not been paid by St. Bernard s customers, which are included in accounts receivable, and that do not otherwise satisfy its revenue recognition criteria.

Subscription and product maintenance revenue recognized was approximately $14.2 million and $15.6 million for the years ended December 31, 2007 and 2006, respectively. Subscription and maintenance are generally recognized over the subscription and maintenance period of twelve to thirty-six months.

Maintenance and Technical Support

St. Bernard believes that providing a high level of customer service and technical support is critical to customer satisfaction and its success in increasing the adoption rate of its solutions. All customers have maintenance and technical support agreements with St. Bernard that provide for fixed fee, renewable annual maintenance and technical support consisting of technical and emergency support, bug fixes and product

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upgrades. St. Bernard offers telephone support, as well as e-mail customer support. Some of the value-added resellers, system integrators and OEMs that offer St. Bernard s products also provide customer technical support for its products through a Tier1/Tier2 arrangement whereby the partner handles the initial customer contact, Tier 1, and St. Bernard provides secondary support and engineering assistance, Tier 2.

Seasonality

As is typical for many software companies, St. Bernard s business is seasonal. Product sales are generally higher in its fourth fiscal quarter and lower in its first fiscal quarter. In addition, St. Bernard generally receives a higher volume of sales orders in the last month of a quarter, with orders concentrated in the later part of that month. St. Bernard believes that this seasonality primarily reflects customer spending patterns and budget cycles. Product revenue generally reflects similar seasonal patterns but to a lesser extent than sales orders because product revenue is not recognized until an order is shipped and other revenue recognition criteria are met.

Customers

St. Bernard s products and services are used by a diverse range of customers including large corporations, small and medium-sized businesses, governmental entities, and educational institutions. As of December 31, 2007, St. Bernard had over 5,000 customers. For the years ended December 31, 2007 and 2006, no end-user customer or distributor accounted for more than 10% of St. Bernard s net revenue.

Competition

The IT security market and the general IT technology market are continuing to consolidate. This consolidation appears in new technology (functionality) combinations and also at the corporate level through acquisitions. The result of this consolidation has broadened the number of competitors that we see in the market place. Our current primary competitors can be divided into two categories and include:

- Web filtering/secure content management appliances and software WebSense, Secure Computing, Blue Coat, McAfee, Inc., Symantec Corporation, Fortinet, Sonicwall, Trend Micro, Cisco Systems, Barracuda, and 8e6 Technologies

- Secure content management services (SCMs) Message Labs and MX Logic

We also face current and potential competition in Web filtering from vendors of Internet servers, operating systems and networking hardware, many of which now, or may in the future, develop and/or bundle Web filtering, Web security or other competitive products with their offerings. We compete against and expect increased competition from anti-virus software developers, traditional network management software developers and Web management service providers.

We believe that we compete effectively against our competitors in our target markets. However, many of our current and potential competitors, such as Symantec Corporation, McAfee, Inc., Trend Micro, Cisco Systems and WebSense have longer operating histories and significantly greater financial, technical, marketing or other resources. They have significantly greater name recognition, established marketing and channel relationships both in the United States and internationally, and access to a larger installed base of customers. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the functionality of their products to address customer needs. Accordingly, new competitors or alliances among competitors may emerge and rapidly acquire significant market share.

Material Supplier

St. Bernard s iPrism products have historically been sold with computer hardware appliances designed and manufactured by one vendor, located in the United States. This vendor represented 71.9% and 73.1% of the appliance cost of sales in 2007 and 2006, respectively. If this vendor unexpectedly stopped supplying the appliances, St. Bernard could have experienced an interruption in its ability to supply customers with the iPrism product.

During the fourth quarter of 2007, the Company established a relationship with a second vendor, located in the United States, to become an alternate material supplier for our iPrism computer hardware appliances. This vendor represented 0% of our appliance cost of sales in 2007.

Research and Development

St. Bernard s research and development efforts have been directed toward continual improvement of its secure content management appliances and system protection products. During 2007, the company s development efforts were primarily focused on delivering the industry s first Hybrid secure content management platform. The investment in a Hybrid appliance and on-demand services product line will continue in 2008.
St. Bernard s recent major research and development initiatives include, but are not limited to:

New iPrism Release. St. Bernard has successfully launched a major product version upgrade in 2007. The product releases include significant product improvements to the iPrism appliance.

New LivePrism Release. St. Bernard successfully released a new version of LivePrism incorporating customer requested features and major performance and scalability enhancements.

Subscription Database Expansion. St. Bernard s products are driven by data. St. Bernard engineers keep these databases up to date. Presently, the databases keep track of over 10 million web sites worldwide. Customers pay an annual subscription fee for access to the latest data. The quality and quantity of this data is a key differentiator for St. Bernard s products.

SBS launched an OEM Program for our iGuard database. Customers pay to use the entire database or a subset in their applications.
St. Bernard had research and development expenses of approximately $6.0 million and $6.4 million in 2007 and 2006, respectively. This equates to 31.4% and 28.3% of net revenues over those same periods. St. Bernard believes that technical leadership is essential to its success and expects to continue to commit substantial resources to its research and development efforts.

Intellectual Property

Protective Measures

St. Bernard regards some of the features of its internal operations, software and documentation as proprietary and relies on copyright, patent, trademark and trade secret laws, confidentiality procedures, contractual and other measures to protect its proprietary information. St. Bernard s intellectual property is an important and valuable asset that helps enable us to gain recognition for its products, services and technology and enhance its competitive position. St. Bernard s intellectual property is further protected by using encryption security and product activation keys.

As part of St. Bernard s confidentiality procedures, it generally enters into non-disclosure agreements with its employees, distributors and corporate partners and license agreements with respect to software, documentation and other proprietary information. These license agreements are generally non-transferable without St. Bernard s consent and have a perpetual term. St. Bernard also employs measures to protect its facilities, equipment and networks.

Trademarks and Copyrights

St. Bernard and the St. Bernard logo are trademarks or registered trademarks in the United States and other countries. In addition to St. Bernard and the St. Bernard logo, the Company has used, registered and/or applied

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to register other specific trademarks and service marks to help distinguish its products, technologies and services from those of its competitors in the U.S. and foreign countries and jurisdictions. St. Bernard enforces its trademark, service mark and trade name rights in the U.S. and abroad. The duration of St. Bernard s trademark registrations varies from country to country and in the U.S. St. Bernard generally is able to maintain its trademark rights and renew any trademark registrations for as long as the trademarks are in use.

St. Bernard s products are protected under U.S. and international copyright laws and laws related to the protection of intellectual property and proprietary information. St. Bernard generally takes measures to label such products with the appropriate proprietary rights notices and actively is enforcing such rights in the U.S. and abroad. However, these measures may not provide sufficient protection, and St. Bernard s intellectual property rights may not be of commercial benefit to St. Bernard or the validity of these rights may be challenged. While St. Bernard believes that its ability to maintain and protect its intellectual property rights is important to its success, it also believes that its business as a whole is not materially dependent on any particular patent, trademark, license or other intellectual property right.

St. Bernard has the right to use certain intellectual property licensed from BorderWare Technologies under an agreement that provides for payments only for products sold using such intellectual property. St. Bernard uses such intellectual property in its ePrism product. St. Bernard believes that if it were unable to use the intellectual property licensed from BorderWare it could find a substitute on terms reasonable to St. Bernard.

Employees

As of December 31, 2007, St. Bernard had 99 employees, including 38 employees in technical operations, 36 in sales and marketing, and 25 in general and administrative services. St. Bernard has not entered into any collective bargaining agreements with its employees and believes that relations with its employees are good. St. Bernard believes that its future success will depend in part upon the continued service of its key employees and on its continued ability to hire and retain qualified personnel.

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RISK FACTORS

Because we derive a majority of our license revenue from sales of a few product lines, any decline in demand for these products could severely harm our ability to generate revenue and our results of operations.

We derive a majority of our revenue from a small number of software products, including our LivePrism, and iPrism and related subscription and maintenance services. In particular, our future success depends in part on achieving substantial revenue from customer renewals for subscriptions. Our customers have no obligation to renew their subscriptions upon expiration. If our products fail to meet the needs of our existing and target customers, or if they do not compare favorably in price and performance to competing products, our growth will be limited. Subscriptions typically have durations of 12, 24 or 36 months. As a result, a majority of the revenue we report in each quarter is deferred revenue from subscription agreements entered into and paid for during previous quarters. Because of this financial model, the revenue we report in any quarter or series of quarters may mask significant downturns in sales and the market acceptance of our products. In addition, our products are concentrated on the small, medium, and enterprise class, or SME, environment. We are particularly vulnerable to fluctuations in demand for these products, whether as a result of competition, product obsolescence, technological change, budget constraints of our potential customers, or other factors. If our revenue derived from these software products were to decline significantly, including as a result of customers not renewing subscriptions, our business and operating results would be adversely affected.

We have a history of losses and negative cash flow and there can be no assurances that we will become profitable or achieve positive cash flow, and we may need additional sources of funding.

We have a history of losses and have not been able to achieve profitability. Our cumulative net loss was approximately $ 47.2 million and $39.7 million as of December 31, 2007 and 2006, respectively. We may not become or remain profitable and losses and negative cash flows may continue to occur.

Our Hybrid Product Line may not be accepted by our current and potential new customers.

We introduced the industry first true Hybrid Product Line (Hybrid) which provides a new way to deliver Secure Content Solutions to customers. Additional marketing efforts may be needed in order create product awareness for this product line. In addition, we will continue to refine and develop the efficiency and effectiveness of the technology and services underlying this product, and will need to continue to expend substantial amounts to develop the infrastructure to support the Hyprid Product. This Hybrid solution is a relatively new product and provides services intended for consumption by SMEs. We may be unable to penetrate the SME market for hosted web, email, and instant message filtering, and archiving services as the competition for these types of products are significant. If we are unable to create product awareness and refine the technology underlying the Hybrid product line in the manner we believe is possible to the satisfaction of current and future customers, if we are unable to penetrate the existing SME market for the product suite for which the Hyrbrid product line is intended, or if our research and development efforts and expenses related to the development of the Hybrid product line exceed the efforts or expenses which we believe are appropriate for this product, we may not realize the projected contribution of our Hybrid product line to our revenues, and we may ultimately discontinue this product or adjust our projections and expectations regarding its contribution to our business and the positive impact on our future financial condition.

Our LivePrism product may not be successful and we may not successfully advance its development in a manner that will be cost-effective or accepted by SMEs.

We have invested significant funds in our LivePrism product and related service offerings. We are continuing to refine the efficiency and effectiveness of the technology and services underlying this product, and will need to continue to expend substantial amounts to develop the infrastructure to support LivePrism. LivePrism is a relatively new suite of products and services intended for consumption by SMEs. We may be unable to penetrate the SME market for hosted email and instant message filtering and archiving services as the

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competition for these types of products are significant. If we are unable to refine the technology underlying LivePrism in the manner we believe is possible to the satisfaction of current and future customers, if we are unable to penetrate the existing SME market for the product suite for which LivePrism is intended, or if our research and development efforts and expenses related to the development of LivePrism exceed the efforts or expenses which we believe are appropriate for this product, we may not realize the projected contribution of LivePrism to our revenues, and we may ultimately discontinue this product or adjust our projections and expectations regarding its contribution to our business and the positive impact on our future financial condition.

If we fail to manage our direct sales and OEM distribution channels effectively our sales could decline.

We market our products and related services both directly to end-users and through a variety of indirect sales channels, which include VARs, distributors, system integrators and OEMs.

Direct Sales. A significant portion of our revenue is derived from sales by our direct sales force to end-users. This sales channel involves a number of special risks, including:

- longer sales cycles associated with direct sales efforts;
- difficulty in hiring, training, retaining and motivating a direct sales force; and
- the requirement of a substantial amount of training for sales representatives to become productive, and training that must be updated to cover new and revised products.

OEMs. A portion of our revenue is derived from sales through our OEM partners that incorporate our products into their products. Our reliance on this sales channel involves a number of special risks, including:

- our lack of control over the shipping dates or volume of systems shipped;
- our OEM partners are not subject to minimum sales requirements or any obligation to market our products to their customers;
- our OEM partners may terminate or renegotiate their arrangements with us and new terms may be less favorable in recognition of our increasingly competitive relationship with certain partners;
- the development work that we must generally undertake under our agreements with our OEM partners may require us to invest significant resources and incur significant costs with little or no associated revenue;
- the time and expense required for the sales and marketing organizations of our OEM partners to become familiar with our products may make it more difficult to introduce those products to the market;
- our OEM partners may develop, market and distribute their own products and market and distribute products of our competitors, which could reduce our sales; and

if we fail to manage our distribution channels successfully, our distribution channels may conflict with one another or otherwise fail to perform as we anticipate, which could reduce our sales and increase our expenses, as well as weaken our competitive position.

If we are unable to maintain and expand, or enter into new, indirect sales channels relationships our operating results would decline.

Our indirect sales channels accounted for approximately 40.4% and 43.8% of our revenue in 2007 and 2006, respectively. We intend to continue to rely on our indirect sales channels for a significant portion of our revenue. We depend on our indirect sales channels, including value-added resellers, distributors, and providers of managed Internet services, to offer our products to a larger customer base than can be reached through a direct sales effort. None of these parties is obligated to continue selling our products or to make any purchases from us. If they are unsuccessful in their efforts or are unwilling or unable to market and sell our new product offerings, our operating results will suffer. We cannot control the level of effort these parties expend or the extent to which any of them will be successful in marketing and selling our products. Some of our indirect sales channels also market and sell products that compete with our products or may decide to do so in the future. We may not be able to prevent these parties from devoting greater resources to support our competitors products and/or eliminating their efforts to sell our products.

The market for our products continues to emerge, and if we are not successful in promoting awareness of the need for our products and of our brand, our growth may be limited.

Based on our experience with potential customers, we believe that many corporations do not recognize or acknowledge the existence or scope of problems caused by misuse or abuse of the Internet or of network computers, creating significant barriers to sales. In addition, there may be a time-limited opportunity to achieve and maintain a significant share of the market for web filtering and email filtering and our other products due in part to the emerging nature of these markets and the substantial resources available to our existing and potential competitors. If companies do not recognize or acknowledge these problems, then the market for our products may develop more slowly than it expects, which could adversely affect our operating results. Developing and maintaining awareness of our brand is critical to achieving widespread acceptance of our existing and future products. Furthermore, we believe that the importance of brand recognition will increase as competition in our market develops. Successful promotion of our brand will depend largely on the effectiveness of our marketing efforts and on our ability to develop reliable and useful products at competitive prices. If we fail to successfully promote our brand, or if our expenses to promote and maintain our brand are greater than anticipated, our results of operations and financial condition could suffer.

If we are not able to develop new and enhanced products that achieve widespread market acceptance, we may be unable to recover product development costs, and our earnings and revenue may decline.

Our future success depends on our ability to address the rapidly changing needs of our customers by developing, acquiring and introducing new products, product updates and services on a timely basis. We must also extend the operation of our products to new platforms and keep pace with technological developments and emerging industry standards. We intend to commit substantial resources to developing new software products and services, including software products and services for the secure content management SME market. Products being developed are new and unproven, and industry standards for these markets are evolving and changing. They also may require development of new sales channels. If these markets do not develop as anticipated, or if demand for our products and services in these markets does not materialize or occurs more slowly than we expect, we will have expended substantial resources and capital without realizing sufficient revenue, and our business and operating results could be adversely affected.

If economic or other factors negatively affect the small and medium-sized business sector, our customers may become unwilling or unable to purchase our products and services, which could cause our revenue to decline.

Our existing and target customers are small, medium, and enterprise businesses. These businesses are more likely to be significantly affected by economic downturns than larger, more established businesses. Additionally, these customers often have limited discretionary funds, which they may choose to spend on items other than our security software products and services. If small, medium, and enterprise businesses experience economic hardship, they may be unwilling or unable to expend resources to develop or improve their IT security, which would negatively affect the overall demand for our products and services, and could cause our revenue to decline.

We have secured the additional funding through debt and equity financing which includes numerous covenants and debt-related obligations that may adversely affect our business and potentially reduce our revenues and affect the value of our common stock.

On January 25, 2008, St. Bernard Software, Inc. entered into a Loan Agreement with Agility Capital, LLC. Pursuant to the terms of the Loan Agreement, Agility provided St. Bernard with a non-revolving term loan in the amount of $750,000, at a 15% fixed interest rate. Beginning March 1, 2008, and on the first day of each month thereafter until July 1, 2008, St. Bernard is required to pay to Agility $25,000 plus accrued but unpaid interest. Beginning July 1, 2008, and on the first day of each month thereafter, St. Bernard is required to pay Agility $50,000 plus accrued interest. The Loan will mature on January 31, 2009. Prior to the Maturity Date, St. Bernard may prepay the Loan without penalty. Pursuant to the Loan Agreement, St. Bernard must pay Agility a one-time $25,000 origination fee and a monthly collateral management fee of $750. The obligations under the Loan Agreement are secured by substantially all of St. Bernard s assets. Pursuant to a Subordination Agreement between Agility and Silicon Valley Bank, the Loan and security interest held by Agility are subordinated to the loan and the security interest held by Silicon Valley Bank pursuant to that certain Loan and Security Agreement dated May 11, 2007, as amended, between Silicon Valley Bank and St. Bernard.

Additionally, the Loan Agreement contains customary events of default including the following: nonpayment of principal or interest; the violation of a Loan Agreement covenant; the occurrence of a material adverse change; the attachment of any portion of St. Bernard s assets; insolvency; material misrepresentations by St. Bernard; and the default by St. Bernard under any other loan agreement. 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 and certain fees become payable.

If St. Bernard ceases to do business or is dissolved or liquidated before payment in full of the Loan, it may owe Agility an exit fee equal to the greater of $250,000 or the amount Agility would have been entitled to receive had Agility exercised the Agility Warrant immediately before such transaction.

On January 25, 2008, St. Bernard entered into a Third Amendment to Loan and Security Agreement (the Loan Amendment) with Silicon Valley Bank (SVB), amending the Loan and Security Agreement entered into between St. Bernard and SVB on May 11, 2007 as amended by that certain First Amendment to Loan and Security Agreement dated as of July 9, 2007 and that certain Second Amendment to Loan and Security Agreement dated as of August 13, 2007. Pursuant to the terms of the Loan Amendment, among other things, SVB (i) refinanced the existing term loan with the proceeds of an advance under the revolving line of credit (and terminated the term loan facility), (ii) reduced the revolving line of credit it will provide to St. Bernard to an amount not to exceed $2,000,000, (iii) increased the interest rate on the revolving line of credit to 3% (from 2%) over the greater of the prime rate or 7.5%, (iv) modified the tangible net worth covenant, and (v) took a security interest in St. Bernard s intellectual property.

Our failure to comply with our debt-related obligations could result in an event of default which, if not cured or waived, could result in an acceleration of our indebtedness, including our loans with Agility and SVB. This in turn could have a material adverse effect on our operations, our revenues and thus our common stock value. In the event we were unable to restructure or refinance our loans or secure other financing to repay this debt, our lenders could foreclose upon the collateral securing that debt.

Our future capital requirements and potentially limited access to financing may harm our ability to develop products and fund our operations.

We expect to continue spending substantial resources on research and development efforts to improve our secure content management appliances and system protection products. To the extent our revenues and borrowing arrangements with SVB and Agility are insufficient to fund our ongoing research and development efforts, we will need to raise additional funding. Other than SVB and Agility, we do not have committed external sources of funding and may not be able to obtain any additional funding, especially if volatile market conditions persist for technology companies. Any additional funding we seek would likely be accomplished through equity or debt financings which would require the consent of SVB and Agility. We may not be able to obtain additional financing on terms that are favorable to us or at all. If we acquire funds by issuing securities, dilution to existing stockholders will result. Our failure to obtain additional funding may require us to delay, reduce the scope of or eliminate one or more of our current research and development projects.

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We incur considerable expenses to develop products for operating systems that are either owned by others or that are part of the Open Source Community. If we do not receive cooperation in our development efforts from others and access to operating system technologies, we may face higher expenses or fail to expand our product lines and revenues.

Many of our products operate primarily on the Linux, UNIX and Windows computer operating systems. As part of our efforts to develop products for operating systems that are part of the Open Source Community, we may have to license portions of our products on a royalty free basis or may have to expose our source code. Open Source describes general practices in production and development which promote access to the end product s sources. The Open Source Community emphasizes collaborative development and requires licensing that allows modifications and enhancements of registered open source code be made available to whoever would like to use it. Developers who use open source code in proprietary products risk exposing the intellectual property developed in conjunction with the open source code to the public. We continue to develop new products for these operating systems. We may not accomplish our development efforts quickly or cost-effectively, and it is not clear what the relative growth rates of these operating systems will be. Our development efforts require substantial capital investment, the devotion of substantial employee resources and the cooperation of the owners of the operating systems to or for which the products are being ported or developed. If the market for a particular operating system does not develop as anticipated, or demand for our products and services in such market does not materialize or occurs more slowly than we expect, we may have expended substantial resources and capital without realizing sufficient revenue, and our business and operating results could be adversely affected.

In addition, for some operating systems, we must obtain from the owner of the operating system a source code license to portions of the operating system software to port some of our products to or develop products for the operating system. Operating system owners have no obligation to assist in these porting or development efforts. If they do not grant us a license or if they do not renew our license, we may not be able to expand our product lines into other areas.

We face increasing competition, which places pressure on our pricing and which could prevent us from increasing revenue or maintaining profitability. In addition, we may face competition from better-established companies that have significantly greater resources.

The market for our products is intensely competitive and is likely to become even more so in the future. Our current principal competitors frequently offer their products at a significantly lower price than our products, which has resulted in pricing pressures on sales of our products. We also face increasing competition from security solutions providers who may add security modules or features to their product offerings. In addition, pricing pressures and increased competition generally could result in reduced sales, reduced margins or the failure of our products to achieve or maintain more widespread market acceptance, any of which could have a material adverse effect on our business, results of operations and financial condition.

We also face current and potential competition from vendors of operating systems and networking hardware, many of which now, or may in the future, develop and/or bundle security, file backup, patch management or other competitive products with their products. We compete against, and expect increased competition from, anti-virus software developers, traditional network management software developers and Web management service providers. If security or file backup functions become standard features of internet-related hardware or software, the demand for our products will decrease. Furthermore, even if our products provide greater functionality and are more effective than certain other competitive products, potential customers might accept limited functionality as part of an unbundled solution in lieu of purchasing separate products which require more administration. In addition, our own indirect sales channels may decide to develop or sell competing products instead of our products. Many of our potential competitors have substantial competitive advantages, such as:

- greater name recognition and larger marketing budgets and resources;
- established marketing relationships and access to larger customer bases; and

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substantially greater financial, technical and other resources.

As a result, they may be able to respond more quickly and effectively than we can to new or changing opportunities, technologies, standards or customer requirements. For all of the foregoing reasons, we may not be able to compete successfully against our current and future competitors, and our results of operations could be adversely affected.

Our database categories and our process for classifying websites and software applications within those categories are subjective and may not be able to categorize websites and software applications in accordance with our customers expectations.

We may not succeed in accurately categorizing Internet and application content to meet our customers expectations. We rely upon a combination of automated filtering technology and human review to categorize websites and software applications in our proprietary databases. Our customers may not agree with our determinations that particular websites and software applications should be included or not included in specific categories of our databases. In addition, it is possible that the filtering processes may place objectionable material in categories that are generally unrestricted by our users Internet and computer access policies, which could result in employees having access to such material in the workplace. Any miscategorization could result in customer dissatisfaction and harm our reputation. Furthermore, we select our categories based on content we believe employers want to manage. We may not now, or in the future, succeed in properly identifying the categories of content that employers want to manage. Any failure to effectively categorize and filter websites and software applications according to our customers expectations will impair the growth of our business and our efforts to increase brand acceptance.

If our databases fail to keep pace with the rapid growth and technological change of the Internet the market acceptance of our products could be impaired.

The success of our products depends, in part, on the breadth and accuracy of our databases. Although our databases currently catalog more than 10 million websites, they contain only a portion of such material that exists. In addition, the total number of websites is growing rapidly, and we expect this rapid growth rate to continue in the future. Our databases and database technologies may not be able to keep pace with the growth in the number of websites and software applications, especially the growing amount of content utilizing foreign languages. Further, the ongoing evolution of the Internet and computing environments will require us to continually improve the functionality, features and reliability of our databases. Because our products primarily can only manage access to websites included in our databases, if our databases do not contain a meaningful portion of relevant content, the effectiveness of iPrism will be significantly diminished. Any failure of our databases to keep pace with the rapid growth and technological change of the Internet will impair the market acceptance of our products, which in turn will harm our business, results of operations and financial condition.

Our business strategy includes possible growth through acquisitions, which involve special risks that could increase our expenses, and divert the time and attention of our management.

As part of our business strategy, we have in the past acquired products, technologies and companies and we expect in the future to acquire other businesses, business units and technologies. Acquisitions involve a number of special risks and challenges, including:

- diversion of management s attention from our business;
- integration of acquired business operations and employees into our existing business, including coordination of geographically dispersed operations, which can take longer and be more complex than initially expected;
- incorporation of acquired products and business technologies into existing product lines, including consolidating technology with duplicative functionality or designed on different technological architecture, and the ability to sell the acquired products through existing or acquired sales channels;

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- loss or termination of employees, including costs associated with the termination of those employees;
- dilution of then-current stockholders percentage ownership;
- dilution of earnings if synergies with the acquired businesses are not achieved;
- ability to generate sufficient revenue to offset acquisition or investment costs;
- assumption of liabilities of the acquired businesses, including costly litigation related to alleged liabilities of the acquired businesses;
- presentation of a unified corporate image to customers and employees;
- increased costs and efforts in connection with compliance with Section 404 of the Sarbanes-Oxley Act; and
- risk of impairment charges related to potential write-down of acquired assets in future acquisitions.

Our management is required to devote substantial time and incur additional expense to comply with public company regulations. Our failure to comply with such regulations could subject us to public investigations, fines, enforcement actions and other sanctions by regulatory agencies and authorities and, as a result, our stock price could decline in value.

The Sarbanes-Oxley Act of 2002, or the Sarbanes-Oxley Act, as well as rules subsequently implemented by the SEC, impose various requirements on public companies, including with respect to corporate governance practices. We have incurred, and expect to continue incurring, significant legal, accounting and other expenses to comply with these requirements. In addition, our management and other personnel will need to devote a substantial amount of time to these requirements.

Our products may contain significant errors and failures, which may subject us to liability for damages suffered by end-users.

Software products frequently contain errors or failures, especially when first introduced or when new versions are released. Our end-user customers use our products in applications that are critical to their businesses, including data protection and recovery, and may have a greater sensitivity to defects in our products than to defects in other, less critical software products. If a customer loses critical data as a result of an error in or failure of our software products or as a result of the customer s misuse of our software products, the customer could suffer significant damages and seek to recover those damages from us. Although our software licenses generally contain protective provisions limiting our liability, a court could rule that these provisions are unenforceable. If a customer is successful in proving its damages and a court does not enforce our protective provisions, we could be liable for the damages suffered by our customers and other related expenses, which could adversely affect our operating results.

Product errors or failures could cause delays in new product releases or product upgrades, or our products might not work in combination with other hardware or software, which could adversely affect market acceptance of our products. If our customers were dissatisfied with product functionality or performance, or if we were to experience significant delays in the release of new products or new versions of products, we could lose competitive position and revenue and our business and operating results could be adversely affected.

Failure to protect our intellectual property rights could impair our ability to protect our proprietary technology and establish our brand.

Intellectual property is critical to our success, and we rely upon trademark, copyright and trade secret laws in the United States and other jurisdictions as well as confidentiality procedures and contractual provisions to protect our proprietary technology and our brand. Any of our trademarks may be challenged by others or invalidated through administrative process or litigation. Furthermore, legal standards relating to the validity, enforceability

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and scope of protection of intellectual property rights are uncertain. Effective trademark, copyright, and trade secret protection may not be available to us in every country in which our products are available. The laws of some foreign countries may not be as protective of intellectual property rights as U.S. laws, and mechanisms for enforcement of intellectual property rights may be inadequate. As a result, our means of protecting our proprietary technology and brands may not be adequate. Furthermore, despite our efforts, we may be unable to prevent third parties from infringing upon or misappropriating our intellectual property, including the misappropriation or misuse of the content of our proprietary database of websites. Any such infringement or misappropriation could have a material adverse effect on our business, results of operations and financial condition.

If we are sued by third parties for alleged infringement of their proprietary rights the cost to litigate or settle such litigation could be material and there can be no assurance that we would be successful in any such suit.

The software and Internet industries are characterized by the existence of a large number of patents, trademarks and copyrights and by frequent litigation based on allegations of patent infringement or other violations of intellectual property rights. As the number of entrants into our market increases, the possibility of an intellectual property claim against us grows. Our technologies and products may not be able to withstand any third-party claims or rights against their use. Any intellectual property claims, with or without merit, could be time-consuming and expensive to litigate or settle, and could divert management attention from executing our business plan. There can be no assurance that we would be successful in any such suit.

Our systems may be vulnerable to security risks or service disruptions that could harm our business.

Although we have taken measures to secure our systems against security risks and other causes of disruption of electronic services, our servers are vulnerable to physical or electronic break-ins and service disruptions, which could lead to interruptions, delays, loss of data or the inability to process customer requests. Such events could be very expensive to remedy, could damage our reputation and could discourage existing and potential customers from using our products.

Evolving regulation of the Internet may adversely affect us by imposing regulations on our activities or causing a decline in Internet usage.

As Internet commerce continues to evolve, increasing regulation by federal, state or foreign agencies becomes more likely. Such regulation is likely in the areas of user privacy, pricing, content and quality of products and services. Taxation of Internet use or other charges imposed by government agencies or by private organizations for accessing the Internet may also be imposed. Laws and regulations applying to the solicitation, collection or processing of personal or consumer information could affect our activities. Furthermore, any regulation imposing fees for Internet use could result in a decline in the use of the Internet and the viability of Internet commerce, which could have a material adverse effect on our business, results of operations and financial condition.

The market price of our securities is likely to be highly volatile and subject to wide fluctuations.

The market price of our securities has been and likely will continue to be highly volatile and could be subject to wide fluctuations in response to a number of factors that are beyond our control, including:

- announcements of technological innovations or new products or services by our competitors;
- demand for our products, including fluctuations in subscription renewals;
- fluctuations in revenue from indirect sales channels;
- changes in the pricing policies of our competitors; and
- changes in government regulations.

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In addition, the market price of our securities could be subject to wide fluctuations in response to a number of factors, including:

- announcements of technological innovations or new products or services by us;
- changes in our pricing policies;
- quarterly variations in our revenues and operating expenses; and
- our technological capabilities to accommodate the future growth in our operations or our customers.

Further, the stock market has experienced significant price and volume fluctuations that have particularly affected the market price of the stock of many Internet-related companies. In some cases, the market price of the stock has been unrelated or disproportionate to the operating performance of these companies. A number of publicly traded Internet-related companies have current market prices below their initial public offering prices. Market fluctuations such as these may seriously harm the market price of our securities. In the past, securities class action suits have been filed following periods of market volatility in the price of a company s securities. If such an action were instituted, we would incur substantial costs and a diversion of management attention and resources, which would seriously harm our business, results of operations and financial condition.

The amount of stock held by our executive officers, directors and other affiliates may limit the ability to influence the outcome of director elections and other matters requiring stockholder approval.

Our executive officers, directors and affiliates own approximately 35.1% of our voting stock as of December 31, 2007. These stockholders can have a substantial influence on all matters requiring approval by stockholders, including the election of directors and the approval of mergers or other business combination transactions. This concentration of ownership could have the effect of delaying or preventing a change in control or discouraging a potential acquirer from attempting to obtain control of the Company, which in turn could have a material adverse effect on the market price of our common stock or prevent stockholders from realizing a premium over the market price for their shares of our common stock.

We may not be able to attract and retain the highly skilled employees we need to support our planned growth.

We may not be successful in attracting and retaining qualified personnel. In order to attract and retain personnel in a competitive marketplace, we believe that we must provide a competitive compensation package, including cash and equity based compensation. The volatility of our stock price and quarterly variations in our revenues and operating expenses may adversely affect our ability to recruit or retain qualified employees. The companies, with which we compete, have experienced personnel that have greater resources than we have. If we fail to attract new personnel or retain and motivate our current personnel, our business and future growth prospects could be severely harmed.

We rely on a relatively new and limited management team to grow our business.

Several of our executive officers and key management personnel have terminated their employment relationship with the Company. Our success and future growth depends to a significant degree on the skills and continued services of Vincent Rossi, our Chief Executive Officer and acting Chief Financial Officer, who was hired in July 2006. We may experience difficulty assimilating our recently hired and promoted managers, and we may not be able to successfully locate, hire, assimilate, and retain other executive officers and qualified key management personnel.

Our employment agreements with our executive officers are at-will and they can terminate their employment relationship with us at any time.

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We could encounter difficulties managing our growth, which could adversely affect our results of operations.

We will need to effectively manage our organization, operations, and facilities in order to successfully sell our services and appliances to reach profitability. We decreased the number of our employees from 169 as of December 31, 2006 to 99 as of December 31, 2007. We believe that this decrease will allow us to reach our strategic objectives to control spending. Our need to effectively manage our operations and grow our business requires that we continue to improve our operational, financial and management controls, reporting systems, and procedures. We may not be able to maintain these improvements, which will not allow us to reach our strategic objectives and become profitable.

Available Information

The St. Bernard Software, Inc. website or internet address is www.stbernard.com. On this website the Company makes available, free of charge, its Annual Report on Form 10-KSB, quarterly reports on Form 10-QSB, current reports on Form 8-K and any amendments to those reports, as soon as reasonably practicable after electronically filing such material with or furnishing it to the Securities and Exchange Commission (SEC). The Company s SEC reports can be accessed through the investor relations section of its website under SEC Filings . All of the Company s filings with the SEC may also be obtained at the SEC s Public Reference Room at Room 1580, 100 F Street NE, Washington, DC 20549. For information regarding the operation of the SEC s Public Reference Room, please contact the SEC at 1-800-SEC-0330. Additionally, the SEC maintains an internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC at www.sec.gov.

Item 2. DESCRIPTION OF PROPERTY

St. Bernard s corporate headquarters is located in San Diego, California. It consists of a leased office facility for sales, research and development, and administrative personnel, which measures approximately 56,000 square feet. St. Bernard s facility is occupied under a lease that expires on December 31, 2010. The Company closed its operations and terminated its office space lease in Camberley, UK and in Chatswood, Australia in November and July 2007, respectively.

Location	Approximate Square Feet	Date Current Lease Expires	Monthly Rent
15015 Avenue of Science San Diego, CA 92128	56,000	December 31, 2010	$ 93,000
Unit 4, Riverside Way Watchmoor Park, Camberley Surrey GU15 3YQ United Kingdom	2,000	Terminated on November 30, 2007	$ 8,000
Level 11, Tower B 821 Pacific Highway Chatswood NSW 2067 Australia	1,700	Terminated on July 31,2007	$ 2,200

The Company believes that our existing facility is well maintained, in good operating condition, suitable for our operations, and is adequate to meet our current requirements.

Item 3. LEGAL PROCEEDINGS

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

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concealment, and negligence. The Company has appealed the Superior Court s denial of its motion to compel arbitration, which is currently pending. The Company intends to vigorously defend its interests in this matter and expects that the resolution of this matter will not have a material adverse effect on its business, financial condition, results of operations, or cash flows. However, due to the uncertainties in litigation, no assurance can be given as to the outcome of these proceedings.

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.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no matters submitted to a vote of security holders during the fourth quarter of 2007.

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PART II

Item 5. MARKET FOR COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND SMALL BUSINESS ISSUER PURCHASES OF EQUITY SECURITIES

(a) Since February 17, 2005 our Common Stock has been traded on the Over-the-Counter Bulletin Board. The table below sets forth, for the calendar quarters indicated, the high and low bid prices of the St. Bernard Software common stock as reported on the Over-the-Counter Bulletin Board. The over-the-counter market quotations reported below reflect inter-dealer prices, without markup, markdown or commissions and may not represent actual transactions.

Fiscal Year 2006	**High**	**Low**
First Quarter	$ 5.35	$ 5.19
Second Quarter	$ 5.36	$ 5.19
Third Quarter	$ 5.37	$ 3.33
Fourth Quarter	$ 3.94	$ 1.80
Fiscal Year 2007		
First Quarter	$ 2.24	$ 1.75
Second Quarter	$ 1.76	$ 0.86
Third Quarter	$ 1.15	$ 0.56
Fourth Quarter	$ 0.87	$ 0.59

(b) As of December 31, 2007, there were approximately 210 holders of our Common Stock.

(c) No cash dividends have been paid on our Common Stock during our two most recent fiscal years, and St. Bernard does not intend to pay cash dividends on its Common Stock in the immediate future.

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Item 6. MANAGEMENT S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION
Selected Financial Data

The selected audited consolidated financial data presented below for the two years ended December 31, 2007 and 2006 are derived from our audited consolidated financial statements and accompanying notes. This selected financial data should be read in conjunction with the other sections of Management s Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and accompanying notes thereto included elsewhere in this report.

Years Ended December 31,

	2007	2006
Statements of Income Data:		
Revenues		
License	$ 1,711,000	$ 3,851,000
Appliance	3,160,000	3,144,000
Subscription	14,205,000	15,563,000
Total Revenues	19,076,000	22,558,000
Cost of Revenues		
License	70,000	101,000
Appliance	3,194,000	2,229,000
Subscription	3,859,000	4,051,000
Total Cost of Revenues	7,123,000	6,381,000
Gross Profit	11,953,000	16,177,000
Sales and Marketing Expenses	13,387,000	11,246,000
Research and Development Expenses	6,035,000	6,401,000
General and Administrative Expenses	7,858,000	7,955,000
Impairment of Intangible Assets	3,262,000	
Total Operating Expenses	30,542,000	25,602,000
Loss from Operations	(18,589,000)	(9,425,000)
Other Expense (Income)		
Interest Expense Net	196,000	128,000
Gain on Sale of Assets	(11,284,000)	
Other Income	(26,000)	
Warrant Income		(2,630,000)
Total Other Income	(11,114,000)	(2,502,000)
Loss Before Income Taxes	(7,475,000)	(6,923,000)
Income Tax Expense	(42,000)	(1,100,000)
Net Loss	$ (7,517,000)	$ (8,023,000)
Basic and Diluted Loss Per Common Share	$ (0.51)	$ (0.68)

Weighted Average Shares Outstanding	14,769,567	11,724,974
Balance sheet data:		
Current Assets	$ 5,150,000	$ 10,020,000
Current Liabilities	15,928,000	18,392,000
Line of Credit	1,566,000	296,000
Stockholders Deficit	$ (7,956,000)	$ (1,213,000)

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The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes that appear elsewhere in this Annual Report on Form 10-KSB. In addition to historical consolidated financial information, the following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to these differences include those discussed below and elsewhere in this Annual Report on Form 10-KSB.

Our Business

We design, develop, and market secure content management (SCM) and policy compliance solutions to small, medium, and enterprise class customers. These SCM solutions enable our customers to efficiently filter and manage their employee usage policy for the internet, e-mail and instant messaging (IM). We also provide an on-demand archiving solution for internet usage, e-mail and IM that supports our customers policy requirements for message retention and discovery. Our solutions are delivered as appliances and as on-demand software as a service (SaaS).

Our customers include more than 5,000 business, education, and government institutions. Our customers purchase our solutions directly from us, through our 1-tier and 2-tier reseller network, and through, original equipment manufacturers, (OEMs). Appliance purchases consist of an initial hardware purchase and software subscription, with recurring fees for data and maintenance. SaaS purchases consist of a single or multi-year subscription to the hosted services. Our primary customers are IT managers, directors, and administrators.

We invested significantly in research and development activities and for the years ended December 31, 2007 and 2006 we spent $6.0 million and $6.4 million, respectively, on research and development. Our research and development efforts have been focused on network based secure content management solutions and expanding our product portfolio into new delivery models, such as SaaS, and additional secure content management markets, such as messaging security.

Our Strategy

During the quarter ended December 31, 2006, we announced a strategy that focused on the secure content management (SCM) market. We implemented a significant transformation that includes the divestiture of two legacy product lines, capacity expansion of our LivePrism SaaS business, and numerous cost reduction initiatives to deliver this strategy. With most of the needed transformation complete, we announced in October 2007 our intent to deliver a hybrid secure content management product family during the first half of 2008. We believe that this hybrid product strategy will differentiate the company and enable us to grow faster than our competition. We have also commenced to realign our sales and marketing efforts to allow us to better serve medium and enterprise class customers in conjunction with the above mentioned product strategy. As we move through 2008, we will finalize the company s transformation and continue to expand our product portfolio to create additional leverage across our customer base.

Our Business Growth

We have historically grown organically 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.

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

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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 $471,000 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 $5.7 million in Singlefin indebtedness and certain Singlefin employees received bonuses totaling $250,000. The aggregate value of the transaction was approximately $8.1 million.

Our Financial Results

We reported revenues of $19.1 million for the year ended December 31, 2007 compared to $22.6 million in the same period last year, a decrease of 15.5%; a net loss for the year ended December 31, 2007 of $7.5 million, compared to a net loss of $8.0 million in the same period last year; net basic and diluted loss per share for the year ended December 31, 2007 was $0.51, compared to $0.68 reported in the same period last year. The decrease in the basic and diluted loss per share was primarily attributable to the $11.3 million gain from the sale of the UpdateEXPERT in January 2007 and Open File Manager in August 2007, offset by an increase in operating expenses of $9.3 million from 2007 as compared to 2006. The year to year increase in operating expenses includes an impairment of $3.3 million for the intangible assets related to the acquisition of AgaveOne.

Cash used in operations for year ended December 31, 2007 was $11.6 million compared to cash used during the year ended December 31, 2006 of $4.9 million. The net increase in use of cash was due primarily to higher operating losses, offset by $4.2 million in non-cash charges, which include an impairment of intangibles related to the acquisition of AgaveOne and stock-based compensation. In addition, a net change of $2.5 million in our balance sheet accounts further offset the increase in our operating expenses.

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.

On May 15, 2007, we established a line of credit with Silicon Valley Bank, terminating our line of credit with Camel Financial. On January 25, 2008, we amended our line of credit agreement with Silicon Valley Bank. See section titled, Credit Facility for the terms of the original and amended agreement with Silicon Valley Bank. The balance on the line of credit with SVB was $1.6 million as of December 31, 2007. In addition, we secured a bridge loan with Agility Capital, LLC for $750,000 on January 25, 2008. See section titled, Bridge Loan for the terms of the agreement with Agility Capital, LLC.

During the year ended December 31, 2007, we continued to invest in product development. Two product extension efforts were underway during the year to enhance the features of iPrism version 6.0 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;
- warranty obligation; 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 the Consolidated Financial Statements of St. Bernard for the year ended December 31, 2007 included herein for further discussion of our accounting policies and estimates. We have revised our accounting policies for our allowance for doubtful accounts and our warranty obligations in 2007. There have been no material changes to all other accounting policies during the year ended December 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 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

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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, or competitive and economic conditions.

Allowance for Doubtful Accounts

The accounts receivable reserve is evaluated quarterly and estimated based on the actual write offs as a percent of average net accounts receivable for the previous six through twelve months. The net accounts receivable is comprised of gross accounts receivable adjusted for advanced billings and any amounts specifically reserved for. 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, or competitive and economic conditions.

To determine the amount specifically reserved for, all accounts on the month end Aged Open Invoice Report past due more than 89 days and in excess of $2,000 will be reviewed for collectability, as well as any other accounts that are not more than 89 days past due but are known to be uncollectible. Accounts receivable, deferred revenue, and recognized revenue (via bad debt expense) are then written off based upon our anticipated inability to collect on these amounts. The estimated reserve is compared to the accounts receivable reserve per the general ledger. Any significant variances are recorded to the reserve account, as well as any recoveries.

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.

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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. As a result of our significant underperformance relative to the expected operating results, we tested our goodwill that arose in 2006 for impairment at during 2007 in accordance with SFAS No. 142. We were not required to record an impairment loss on that goodwill. The Company is one reporting unit for purposes of testing goodwill.

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. As a result of our significant underperformance relative to the expected operating results and current-period operating and cash flow losses coupled with the operating history of such losses, the Company tested its intangible assets for impairment during the year ended December 31, 2007. Based upon the results of the test, management has concluded that the intangible assets related to the acquisition of AgaveOne were impaired during 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 during 2007 to write-down the intangible asset to zero. See Notes 1 and 3 in the Notes to the Consolidated Financial Statements of St. Bernard for the year ended December 31, 2007 included herein.

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.

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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, its 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, 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 December 31, 2007 and 2006, we fully reserved the deferred tax assets resulting in a tax expense of $42,000 and $1.1 million, respectively. 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 proportion of revenue and income before taxes in the various domestic and international jurisdictions in which we operate.

Warranty Obligation

The company prepares a quarterly analysis of the estimated warranty liability. This is achieved by first obtaining a current listing of all active appliances in the field, as well as each appliance s remaining maintenance term. Then, we calculate an average repair cost as well as an average yearly replacement percentage per appliance model based on historical failure rates, for both in and out of warranty appliances. These estimates are then applied to the remaining maintenance terms outstanding, in order to obtain a point in time estimate of the future warranty expense for all active appliances.

Accounting for Stock Options

Effective January 1, 2006, the Company adopted the fair value recognition provisions of *SFAS No. 123R (revised 2004), Share-based Payment* , using the modified prospective method. 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. Stock-based compensation expense for all stock-based compensation awards granted after January 1, 2006 are 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 and others as deemed appropriate by the Board of Directors. Terms of options issued under the Plans include an exercise price equal to the estimated fair value (as determined by the Board of Directors) 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 fair value of the Company s stock is derived using the value of the stock price at the grant date.

Calculating stock-based compensation expense requires the input of highly subjective assumptions, including the expected term of the stock-based compensation, expected stock price volatility factor, and the pre-vesting option forfeiture rate. The weighted average fair value of options granted during the year ended December 31, 2007 and 2006, was calculated using the Black-Scholes option pricing model with the following valuation assumptions in the table below. The Company estimates the expected life of stock options granted based upon management s consideration of the historical life of the options, the vesting period of the options granted, and the contractual period options granted. The Company estimates the expected volatility factor of its common stock based on the weighted average of the historical volatility of a publicly traded surrogate of the Company and the Company s implied volatility from its common stock price. The Company applies its risk-free interest rate based on the U.S. Treasury yield in effect at the time of the grant. The Company has no history or expectation of paying any cash dividends on its common stock. Forfeitures were estimated based on historical experience.

Commitments and Contingencies

Effective October 1, 2006, we adopted the provisions of the Financial Accounting Standards Board (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 measure 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, 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. The Company has appealed the Superior Court s denial of its motion to compel arbitration, which is currently pending. The Company intends to vigorously defend its interests in this matter and expects that the resolution of this matter will not have a material adverse effect on its business, financial condition, results of operations, or cash flows. However, due to the uncertainties in litigation, no assurance can be given as to the outcome of these proceedings.

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

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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.

Results of Operations of St. Bernard

Comparison of Fiscals Years Ended December 31, 2007 and 2006 (In millions, except percentages)

Revenues

	For the Years Ended December 31,		
	2007	2006	% Change
Total revenues	$ 19.1	$ 22.6	(15.5)%

Revenues decreased $3.5 million for the fiscal year ended December 31, 2007 as compared to the comparable period in the prior year primarily due to an increase of $2.6 million in our core product line revenue, which includes iPrism, offset by a decrease of $6.1 million in our UpdateEXPERT and Open File Manager revenue. We sold the UpdateEXPERT product line to Shavlik Technologies in January 2007, and we sold the Open File Manager product line to EVault, Inc. in August 2007. See discussion of changes in net license revenue, net appliance revenue, and net subscriptions below.

License Revenues

	For the Years Ended December 31,		
	2007	2006	% Change
License revenues	$ 1.7	$ 3.9	(56.4)%
As a percentage of revenues	8.9%	17.3%	

For the year ended December 31, 2007 our net license revenue decreased $2.2 million as compared to the same period in 2006 due primarily to a decrease in UpdateEXPERT and Open File Manager license revenue. We sold the UpdateEXPERT product line to Shavlik Technologies in January 2007, and we sold the Open File Manager product line to EVault, Inc. in August 2007. We do not expect significant license revenue in future periods due to the sale of the two products lines mentioned above.

Appliance Revenues

	For the Years Ended December 31,		
	2007	2006	% Change
Appliance revenues	$ 3.2	$ 3.1	3.2%
As a percentage of revenues	16.8%	13.7%	

For the year ended December 31, 2007, appliance hardware sales increased $0.1 million as compared to the same period in 2006. Total units shipped for the year ended December 31, 2007 were 2,550 compared with 2,374 for the same period in 2006. We expect appliance revenue to increase in future periods due to the increased efforts of our sales team to upsell our customers to our h-series appliances, which are designed to enhance the iPrism web filtering capabilities.

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Subscription Revenues

	For the Years Ended December 31,		
	2007	2006	% Change
Subscription revenue	$ 14.2	$ 15.6	(9.0)%
As a percentage of revenues	74.3%	69.0%	

For the year ended December 31, 2007, our subscription revenue decreased $1.4 million over the same period in 2006 due primarily to the sale of UpdateEXPERT to Shavlik Technologies in January 2007 and the sale of Open File Manager to EVault in August 2007. The net decrease was composed of a $2.6 million increase in our core product lines, which includes iPrism, offset by a $4.0 million decrease in the UpdateEXPERT and Open File Manager subscription revenues. As of January 2007, we no longer marketed our Open File Manager product line, causing the subscription revenue for that product to decline in the year ended December 31, 2007, as compared to the same period on 2006. Our marketing efforts were concentrated towards the iPrism and LivePrism product lines. Renewal rates for our products range from 75% to 95%. We expect our subscription revenues to increase in the future periods by increasing our customer base and exploring opportunities to increase our core business lines.

Cost of Revenue

	For the Years Ended December 31,		
	2007	2006	% Change
Total cost of revenue	$ 7.1	$ 6.4	10.9%
Gross margin percent	62.8%	71.7%	

Cost of revenues consist primarily of the cost of contract manufactured hardware, royalties paid to third parties under technology licensing agreements, packaging costs, fee-based technical support costs and freight. Cost of revenue increased $0.7 million for the year ended December 31, 2007 compared to the same period in 2006. Gross margin decreased 8.9% for the year ended December 31, 2007 compared to the same period in 2006, primarily due to an increase in appliance hardware costs and the write-down of our historical costs associated with our M-series appliances which has been replaced by our h-series appliances, the addition of LivePrism costs, which include direct subscription costs and payroll related costs for our LivePrism technical support staff, and an increase to our warranty liability at December 31, 2007. The LivePrism product line has not gained adequate revenue traction to support its costs of revenue.

Cost of Appliance Revenue

	For the Years Ended December 31,		
	2007	2006	% Change
Total cost of appliance revenue	$ 3.2	$ 2.2	45.5%
Gross margin percent	0.0%	29.0%	

The cost of appliance revenue includes contract manufactured equipment, packaging and freight. The cost of hardware for the year ended December 31, 2007 increased $1.0 million fr