NEW MEXICO SOFTWARE, INC
Form 10KSB/A
March 24, 2006

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-KSB /A

ANNUAL REPORT UNDER SECTION 13 OR 15(D) OF THE

SECURITIES EXCHANGE ACT OF 1934

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES**

EXCHANGE ACT OF 1934

FOR FISCAL YEAR ENDED

DECEMBER 31, 2004

COMMISSION FILE #333-30176

NMXS.COM, INC.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE

(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)

91-1287406

(IRS EMPLOYER IDENTIFICATION NUMBER)

5021 Indian School Road, Suite 100

Albuquerque, New Mexico 87110

(505) 255-1999

(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)(ZIP CODE)

(505) 255-1999

(REGISTRANT S TELEPHONE NO., INCLUDING AREA CODE)

NONE

(FORMER NAME, FORMER ADDRESS AND FORMER FISCAL YEAR,

IF CHANGED SINCE LAST REPORT)

SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT: NONE

SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT: COMMON STOCK, $0.001

PAR VALUE

INDICATE BY CHECK MARK WHETHER THE REGISTRANT (1) HAS FILED ALL REPORTS REQUIRED TO BE FILED BY SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 DURING THE PRECEDING 12 MONTHS (OR FOR SUCH SHORTER PERIOD THAT THE REGISTRANT WAS REQUIRED TO FILE SUCH REPORTS), AND (2) HAS BEEN SUBJECT TO SUCH FILING REQUIREMENTS FOR THE PAST 90 DAYS.

YES x NO o

CHECK IF THERE IS NO DISCLOSURE OF DELINQUENT FILERS IN RESPONSE TO ITEM 405 OF REGULATION S-B NOT CONTAINED IN THIS FORM, AND NO DISCLOSURE WILL BE CONTAINED, TO THE BEST OF THE REGISTRANT S KNOWLEDGE, IN DEFINITIVE PROXY OR INFORMATION STATEMENTS INCORPORATED BY REFERENCE IN PART III OF THIS FORM 10-KSB OR ANY AMENDMENT TO THIS FORM 10-KSB. o

REVENUES FOR YEAR ENDED DECEMBER 31, 2004: $1,018,000

AGGREGATE MARKET VALUE OF THE VOTING COMMON STOCK HELD BY NON-AFFILIATES OF THE REGISTRANT AS OF APRIL 11, 2005, WAS: $ 7,903,283

NUMBER OF SHARES OF THE REGISTRANT S COMMON STOCK OUTSTANDING AS OF APRIL 11, 2005 IS: 36,431,194

TRANSFER AGENT AS OF APRIL 11, 2005: Interwest Transfer Company, Inc., 1981 East 4800 South, Suite 100, Salt Lake City, Utah 84117

PART I

ITEM 1. DESCRIPTION OF BUSINESS

BUSINESS - OUR COMPANY

Our History and Background

New Mexico Software, Inc., was originally incorporated under the laws of the state of New Mexico in April 1996. The privately held company was involved in a reverse merger with Raddatz Exploration, Inc. on August 3, 1999, and the corporate name was changed to NMXS.com, Inc., with New Mexico Software, Inc. becoming a wholly-owned subsidiary. NMXS.com, Inc. went public at that time. NMXS is quoted on the OTC Bulletin Board under the symbol NMXS and on the Berlin Stock Exchange with the symbol NM9. In 2004 we filed an alternate name registration in the state of Delaware to use the name New Mexico Software.

Through our wholly-owned subsidiaries, New Mexico Software, Inc. and Working Knowledge, Inc. (which we acquired in April 2000), we develop and market a range of proprietary Internet-based software products for information lifecycle management, as well as providing web services and web database management. Our software can assist the customer in the management of digital documents, high-resolution graphic images, video clips, and audio recordings. Through New Mexico Software we develop and market the software, and through Working Knowledge we provide related professional services.

Working Knowledge

In April 2000, we acquired Working Knowledge, Inc., a Kansas corporation. Working Knowledge became our wholly-owned subsidiary which provides services that are necessary to prepare, enter, and maintain the customer s data in our software. These services include web design, database development, image scanning, file uploading and technical support. As well, Working Knowledge is able to serve the customer by utilizing the stored images to produce compact disks, digital prints, and large poster formats. These complementary services allow us to complete our business model of offering comprehensive digital management.

Our Products

New Mexico Software develops and markets sophisticated Internet-based document and image management systems for a wide variety of applications. Our products range from pre-packaged desktop software products to complex enterprise systems.

Our products organize, search, retrieve, display, archive and distribute digital content from a central repository. Further, they convert analog and digital files to all digital. They use the popular Linux-based operating system. Our software can handle photographs and images, email, electronic files, paper documents, x-rays and other high-definition media. Our products include web servers, databases, firewalls and search engines, as well as advanced technology such as

3

biometric security devices, optical character recognition, speech recognition to text translation, and personal video recorders.

At the enterprise level, we have two products currently available and several products under development. The first available product is Roswell, our core product. It is used for information lifecycle management systems demanding database integration, web services, file systems, Internet security, high-definition viewing environments, and advanced search engines. We market Roswell in two ways: as a hosted application on the Internet, and as a highly customized application according to clients specifications. A hosted application provides a customer with access to the Roswell product over the Internet. Customers log on to a dedicated server run at our Albuquerque data center and use Roswell to manage, view and distribute their media assets. The customers media files are also stored on our server. Customers using our hosted model are billed on a monthly basis according to the number of registered users and the amount of disk space their media files will occupy. This is the primary basis for our recurring revenue.

Our second enterprise-level product is called XR-EXpress. It is a secure, web-based software that allows medical providers to store, organize and access patient medical diagnostic images such as x-rays, EKG s, MRI s, CT s, and ultrasounds, as well as to diagnose and interpret cases and generate medical reports in conjunction with those images. It incorporates biometric devices, speech recognition to text translation, multiple security levels, comparative image viewing, and a customizable workflow model to provide a streamlined process for medical providers.

SOX Advisors is our new division. The purpose of this division is to provide much needed technical and accounting consulting and to assist CEOs and CFOs in reducing the cost of compliance with Sarbanes-Oxley regulations by offering a total package including the use of subject matter experts (SMEs) deployed to companies requiring the service.

SOXtrac is a software service currently being developed that will enable companies to organize their compliance materials digitally and help them in the control and auditing process within the IT infrastructure and security required by the Sarbanes-Oxley regulations. Many companies are finding it difficult and expensive to initiate and maintain the internal control process required by the new regulations, and we believe our service can have a positive effect. We expect SOXtrac to be available in mid-2005.

Together our SOX Advisors and SOXtrac will minimize the impact of the Sarbanes-Oxley Act on businesses and their managers who have a strong desire to be fully compliant with the Sarbanes-Oxley Act. SOX Advisors will enable CEOs and CFOs to monitor their legal compliance requirements in accordance with Section 302 of the Act, while also enabling financial auditors to identify and clarify the effectiveness of a company s system of internal accounting controls in accordance with Section 404 of the Act.

Digital Filing Cabinet is a mid-level server that can be located at a customer s facilities to provide a similar functionality as our Roswell custom products. However, more companies are choosing to use our DFC to be maintained in our data center instead of purchasing and maintaining the products at their location.

Last fall we launched three new desktop products. The three products, Santa Fe, White Sands, and Taos, further extend our document and image management capabilities, as well as the potential for market penetration. The three new products are prepackaged software ranging in price from $39.95 to $249.95.

Santa Fe is a desktop Linux operating system. Its design emphasizes ease-of-use and a familiar appearance, allowing New Mexico Software to target a large customer base of non-technical users. At the same time, it provides advanced features such as automatic hardware and software configuration as well as superior security. The software is pre-installed with over 60 Linux applications, including photo editing, finance management, desktop publishing, video teleconferencing, games, and a full office suite.

White Sands is an inexpensive but powerful document management system for the small office. It can import electronic files into the database or scan paper documents into the computer and turn them into portable data files (PDF s). White Sands includes a search engine and metadata tagging system, providing the ability to quickly and easily organize, archive and locate the documents. It incorporates optical character recognition technology which allows the customer to search on any word or phrase in the document.

Taos is a next-generation digital photo application. It provides a low-cost image database solution for organizing, cataloging, and searching for images based on their color or shape. The Taos software takes advantage of bleeding-edge performance and graphic processors to provide enhanced photo editing, and it allows images to be tagged with hot words and exported to popular database and image formats.

Our newest consumer product is the Trinity Mothership. It is a media management center combining our Santa Fe Linux software, high-end nVidia hardware and AMD 64-bit gaming and cinematic processors. As a personal video recorder, it provides the ability to record and playback high-definition media, complete with time shifting, commercial skips, and advanced scheduling. It also offers additional features such as a DVD player and recorder, MP3 music player, video games, photo management, and web browser. Each Trinity Mothership product will be custom built by New Mexico Software, allowing a combination of hardware possibilities and upgrades.

Our Technology

We engineer database products around a central core of unique Internet technology that makes it possible to rapidly view, distribute and manage a variety of media files such as documents, graphic images, animation sequences, film clips, audio files, x-rays and high-definition media streams. The value of our core technology, which is found in our Roswell product, is that it provides maximum flexibility in the presentation of digital images to the customer, and integrates general browsing capabilities with specific search capabilities in one product.

Our technology is based on Open Source. Open Source is source code from independent programmers who build applications and release their source code in the public interest. By integrating Open Source programs into our technology, we are able to reduce development time and costs, thereby providing well-built, low-cost products for the digital management market. In

addition, the code that we deliver to customers is compiled. When you compile software code it makes it difficult to use the code to create a similar program, even though the code we create originates from Open Source. This provides better protection and security of our products.

Another technological advantage our company has is the ability to provide totally integrated services that a customer would normally need to outsource to several different suppliers. For example, with our business model and technology, we are able to provide the software itself, plus custom programming, hosting, and database administration as a total solution.

In addition, our core technology is characterized by the following features that contribute to what we perceive to be marketplace advantages:

Ability to use high-resolution graphics files -- large files with lots of detail as opposed to the low resolution files with indistinct detail used by conventional Internet programs.

Ability to use a single image in multiple resolutions, and to magnify the details in the high-resolution images.

Ability to track images with special codes assigned to each image.

Allows rapid transmission of a portion of the image based on user input, significantly enhancing the responsiveness of the system to deliver images over the Internet.

Our technology works on current versions of Internet browsers on Macintosh, PC and UNIX computers.

The enterprise level system is easy to use because it does not require any new software programs, only a familiarity with Netscape or Internet Explorer browsers.

These unique features make our core technology adaptable to and highly desirable in a wide variety of commercial applications. Basically, any company in any industry that manages digital assets and makes use of browser and search engine technology can benefit from our products.

In general, our programmers and engineers are tasked with adding new features to our products and fixing any problems users might encounter. There are risks inherent in software development including unanticipated delays, technical problems that could mean significant deviation from original product specifications, and hardware problems. In addition, once improvements and bug fixes are deployed there is no assurance that they will work as anticipated or that they will be durable in actual use by customers.

We are continuing to develop our core products using a mix of readily available Open Source software development tools. Knowledgeable competitors may be able to deduce how we have assembled our code base and be able to develop competing products. The principal advantage in utilizing Open Source tools is the extremely high degree of portability they ensure. Migrating our products from one operating system or hardware base to another is more easily accomplished by

6

avoiding proprietary development tools. The risk factor inherent in the use of such freely available tools is the fact that a sophisticated competitor might be able to imitate our work and produce similar functionality. Any such imitation, should it occur, could have material adverse effects on our business, operations, and financial condition.

Business Strategy

The digital lifecycle management market is one of the newest in the rapidly growing information services industry. Competition at this time is broad, with many vendors offering systems that have some comparable features as our current product. However, to our knowledge, few competitors have all of our comparable features for the complete management and distribution of images.

One competitive strategy we are using is offering our enterprise-level products as hosted applications. By hosting our applications, we are able to provide the customer with a customized product that is maintained by us, which eliminates the customer s need for an information technology staff. We provide the hardware, connectivity, maintenance, technical support, and automatic backups of the customer s data. In addition, now that our core product has been completed, our cycle time (the time required to get a new customer up and running) is greatly reduced. We are often able to accommodate new customers, even those with complex databases, in a matter of weeks. We believe that our strategy to provide hosted applications, coupled with our custom system design capabilities provide us with a diversity of competitive market penetration opportunities.

We believe that establishing and maintaining brand identity of our products and services is critical to attracting new customers and retaining our customer base of large corporations. The importance of brand recognition will continue to increase as new competitors enter the digital lifecycle management marketplace. Promotion and enhancement of our brands will depend largely on our success in continuing to provide high quality service and developing leading-edge products, and this cannot be assured. If businesses do not associate our product names or brands with high quality, or if we introduce new products or services that are not favorably received, we will run the risk of compromising our product line and decreasing the attractiveness of our products to potential new customers. In addition, to attract and maintain customers and to promote our products in response to competitive pressures, we may find it necessary to increase our financial commitment substantially to create and maintain product loyalty among our customers. If we are unable to provide high quality services, or otherwise fail to promote and maintain our products, or if we incur excessive expenses in an attempt to improve our services, or promote and maintain our products, our business, results of operations, and financial condition could be adversely affected.

Our current business strategy is to form up to twenty joint venture projects over the next two to three years. These joint venture projects would be formed to develop, market and distribute various digital lifecycle management applications built around our core Roswell technology. Now that our core technology has been completed, the joint venture format allows us to create distinct product lines using this technology, and to exploit unique marketing opportunities arising from the new product differentiation. The risks and costs of new product development and distribution would be shared among the joint venture partners, as would the resulting revenues, thus benefiting all partners. Sharing costs allows us to reduce our initial capital requirements, and the joint venture structure allows us to bring new products to market very quickly.

Other, better-financed companies may be developing similar products that could compete with our products. Such competition could materially adversely affect our financial condition. Although we have been established for nine years, our initial product was not marketed until 1998. There may exist better-capitalized companies on a parallel development path with similar products addressing our target markets. While the Internet technology marketplace is extremely competitive, we have anticipated a first-to-market advantage with our products. However, other highly capitalized companies that have recognized the absence of digital image management products could overwhelm our first-to-market advantage with expensive and expansive media blitzes that create the perception of a dominant market presence and/or superior products. If we are unsuccessful in addressing these risks and uncertainties, our business, results of operations, and financial condition will be materially and adversely affected.

Marketing and Customers

Our marketing focus to date has been in three principal fields. Approximately 70% of our clients have been in the entertainment industry, approximately 10% have been in the medical field, and approximately 10% have been government agencies. In the fourth quarter 2004, we began marketing our desktop software products to a wide retail market, which, along with several customers in various other industries, encompasses the other 10%. In 2005 we will focus on finding new applications and markets for our core technologies via the joint venture strategy mentioned described above.

Although we were still dependent upon a small number of clients in the year ended December 31, 2004, that trend has been changing, and we believe it will continue to change. During the year ended December 31, 2004, five clients accounted for 55% of our revenues, as compared to the year ended December 31, 2003, when seven clients accounted for 85% of our revenues. As we retain current clients and gain new clients, this reliance on a small number of customers will continue to decrease. In addition, while our enterprise-level products will continue to depend on a relatively small number of customers, we expect an expanded customer base for our Trinity Mothership, XR-Express and SOX Advisors, and a wide retail base for our desktop products. Overall, we anticipate that our customer base will continue to broaden in the next year with the marketing of our medical and consulting practice, giving more stability and predictability to our revenues.

Our Intellectual Properties

We have several proprietary aspects to our software that we believe make our products unique and desirable in the marketplace. Consequently, we regard protection of the proprietary elements of our products to be of paramount importance and we attempt to protect them by relying on trademark, service mark, trade dress, copyright and trade secret laws, and restrictions on disclosure and transferring of title. In addition, as stated above in the technology section, the compiled software code that we offer makes it difficult to use the source code to create other similar programs, even though the code used originates from Open Source. Because we maintain our enterprise software code on dedicated servers in our Albuquerque data center, it provides better protection and security of our products.

We have entered into confidentiality and non-disclosure agreements with our employees and contractors in order to limit access to, and disclosure of, our proprietary information. There can be no assurance that these contractual arrangements or the other steps taken by us to protect our intellectual property will prove sufficient to prevent misappropriation of our technology or to deter independent third-party development of similar technologies.

Although we do not believe that we infringe the proprietary rights of third parties, there can be no assurance that third parties will not claim infringement by us with respect to past, current, or future technologies. We expect that participants in our markets will be increasingly subject to infringement claims as the number of services and competitors in our industry grows. Any such claim, whether meritorious or not, could be time-consuming, result in costly litigation, cause service upgrade delays, or require us to enter into royalty or licensing agreements. Such royalty or licensing agreements may not be available on terms acceptable to us or at all. As a result, any such claim could have a material adverse effect upon our business, results of operations, and financial condition.

While we have commenced the process to protect our trade names, we have not completed the process. Thus, others could attempt to use trade names that we have selected. Such misappropriation of our brand identity could cause significant confusion in the highly competitive Internet technology marketplace and legal defense against such misappropriation could prove costly and time-consuming. As part of the brand identity creation process that defines our products to be unique in the Internet technology marketplace and proprietary in nature, we have begun the process to protect certain product names and slogans as registered trademarks to designate exclusivity and ownership.

Although trademarked in the U.S., effective trademark, copyright or trade secret protection may not be available in every country in which our products may eventually be distributed. There can also be no assurance that the steps taken by us to protect our rights to use these trademarked names and slogans and any future trademarked names or slogans will be adequate, or that third parties will not infringe or misappropriate our copyrights, trademarks, service marks, and similar proprietary rights.

Copyrights and Trademarks

We have four copyright registrations, one of which was effective June 18, 2001, and three federal trademark applications which were filed in January 2000. The copyright is for our MagZoom product. Three additional trademarks were granted in 2002 and they are: for the names AssetWare, Real Time Real Organized Real Simple, and The Look and Feel of e-Commerce.

Government Regulation

Our operations, products, and services are all subject to regulations set forth by various federal, state and local regulatory agencies. We take measures to ensure our compliance with all such regulations as promulgated by these agencies from time to time. The Federal Communications Commission sets certain standards and regulations regarding communications and related equipment.

There are currently few laws and regulations directly applicable to the Internet. It is possible that a number of laws and regulations may be adopted with respect to the Internet covering issues such as user privacy, pricing, content, copyrights, distribution, antitrust and characteristics and quality of products and services. The growth of the market for online commerce may prompt calls for more stringent consumer protection laws that may impose additional burdens on companies conducting business online. Tax authorities in a number of states are currently reviewing the appropriate tax treatment of companies engaged in online commerce, and new state tax regulations may subject us to additional state sales and income taxes.

Because our services are accessible worldwide, other jurisdictions may claim that we are required to qualify to do business as a foreign corporation in a particular state or foreign country. Our failure to qualify as a foreign corporation in a jurisdiction where we are required to do so could subject us to taxes and penalties for the failure to qualify and could result in our inability to enforce contracts in such jurisdictions. Any such new legislation or regulation, or the application of laws or regulations from jurisdictions whose laws do not currently apply to our business, could have a material adverse effect on our business, results of operations, and financial condition.

Employees

As of April 11, 2005, we had 13 employees, including 9 in systems engineering and quality assurance; 3 in administration and sales; and 1 in scanning and site development. We offer and share in the cost of health and dental insurance. A stock option plan and a stock issuance plan for employees and others were adopted on August 3, 1999, and July 27, 2001, respectively. The competition for qualified personnel in our industry and geographic location is intense, and there can be no assurance that we will be successful in attracting, integrating, retaining and motivating a sufficient number of qualified personnel to conduct our business in the future. We have never had a work stoppage, and no employees are represented under collective bargaining agreements. We consider our relations with our employees to be good. From time to time, we also utilize services of independent contractors for specific projects or to support our research and development effort. Our firm also hires independent sales agents who work on commission, and these agents are paid a percentage of the sale once the transaction has been completed.

ITEM 2. DESCRIPTION OF PROPERTY

We currently lease a 3,000 square foot facility in Albuquerque, New Mexico, at a cost of approximately $4,000 per month. The lease expires on April 30, 2009. The facility provides both administration and engineering offices. It is in close proximity to the location of the servers, and the two locations are networked together by fiber optics. The new space provides adequate room for expansion. In addition, we will have access to a large power generator, which will enable our

servers to continue operating during power outages. It also contains an advanced telephone system which will provide the capability needed to provide adequate customer telephone support.

In March 2005, we leased approximately 400 square feet of office space in Santa Monica, California, to house the Working Knowledge, Inc. operations. Current monthly lease payments are $1,400. The lease expires on February 28, 2006.

ITEM 3. LEGAL PROCEEDINGS

Grossman Lawsuit: Kurt Paul Grossman and Ann Grossman filed a complaint for Breach of Contract on a Promissory Note against us on November 25, 2003, in the Superior Court of California, Orange County Division, case # 03CC14074. There was a question of whether the complaint was properly served and whether the California courts have jurisdiction over us. The Grossmans filed an Application for Writ of Attachment which was denied on January 30. The Grossmans asked for $55,000 ($50,000 on the promissory note plus $5,000 interest); $304.40 in costs; and $24,000 in attorney s fees. The Grossmans, through a separate entity, Doctors Telehealth Network, purchased software from us, and it has not been paid for. We filed a motion to quash the service of summons for lack of personal jurisdiction and to vacate a default judgment against us. The court tentatively ruled in favor of the Grossmans. However, after our oral argument on April 23, 2004, the court withdrew its tentative ruling and ruled in favor of us. Specifically, the court ruled that we do not have sufficient contact with California to warrant the exercise of personal jurisdiction. Based on this ruling, there is no action pending against us at this time.

Internal Revenue Service Payments: In October 2003 we entered into an interim agreement with the Internal Revenue Service concerning the repayment of federal tax deposits which we failed to pay for the six operating quarters ended September 30, 2003. We have agreed to pay $5,000 per month beginning November 1, 2003. During this interim period the IRS has agreed to withhold the filing of a federal tax lien. Consideration of filing a lien in the future will be based upon a determination of how long it may take to pay the taxes. Also, our failure to make timely federal tax deposits will default this interim agreement and necessitate the filing of the lien. Our unpaid tax returns for these quarters are being assessed by the IRS, and we expect to receive an assessment notice for each period upon completion of this assessment. We estimate that these assessments will total approximately $269,000, including penalties and interest.

Manhattan Scientifics Lawsuit: On March 9, 2004, our legal counsel received a letter from an attorney representing Manhattan Scientifics. The letter threatened litigation against us for alleged breach of contract and against Richard Govatski for alleged tortious interference with contract. This is based on the fact that we were alleged to have declined to honor Manhattan Scientifics request for a cashless exercise of 150,000 of our Common Stock Purchase Warrants (the Warrants) allegedly issued to Manhattan Scientifics. It is our position that the Warrants, among other things, were issued in a transaction that was not an arms-length transaction and therefore, the Warrants should be cancelled, and that in any event, the alleged cashless exercise was not properly done and itself is a nullity. In May 2004, Manhattan Scientifics filed a suit in Federal Court in New York against us and Mr. Govatski for damages in this matter. The case was dismissed by the Federal Court due to a lack of diversity jurisdiction. On June 25, 2004, we were served with a complaint filed in the Supreme Court of the State New York, County of New York, Index No. 601793/04, asserting the same claims. Manhattan Scientifics seeks damages against us for an alleged breach of contract for failure to allow the cashless exercise, in an amount of $1.5 million, and alleges a tortious interference claim against Mr. Govatski.

We served our Answer to the Complaint on August 16, 2004. Mr. Govatski is seeking dismissal of the claim against him for lack of personal jurisdiction and for failure to state a claim. Mr. Govatski s motion to dismiss has been fully submitted to the court, but has not yet been decided. Along with our Answer, we are asserting Counterclaims against Manhattan Scientifics for monies owed by Manhattan Scientifics and for a declaratory judgment, and against a former Company Director, Marvin Maslow for fraud and breach of fiduciary duty due to his persuading the Company to enter into the Warrant transaction with Manhattan Scientifics, which we contend was done for the benefit of Maslow and Manhattan Scientifics, and not for the benefit of the Company. We believe that due to the fact that Mr. Maslow and a second former Company director (Scott Bach), were also Directors of Manhattan Scientifics at the time of the transactions in dispute, and constituted two of the Company s three Directors at the time, Mr. Maslow and Mr. Bach should have excused themselves from participating in negotiating and voting on the issue of whether to approve the Warrants. Messrs. Maslow and Bach resigned as our Directors in December 2002. It is our position that such financial conflicts include Mr. Maslow s causing the Company to pay for third-party consulting services provided to Manhattan Scientifics, while stating that such services would be provided to, and were needed by, the Company as part of the transaction. It is our position that Mr. Maslow also misrepresented the fairness of the transaction in dispute at the time to us, which we contend was being done for the benefit of Mr. Maslow and Manhattan Scientifics, to the detriment of the Company In our counterclaims, we are seeking, among other relief, a determination that the Warrants should be declared null and void from inception, plus damages against Mr. Maslow. It is further our position that even if the Warrants were properly issued (we contend they were not), the Warrants were never properly exercised by Manhattan Scientifics. Manhattan Scientifics and Mr. Maslow have moved to dismiss certain of our Counterclaims alleged against them. That motion too has been fully submitted to the court, but not yet decided.

Other than listed above, neither our parent company nor any of its subsidiaries, or any of their properties, is a party to any pending legal proceeding. We are not aware of any contemplated proceeding by a governmental authority. Also, we do not believe that any director, officer, or affiliate, any owner of record or beneficially of more than five percent of the outstanding common stock, or security holder, is a party to any proceeding in which he or she is a party adverse to us or has a material interest adverse to us.

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

No matters were submitted to a vote of the security holders during the fourth quarter ended December 31, 2004.

PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Market Information

Our stock is currently quoted on the OTC Bulletin Board under the symbol NMXS. The table below sets forth, for the periods indicated below, our high and low sales prices. These quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not necessarily represent actual transactions.

	Quarter	High	Low
FISCAL YEAR ENDED DECEMBER 31, 2003	First	$0.19	$0.05
	Second	$0.11	$0.055
	Third	$0.21	$0.06
	Fourth	$0.71	$0.20
FISCAL YEAR ENDED DECEMBER 31, 2004	First	$1.07	$0.41
	Second	$0.78	$0.22
	Third	$0.46	$0.22
	Fourth	$0.28	$0.13
FISCAL YEAR ENDED DECEMBER 31, 2005	First	$0.505	$0.135
	Second (to April 9, 2005)	$0.22	$0.171

Our shares are subject to Rule 15g-9 under the Exchange Act. This rule imposes additional sales practice requirements on broker-dealers that sell low-priced securities designated as penny stocks to persons other than established customers and institutional accredited investors. The SEC s regulations define a penny stock to be any equity security that has a market price less than $5.00 per share or with an exercise price of less than $5.00 per share, subject to certain exceptions. Currently our stock is a penny stock. We cannot assure you that our shares will ever qualify for exemption from these restrictions. For transactions covered by this rule, a broker-dealer must make a special suitability determination for the purchaser and have received the purchaser s written consent to the transaction prior to sale. Consequently, the rule may affect the ability of broker-dealers to sell our shares and may affect the ability of holders to sell their shares in the secondary market.

Shareholders

As of April 11, 2005, there were 350 holders of record of our common shares. Such number of record owners was determined from our shareholders records maintained by our transfer agent and does not include beneficial owners of our common stock held in the name of various security holders, dealers and clearing agencies.

13

Dividends

We did not declare any cash dividends on our common stock during the year ended December 31, 2004. We have no plans to pay any dividends to the holders of our common stock in 2005.

ITEM 6. MANAGEMENT S DISCUSSION AND ANALYSIS

OVERVIEW

New Mexico Software develops a variety of products centered around the concept of digital lifecycle management systems. The digital lifecycle is the IT (information technology) strategy that associates database information with both paper and digital files including text, email, images, audio, graphics, video and animation files, and coordinates access to a common repository of these processes and files. The digital lifecycle encompasses creation, approval, sharing, storage, retrieval, usage, capture and archiving of the database information. Our core product, Roswell, is an enterprise-level platform that manages digital files. It manages assets by creating folders, or groups of files, catalog hierarchies, users, user groups, and user permissions. The files are managed by a database that maintains both the membership of the file in a folder(s) and information about the file. Roswell s main user interface is a web browser, which makes it accessible and more intuitive to a greater number of users. It can be used on Windows, Macintosh or Linux operating systems.

In addition to developing the software itself, New Mexico Software also provides services such as web hosting, data storage, custom programming, technical support, database development, image scanning and other support services. Since our core technology is based on internet browsers and the majority of our services are either Internet-based or performed via the Internet, the market conditions surrounding the Internet industry directly impact our business.

One of the most significant issues affecting our type of business is that the Internet as a commercial industry is less than ten years old. Therefore, the entire industry is subject to intense competition and rapidly changing conditions, causing uncertainty and inconsistencies for the individual companies operating within that industry. According to the Standard & Poors Industry Survey Computers: Consumer Services & The Internet dated March 3, 2005, two key factors in analyzing Internet-related companies are that because many Internet-related companies do not generate consistent and substantial earnings, and some have only a small base of revenues, such firms often are valued largely on their prospects for future growth , and that for Internet-related companies qualitative assessments are crucial in helping to determine the competitive position, growth opportunities, and value of an Internet company . According to Standard & Poors, some of the qualitative items investors should look at in addition to financial statement analysis are business models, competitive positioning, management s vision and execution, diversification of revenue streams, capital requirements, ability to recruit and retain skilled software programmers, ability to convert new ideas into saleable offerings quickly, ability to capitalize on the unique benefits offered by the Internet, and the ability to generate new ideas, market new products and foster an entrepreneurial and innovative corporate structure. We believe that these subjects apply to New Mexico Software.

We have spent the last two years positioning our business for future growth. Our focus has been on creating a stable team of software engineers, completing the development of our core product (Roswell), streamlining our expenses and clearing up old obligations on the balance sheet. Although the development of our core technology has taken several years, its adaptability to any industry provides us with numerous opportunities for growth and market penetration as more creative applications are discovered and developed from within our core intellectual property (Roswell). These new applications will have low capital requirements and provide additional revenue diversification.

One of the challenges of operating in this industry is creating a balance between sustaining a consistent vision and business strategy and yet maintaining the flexibility required to adapt to the rapidly changing market conditions. We believe that our product structure allows us to do that. Since our core technology is useful to literally any company that manages digital assets and requires browser and search functions, it is the backbone of our product framework. As such, it provides the consistency and stability aspect of the business strategy. The next generation of our products primarily consists of derivative products, new technological combinations, and enhancements to the core product. These have the advantage of taking less than a year to develop into a marketable product, thus providing the flexibility necessary to be able to respond quickly to new market opportunities.

Some challenges we face in the next year are continuing to develop a sales force and distribution channels in order to market our products, as well as educating potential customers about the benefits of digital lifecycle systems. We have hired two executive managers to focus on marketing XR-EXpress, and we are in the process of hiring a manager to focus on the consumer products division (Santa Fe, White Sands, Taos and Trinity Mothership. We also have made the same commitment for our Sox Advisors products and services. These executive managers are known as SME s (Subject Matter Experts) who have had the experience to understand the broad range of requirements needed to successfully manage complex IT structures, technology, client relationships and products.

Another possible opportunity for our business can be found in the current expansion of the open-source software market. The growth in this market was discussed in a May 10, 2004 article in Business Week Online entitled Software Shift . According to this article, the market for software products using open source programming is expanding beyond the Linux operating system to include software products such as databases, search engines, programming tools and desktop PC software. Since our products have all been developed with open source code, we may be in a position to take advantage of this expansion by identifying opportunities to integrate our software with some of the newly emerging open source products.

We presently realize revenues from four primary sources: (i) software sales, maintenance and hosting; (ii) custom programming services; (iii) license fees; and (iv) scanning and other services. We also occasionally realize revenues from hardware sales when the hardware is sold together with the software, and occasionally from other services. To date, license fees and software sales have been directly related. With each sale of our enterprise-level products, the end user enters into a license agreement for which an initial license fee is paid. The license agreement also provides that in order to continue the license, the licensee must pay an annual software maintenance fee for which the party receives access to product upgrades and bug fixes or product patches. Software maintenance consists primarily of hosting and managing our customers data on our servers, as well as technical support programs for our products. This hosting and licensing structure will continue with both our Roswell and XR-EXpress products; therefore, we anticipate a positive impact on license fees, software maintenance, and custom programming revenues from sales of these products. However, according to an article in Forbes magazine on March 29, 2004 entitled A Hard Landing for Software , software companies are gradually relying less on the software license for revenues and more on professional services such as programming and consulting. Management believes this trend applies to our revenues as well, since only our enterprise-level products will use this licensing structure.

With the marketing of the new prepackaged products, management anticipates that revenues for direct software sales and technical support will increase as those products are sold and the associated technical support programs are purchased. The change in focus to include our newer products reflects management s belief that a broader range of products and customers will provide greater stability in revenues.

Scanning services are performed principally by Working Knowledge at its site in Santa Monica, California. To date, management has anticipated that these services will be reserved in the future primarily for existing customers and customers of our core products, although revenue could be generated from unsolicited customers. Accordingly, in 2004 management has not focused on developing this segment of our business, but we are currently assessing the importance of scanning services as part of an overall focus on client services during the coming year.

Cost of services consists primarily of engineering salaries, engineering supplies, compensation-related expenses, hardware purchases and equipment rental. General and administrative expenses consist primarily of salaries and benefits of personnel responsible for business development and operating activities, and include corporate overhead expenses. Corporate overhead expenses relate to salaries and benefits of personnel responsible for corporate activities, including acquisitions, administrative, and reporting responsibilities. We record these expenses when incurred.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America requires our management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. As such, in accordance with the use of accounting principles generally accepted in the United States of America, our actual realized results may differ from management s initial estimates as reported. A summary of our significant accounting policies is detailed in the notes to the financial statements which are an integral component of this filing.

Revenue Recognition

The Company derives revenues from three main activities: the sale of software licenses to end users, software hosting and maintenance contracts, and software licenses that require us to provide significant production, customization or modification to our core software product. The Company also derives revenue from third party hardware and software sales, and from installation, training and consulting services.

Our software recognition policies are in accordance with the American Institute of Certified Public Accountants Statement of Position (SOP) 97-2, *Software Revenue Recognition* as amended.

The Company sells software licenses directly to its end user customers. These sales do not require further commitment from the Company and are recognized upon persuasive evidence of an arrangement as provided by agreements executed by both parties, delivery of the software, and determination that collection of a fixed or determinable fee is probable, in accordance with paragraph 8 of SOP 97-2.

In connection with the sales of software licenses for our enterprise-level products, we sell hosting and maintenance contracts that vary in terms. For these hosting contracts, the customer has possession of the software, which resides on the customer s hardware, and we host the customer s data. These hosting arrangements fall within the scope of SOP 97-2. However, although a fee may be charged at the beginning of the contract for the software license and any customization of the software, the hosting portion of the arrangement is billed and recognized on a monthly basis for the term of the contract. The Company has established vendor-specific objective evidence (VSOE) of fair value per paragraph 10 of SOP 97-2 for the hosting services. The VSOE for the hosting portion of contracts with multiple elements is the price charged for hosting when it is sold separately.

However, in some of our hosting arrangements both the software application and the customer s data reside on our hardware. The customer accesses and uses the software on an as-needed basis over the internet, and the customer does not have the right to take possession of the software. Therefore, according to paragraph 5 of EITF 00-3, these hosting arrangements do not fall within the scope of SOP 97-2. Accordingly, we recognize revenue from these hosting services on a straight-line basis over the life of the respective contracts.

Maintenance contract revenue also is recognized on a straight-line basis over the life of the respective contracts, as this format best approximates the timing of the services rendered per paragraph 57 of SOP 97-2. If a maintenance contract is sold as part of a contract with multiple elements, the amount allocated to the maintenance portion is based on VSOE of fair value, which is the price charged for software maintenance services sold separately.

We follow the guidance in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* for custom software development arrangements that require us to provide significant production, customization or modification to our core software. Revenue is generally recognized for such arrangements under the percentage of completion method. Under percentage of completion accounting, both the product license and custom software development revenue are recognized as work progresses based on specific milestones in accordance with paragraphs 85 through 91 of SOP 97-2. We believe that project milestones based on completion of specific tasks provide the best approximation of progress toward the completion of the contract. If custom programming services are sold as part of a contract with multiple elements, a portion of the contract revenue is allocated to the custom programming services based on VSOE of fair value. VSOE for custom programming services is determined based on the price charged for these services when they are sold separately. At December 31, 2003 and December 31, 2004, there were no custom software development arrangements in progress.

The sale of third party hardware and software generally is billed as a separate deliverable under consulting or custom development contracts.

Installation, training and consulting revenue is recognized as the services are rendered. These services are accounted for separately per paragraph 65 of SOP 97-2. They include services that are not essential to the functionality of the software. They are usually billed separately; however, if they are included in a software agreement with multiple elements, a portion of the contract revenue is allocated to these services based on VSOE of fair value. VSOE is determined based on the price charged for these services when they are sold separately.

Amounts collected prior to satisfying the above revenue recognition criteria are included in deferred revenue.

The Company follows the guidance provided by SEC Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements* and SAB No. 104 *Revenue Recognition* which provide guidance on the recognition, presentation and disclosure of revenue in financial statements filed with the SEC.

The application of SOP 97-2, as amended, requires judgment, including a determination that collectibility is probable and the fee is fixed and determinable. On occasion, we have approved extended payment arrangements for certain customers. In all cases except one, the extended payment arrangements did not exceed 120 days, therefore we considered collectibility to be probable as per paragraph 8 of SOP 97-2. The revenue for the sale of the software licenses to these customers was recognized upon delivery of the software, in accordance with paragraph 28 of SOP 97-2. In one case, a customer was allowed to pay a second installment at the end of twelve months. Since that software license expired at the end of twelve months, the revenue from the second installment payment was recognized at the time that payment became due, in accordance with paragraph 29 of SOP 97-2.

Income Taxes

Management evaluates the probability of the utilization of the deferred income tax assets. The Company has estimated a $8,754,000 deferred income tax asset at December 31, 2004, related primarily to net operating loss carryforwards at December 31, 2004. Management determined that because the Company has not yet generated taxable income it was not appropriate to recognize a deferred income tax asset related to the net operating loss carryforward. Therefore, the fully deferred income tax asset is offset by an equal valuation allowance. If the Company begins to generate taxable income, Management may determine that some, if not all of the deferred income tax asset may be recognized. Recognition of the asset could increase after tax income in the future. Management is required to make judgments and estimates related to the timing and utilization of net operating loss carryforwards, utilization of other deferred income tax assets, applicable tax rates and feasible tax planning strategies.

Goodwill

Goodwill was recognized in the Company s acquisition of Working Knowledge, Inc. In December 2004, based upon the Company s impairment analysis, the remainder of the goodwill was written off.

Stock Based Compensation

The Company grants stock awards and stock options to employees and non-employees as consideration for services. Management believes that the best indicator of value for stock awards is the trading value of the shares of stock on the date the Company enters into the agreements. For non-employees, that date is generally the date on which the company is committed to such an agreement. At times the Company may grant stock as payment for accrued but unpaid payroll. In these cases, the Company values the shares at the trading price on the date they are granted and reduces the payroll accrual by the same amount. We have elected to apply the intrinsic value method prescribed in APB No. 25 for stock options granted to employees. For options granted to non-employees, we estimate the value of those awards using the Black-Scholes option pricing model.

Contingencies

We are subject to the possibility of various law contingencies arising in the ordinary course of business. We consider the likelihood of loss or impairment of an assets or the incurrence of a liability, as well as our ability to reasonably estimate the amount of the loss contingencies.

At December 31, 2004, the Company is involved in litigation related to a dispute over the validity of the issuance of 150,000 of the Company s common stock warrants. The plaintiff has made a claim of damages of $1,500,000 against the Company. We believe that we have adequate defenses and counter claims and therefore we have not accrued for any potential loss on this case nor are the 150,000 warrants included in the number of our potentially dilutive securities at December 31, 2004.

The Company is paying past due payroll taxes of approximately $269,000 (including estimated penalties and interest) at a rate of $5,000 per month. The Company has accrued its estimate of interest and penalties of $75,000 on this past due amount. However, the Company has received notices from the IRS reflecting interest and penalty amounts greater than $75,000. We believe that the Company will negotiate a final settlement with the IRS of approximately $75,000 for those penalties and interest. However, the final settlement may vary from our estimate.

Software Development Costs

19

We account for software development costs in accordance with SFAS No. 86 *Accounting for Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*. Product research and development expenses consist primarily of personnel, outside consulting and related expenses for development, and systems personnel and consultants and are charged to operations as incurred until technological feasibility is established. The Company considers technological feasibility to be established when all planning, designing, coding and testing have been completed to design specifications. After technological feasibility is established, costs are capitalized. Historically, product development has been substantially completed with the establishment of technological feasibility and, accordingly, no costs have been capitalized.

RESULTS OF OPERATIONS

A summary of operating results for the twelve months ended December 31, 2004 and 2003 is as follows:

	2004		**2003**	
	Amount	**% of Revenue**	**Amount**	**% of Revenue**
Revenues	$1,018,000	100.0%	$1,300,000	100.0%
Cost of service	374,000	36.7%	330,000	25.4%
Gross profit	644,000	63.3%	970,000	43.7%
General & administrative	992,000	97.4%	1,155,000	88.8%
Research & development	207,000	20.3%	112,000	8.6%
Impairment of good will	75,000	7.4%	0	0.0%
Bad Debt Expense	0	0.0%	554,000	42.6%
Net operating (loss)	(630,000)	(61.9)%	(851,000)	(63.1)%
Other income (expense)	(73,000)	(7.2)%	(33,000)	(2.5)%
Net income (loss)	(703,000)	(69.21)%	(884,000)	(65.6)%
Earnings (loss) per share	$(0.02)		$(0.03)	

Revenues: Total revenues decreased 21.7%, or $282,000, for the year ended December 31, 2004, as compared to the same period in the prior year (the comparable prior year period). These revenues were primarily generated from the following four revenue streams:

1. Revenues generated by software sales and maintenance decreased 31.0%, or $257,000, for the year ended December 31, 2004, as compared to the comparable prior year period. This decrease is attributable to a combination of factors. Software sales decreased 44.2% or $197,000 as compared to the comparable prior year period. This decrease was mostly attributable to a decrease in the number of large contracts for our enterprise-level products. We completed the development phase of Roswell, XRexpress and our three desktop products during 2004. As a result, sales of these products have only recently begun to impact our revenues and their sales growth is still inconsistent. We anticipate that sales of Roswell and XRexpress will increase gradually over the next two years; however, since they are high-level enterprise systems, their sales are characterized by a small number of contracts with much higher revenues than our other products. As a result, their sales growth will most likely be inconsistent from one quarter to the next. Sales of these enterprise products, however, will be balanced by sales of our desktop products. Development was completed on the desktop products in the third quarter 2004, and we made our first shipment in September. These desktop products range in price from $39.95 to $249.95, so they will have a much lower margin than Roswell and XRexpress. Revenues from these products will be driven more by volume, providing balance for the more expensive enterprise products which provide only a few contracts per year. We are not currently emphasizing sales of our DFC product, although we will continue to sell it as customers request it. We also occasionally sell upgrades to current DFC customers.

Revenues from software maintenance decreased 15.8% or $60,000 for the year 2004 as compared to the comparable prior year period. This decrease is due to the termination of the hosting agreement for one customer. Software maintenance consists mainly of hosting and managing our customers   data on our systems, and to a lesser extent includes technical support programs associated with our products. We will continue hosting for various existing clients and for our Roswell and XRexpress products, in addition to focusing new marketing efforts on the sale of our desktop products. We have several projects currently in negotiations that will involve on-going software maintenance. Based on these projects in addition to our current contracts, management anticipates that revenues from software maintenance will increase in the coming year.

2. Custom programming revenue decreased 71.8%, or $161,000, for the year ended December 31, 2004, as compared to the comparable prior year period. This decrease was primarily due to the fact that we recognized revenue on two custom programming contracts of $72,000 and $75,000 respectively during the third quarter of 2003, and we had no major custom programming contracts during 2004. Approximately 10% of the customers that purchase our products will require customization, and we continue to offer this service. In addition, our Roswell and XRexpress products are offered chiefly as customizable packages, so we anticipate that custom programming projects associated with new product purchases will continue to provide revenues in this category. We currently are working on two major projects involving custom programming. We also continue to offer programming services for customer database integration. Therefore, we anticipate that this revenue source will increase in the coming year.

3. Revenues generated by license fees increased 136.8%, or $82,000 during the year ended December 31, 2004, as compared to the comparable prior year period. This increase is primarily due to the renewal of licenses by two customers during 2004. Although our products have been

developed using open source code, we have added additional code that is considered proprietary technology, particularly in our Roswell, XRexpress, and Santa Fe products. This additional technology can be licensed, however we anticipate generating license fees only from the enterprise-level products in the future. As a result, management believes that this category may increase modestly but probably not significantly in the coming years. We anticipate that most revenues will be generated from sales of our software products.

4. Revenue generated by scanning services remained steady for the year ended December 31, 2004, as compared to the comparable prior year period. We continued our progress on a long-term scanning project with a major movie studio. This studio has committed to scan over 5,000 titles for this project. At the current rate of progress, we expect the project to continue for approximately three to four years. We had no additional scanning projects during 2004. In general, management is currently assessing the importance of scanning services as part of an overall focus on client services during the coming year. Although we are not emphasizing scanning services at this time, we anticipate that this revenue source will continue to remain steady during the coming year due to the long-term project mentioned above.

We also generated other revenue from hardware sales and the sale of other miscellaneous items and services. Revenue generated by these other services increased 703.5% or $53,000, for the year ended December 31, 2004, as compared to the comparable prior year period. Sales of hardware associated with our Digital Filing Cabinet system accounted for 100% of this revenue. The Digital Filing Cabinet system may be sold as software only, or as a complete system of software and hardware. We provide the option including hardware for customers who need the complete system, but we do not emphasize hardware sales, therefore we do not consider it a significant part of our business on an on-going basis.

Cost of Services. Cost of services increased 13.3%, or $44,000, for the year ended December 31, 2004, as compared to the comparable prior year period. Approximately $37,000 (38%) of this increase is attributable to the cost of inventory and stocking fees related to manufacturing and preparing our prepackaged software products for shipment. The remainder of the increase is due to increased compensation-related expenses due to the hiring of a technical writer and graphics designer. During the current year, approximately 80% of our cost of sales consists of engineering salaries and compensation-related expenses. We consider these salaries to be directly associated with our ability to generate revenues, however, they do not vary with revenues in that much of those costs are fixed. As a result, the gross margin percent will vary as sales vary. During the current year, revenues decreased 16.6% as compared to last year, while engineering salaries increased slightly, resulting in a higher ratio of cost of sales to revenues.

For the year ended December 31, 2004, cost of services as a percentage of revenues was 36.7%, as compared with 25.4% for the comparable prior year period. Management anticipates that as revenues increase in the coming year, the cost of goods and services required to support those revenues will continue to increase, and engineering salaries will also increase as we hire additional staff to support a greater number of products and customers. However, we expect that revenues will increase at a greater rate than cost of services, since most of our costs are relatively fixed. We believe this range of percentages over the last two years is more indicative of the percentage of costs associated with future revenues, but until we have been in the active marketing phase for a longer period, management is unable to yet determine to what extent this percentage may change in the future.

General and Administrative. General and administrative expenses decreased 14.1%, or $163,000, for the year ended December 31, 2004, as compared to the comparable prior year period. We have made a dedicated effort in the last year to reduce our general and administrative expenses. Although compensation-related expenses and accounting expenses increased by $113,000 (51.0%) and 71,000 (100.0%) respectively, advertising and legal/consulting expenses decreased by $147,000 (78.2%) and $155,000 (77.3%) respectively. The apparent increase in accounting expenses is mainly due to a $75,000 credit in 2003 related to the settlement of an account. The remainder of the decrease in general and administrative expenses is comprised of a variety of smaller items.

For the year ended December 31, 2004, general and administrative expenses as a percentage of revenues was 97.4%, as compared with 88.8% for the comparable prior year period. Management believes the ratio of general and administrative costs to revenues will decrease in the future because revenues will increase at a greater rate than general and administrative costs, but until we have been in the active marketing phase for a longer period, management is unable to yet determine to what extent this percentage may change in the future.

Research and Development. Research and development expenses increased 84.8%, or $95,000, for the year ended December 31, 2004, as compared to the comparable prior year period. This increase is primarily attributable to management s focus on completing the development phase of the first version of our three new desktop products, XRexpress, and Trinity Mothership. Additional staff was hired in order to accomplish these goals. However, in the software industry it is common for research and development costs to be ongoing, since development of the next version of the software begins as soon as the current version is completed. Management anticipates that research and development costs in the future will focus both on the upgrading of our existing products and the continued development of new products using our core technology; therefore they will remain relatively steady or increase slightly in the coming year.

Other Income. Interest expense increased 121.2%, or $40,000 for the year ended December 31, 2004, as compared to the comparable prior year period. The increase in interest expense was due to the accrual of an additional $46,000 in estimated penalties and interest on the outstanding payroll tax obligation, which was recorded in the year ended December 31, 2004, while a $37,000 accrual for such was recorded in the year ended December 31, 2003. There was no loss on disposal of fixed assets in the third quarter of 2004.

In general, our key indicator of operating progress is gross revenue. For the years ending December 2004 and 2003, personnel-related expenses have accounted for approximately 56% of our total expenses, with fixed costs such as building and equipment rent, utilities, insurance, communications and depreciation accounting for an additional 20%. The only personnel-related costs that are directly variable with sales are those associated with custom programming, because they are directly billable. This means that over 75% of our expenses are relatively fixed. All of the remaining expenses vary, but less than 5% varies directly with sales. We will incur more definite variable costs associated with our new desktop products beginning in the fourth quarter of 2004, so in 2005 we may be able to use some other indicators such as gross margins to help analyze performance, but for 2003 and 2004 gross revenue is our primary indicator of when we will achieve profitability and break-even cash flow.

REPORTABLE SEGMENTS

Management has identified the Company s reportable segments based on the two distinct product lines and the two separate legal entities. New Mexico Software (NMS) derives revenues from the development and marketing proprietary internet technology-based software and Working Knowledge, Inc. (WKI) provides data maintenance services related to the NMS digital asset management system. Information related to the Company s reportable segments for the year ended December 31, 2004 is as follows:

	2004		2003	
	NMS	**WKI**	**NMS**	**WKI**
Revenue	$982,000	$36,000	$1,266,000	$34,000
Cost of services	335,000	39,000	267,000	62,000
General and administrative	826,000	166,000	1,556,000	123,000
Research and development	207,000		112,000	
Impairment of goodwill		75,000		
Operating income (loss)	(386,000)	(244,000)	(669,000)	(151,000)
Total assets	$528,000	$23,000	$704,000	$36,000

Generally, New Mexico Software develops and markets the software, and therefore, software sales and maintenance, licensing and custom programming are considered revenue streams for that entity. Working Knowledge, Inc. provides services that are necessary to prepare, enter, and maintain the customer s data on our image management system. These include web design, database development, image scanning, asset uploading, and database support. In addition, Working Knowledge is able to serve the customer by utilizing the stored images to produce compact discs, digital prints, and large poster formats. These revenue streams, usually classified as scanning and other revenue, are considered revenue streams for that entity. These complementary services allow us to complete our cycle of comprehensive image management.

Liquidity and Capital Resources

As of December 31, 2004, cash and cash equivalents totaled ($11,000), representing a $22,000 decrease from the beginning of the period. The decrease in available cash was due to a combination of several factors during the year, but the primary factor at the end of the year was a slight delay in regular monthly collections. In the first four days of 2005 we had received approximately $104,000 in payments on customer accounts, which brought the available cash balance to over $70,000.

Operating activities used $118,000 of cash for the year ended December 31, 2004, as compared to $179,000 for the comparable prior year period, a decrease of $61,000. The decrease in the use

of cash for operating activities was mainly due to our collection of funds for stock not yet issued offset by our emphasis on reducing the number of equity transactions used for operating activities. Equity transactions used for salaries or services have decreased from $469,000 in 2002, to $383,000 in 2003, and to $284,000 in 2004. The subscription payable increase of $130,000 offset by the decrease in equity transactions issued during 2004 as opposed to 2003 of $99,000, accounts for the majority of the decrease in the use of cash for operating activities during 2004.

During the year ended December 31, 2004, we used $28,000 to continue paying down accrued expenses and trade accounts payable, as opposed to using $46,000 during the same period in 2003. This resulted in total accrued expenses and trade accounts payable of $559,000 as of December 31, 2004, as compared with $587,000 at December 31, 2003, a decrease of $28,000. However, the balance in accrued expenses as of December 31, 2004 includes an additional accrual of estimated penalties and interest on the payroll tax obligation of $46,000. Excluding that accrual, we actually used operating cash of $74,000 to continue to pay down accounts payable and accrued expenses during 2004. The payments on accrued expenses are all payments toward past-due tax obligations.

Trade accounts payable were $111,000 at December 31, 2004 as compared to $122,000 at December 31, 2003, reflecting our emphasis on keeping our payables current. We continue to carry the accrued salary of our president, Richard Govatski, which totaled $107,000. This amount represents 88% of the accrued payroll balance at December 31, 2004. This obligation will only be paid when there is available cash, therefore it will have no material adverse effect on our liquidity. The remaining accrued payroll of $15,000 will be paid in common shares, therefore it also will have no material adverse effect on our liquidity. Payroll taxes due as of December 31, 2004, are approximately $283,000, including penalties and interest.

The following table shows current balances and payment details of our obligations as of December 31, 2004:

	Dec 31 Balance	Negotiated Payment	Payment Frequency
Notes Payable:			
Los Alamos National Bank note + interest	140,000	25,000	semiannually
Grossman + interest	62,000	In negotiations	
First Mirage + interest	82,000	No payment plan established yet	
Demand notes	13,000		
Past due Accounts Payable:			
New Mexico payroll taxes	14,000	1,000	monthly
IRS + estimated penalties & interest	269,000	5,000	monthly
Attorney fees	6,000	No payment plan established yet	
Other payables (current)	127,000		
Subscriptions payable	130,000		
Accrued payroll and deferred revenue	208,000		
Total Liabilities per Balance Sheet	1,051,000		

Net accounts receivable decreased from $450,000 at December 31, 2003 to $433,000 at December 31, 2004. Four customers account for $379,000 (87%) of the outstanding balance at December 31, 2004. One is a December billing of $75,000 for 2005 services, one is a new contract of $65,000 an extended payment plan, one is an existing customer on a payment plan with a current balance of $104,000, and the other $135,000 is an agreement for advertising still owed to us, which we anticipate using during 2005. The advertising agreement was a barter transaction, so this receivable will not directly generate cash. However, it will allow us to generate advertising in the coming year without expending cash. In this barter transaction we transferred customized software to the customer in return for print advertising. Paragraph 2 of the Minutes of the 11/18/93 Meeting on EITF Issue 93-11 specifically refers to the transfer of non-monetary assets such as inventory in return for barter credits used to purchase goods and services such as advertising. Paragraph 7 of those Minutes states that it should be presumed that the fair value of the non-monetary asset exchanged is more clearly evident than the fair value of the barter credits received and that the barter credits should be reported at the fair value of the non-monetary asset exchanged. The software and customization was valued at the same price it would have been valued if it had been sold for cash, so no impairment was recorded before the asset was transferred. The revenue was recognized when the software was transferred to the customer in accordance with paragraph 8 of SOP 97-2, and a corresponding receivable for the barter credits was recorded at that time. The advertising expense will be recognized as the ads are placed. The value of any remaining barter credits will be reviewed at the end of each fiscal year for possible impairment, and any such impairment loss will be recorded at that time.

Investing activities used $16,000 for the year ended December 31, 2004, as compared to $1,000 for the comparable prior year period. The increase in the cash used for investing activities for the current period was due to the purchase of leasehold improvements associated with our office relocation (approximately $11,000) and the purchase of equipment to manufacture our new prepackaged products (approximately $5,000).

Financing activities provided $112,000 in cash for the year ended December 31, 2004, as compared to $152,000 for the comparable prior year period. The decrease in cash provided by financing activities was due a decrease in issuance of common stock for cash during the year ended 2004. During the year we issued 588,000 shares of common stock for gross proceeds of $112,000.

Management anticipates that our primary uses of cash in the next year will be allocated to continue to satisfy delinquent obligations and for general operating purposes. Our business strategy is to increase working capital by internal growth through the development of joint venture projects as discussed in the Business Strategy section above, continued hosting of our existing customers, sale of licenses for our Roswell products, maintenance of these licenses, and sales of our prepackaged products, as well as externally through the sale of potentially dilutive securities. We may also continue to incur debt as needed to meet our operating needs. In addition, we may be forced to issue additional equity compensation to employees and outside consultants to meet payroll and pay for needed legal and other services.

At December 31, 2004, we had an outstanding balance on a line of credit with Los Alamos National Bank (LANB) which was originally due on July 24, 2002. The outstanding principal amount due at that date was $300,000, plus interest of $10,545. We negotiated a three month extension on the repayment of the outstanding balance of the line of credit by reducing the principal amount of the debt with the payment of $50,000 and the payment of the interest due on July 24, 2002. We were able to negotiate an extension of the amount due on the line of credit until April 24, 2003, by paying $25,000 of the principal amount due and $4,555 in interest due at October 24, 2002. On April 24, 2003, we paid $12,224 of principal and $12,768 of interest, and we negotiated another six-month extension to October 20, 2003. On October 20, 2003 we negotiated an extension of the amount due until April 23, 2004 by paying $25,000 in principal and $7,500 in interest. On March 27, 2004, we received a letter from LANB extending the note until October 15, 2004, with payment of $25,000 of principal and approximately $6,000 of interest due on April 15, 2004. On April 5, 2004, we paid the $25,000 of principal and $6,000 of interest as agreed. On October 4, 2004, we received a letter from LANB extending the note until April 15, 2005 upon payment of $25,000 of principal and approximately $6,000 of interest, which we paid on October 8, 2004. The outstanding principal balance was $138,168 at December 31, 2004. The company has the necessary cash to continue to reduce the note under these circumstances. Our inability to retire this debt, negotiate an extension of the payment amount and/or date, or obtain an alternative loan would likely have a material negative impact on our business, and could impair our ability to continue operations if the bank foreclosed on the note. However, the bank has continued to extend the note six months at a time, providing we pay an agreed-upon amount of principal and interest at the time of the extension. We believe that LANB will continue to work with us in this manner.

We do not currently have material commitments for capital expenditures and do not anticipate entering into any such commitments during the next twelve months. Our current commitments consist primarily of lease obligations for office space.

Management anticipates that the capital requirements for operations for the next twelve months will be approximately $1,500,000 - $1,800,000, based on cash flow projections. The company currently has contracts which provide for recurring revenues of approximately $700,000 over the next twelve months. Although one annual contract for software maintenance for 2005 was prepaid at the end of 2004, the remaining software maintenance contracts provide a monthly cash flow of approximately $45,000. Based on the prior two years licensing and custom programming revenue, we can expect these services to generate an additional $250,000 - $350,000 over the next twelve months. We have four projects in process (combined maintenance and custom programming) that will generate additional cash flow of approximately $30,000 per month plus initial custom programming fees of approximately $300,000. We anticipate that new clients and our new products will provide the remaining necessary cash flow for the next year.

We have received a non-binding letter of intent from a fiduciary trust, In God We Trust, to invest up to $500,000 in the company through December 31, 2005. These funds, if made available, would provide additional working capital necessary for operations over the next twelve months and to retire long-term debt and past-due payroll taxes. The letter of intent does not require the investor to fund. To date, we have not received any financing from this investor. However, we have had a long-term relationship with this investor and believe that the investor has the willingness and wherewithal to provide funds should our cash requirements exceed our abilities to generate cash elsewhere. Through a combination of increased marketing efforts and continued reduction of expenses, management anticipates positive working cash flow during 2005.

ITEM 7. FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and Board

of NMXS.com, Inc.:

We have audited the accompanying consolidated balance sheet of NMSX.com, Inc. and subsidiaries as of December 31, 2004 and the related statements of operations, stockholders equity and cash flows for the year then ended. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of NMXS.com, Inc. and subsidiaries as of December 31, 2004, and the consolidated results of its operations and cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ Epstein, Weber & Conover, PLC

Scottsdale, Arizona

April 13, 2005

NMXS.com, Inc. and Subsidiaries

Consolidated Balance Sheets

(Rounded to the nearest thousand)

	December 31, 2004	2003
Assets		
Current assets:		
Cash and equivalents	$ (11,000)	$ 11,000
Accounts receivable, net	433,000	450,000
Inventory	7,000	3,000
Prepaid expenses and other assets	26,000	21,000
Officer advances	-	-
Total current assets	455,000	485,000
Furniture, equipment and improvements, net	85,000	141,000
Security deposits	11,000	39,000
Goodwill, net	-	75,000
	$ 551,000	$ 740,000
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 111,000	$ 122,000
Accrued expenses	448,000	465,000
Deferred revenue	86,000	70,000
Subscriptions payable	130,000	-
Notes payable	276,000	276,000
Total current liabilities	1,051,000	933,000
Stockholders' equity:		
Preferred stock, $0.001 par value, 500,000 shares authorized, 135 and 135 shares issued and outstanding as of 12/31/04 and 12/31/03, respectively	-	-
Common stock, $0.001 par value, 50,000,000 shares authorized, 32,834,458 and 29,392,256 shares issued and outstanding as of 12/31/04 and 12/31/03, respectively	33,000	29,000
Additional paid-in capital	9,279,000	8,861,000
Deferred compensation	(161,000)	(135,000)
Accumulated (deficit)	(9,651,000)	(8,948,000)
Total stockholders' equity	(500,000)	(193,000)
	$ 551,000	$ 740,000

The accompanying notes are an integral part of these financial statements

30

NMXS.com, Inc. and Subsidiaries

Consolidated Statements of Operations

(Rounded to the nearest thousand)

	For the years ended December 31, 2004	2003
Revenue		
Software sales and maintenance	$ 572,000	$ 841,000
Custom programming	63,000	224,000
License fees	142,000	60,000
Scanning services	181,000	168,000
Other	60,000	7,000
	1,018,000	1,300,000
Operating costs and expenses:		
Cost of services	374,000	330,000
General and administrative	992,000	1,678,000
Research and development	207,000	112,000
Impairment of goodwill	75,000	-
Total operating costs and expenses	1,648,000	2,120,000
Net operating (loss)	(630,000)	(820,000)
Other income (expense):		
Interest income	-	-
Interest (expense)	(73,000)	(64,000)
(Loss) on disposal of fixed assets	-	-
Total other income (expense)	(73,000)	(64,000)
Net (loss)	$ (703,000)	$ (884,000)
Weighted average number of common shares outstanding - basic and fully diluted	30,744,304	26,794,295
Net (loss) per share - basic and fully diluted	$ (0.02)	$ (0.03)

The accompanying notes are an integral part of these financial statements

NMXS.com, Inc. and Subsidiaries

Consolidated Statements of Stockholders Equity

(Rounded to the nearest thousand)

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Deferred Compensation	Accumulated (Deficit)	Total Stockholders Equity
Balance, December 31, 2002			24,757,726	25,000	8,184,000		(8,064,000)	145,000
Issuance of common stock for salaries			590,076		89,000			89,000
Issuance of common stock for services			1,016,954	1,000	102,000			103,000
Issuance of options for services					83,000			83,000
Issuance of common stock for services to be rendered			2,750,000	3,000	162,000	(165,000)		
Issuance of warrants for services					67,000			67,000
Issuance of preferred stock for cash	135				135,000			135,000
Compensation expense						30,000		30,000
Issuance of common stock for cash			250,000		28,000			28,000
Issuance of common stock for bonuses			27,500		11,000			11,000
Net (loss) For the year ended December 31, 2003							(884,000)	(884,000)
Balance, December 31, 2003	135	$	29,392,256	$ 29,000	$ 8,861,000	$ (135,000)	$ (8,948,000)	$ (193,000)
Issuance of common stock								

for services	90,000	22,000	22,000

32

NMXS.com, Inc. and Subsidiaries

Consolidated Statements of Stockholders Equity

(Rounded to the nearest thousand)

Continued

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Deferred Compensation	Accumulated (Deficit)	Total Stockholders Equity
Issuance of common stock for services to be rendered			1,425,000	1,000	85,000	(86,000)		
Cash received for exercise of warrants								
Compensation earned						60,000		60,000
Cancellation of common stock for bonus correction			(22,500)		(9,000)			(9,000)
Issuance of common stock for cash			243,000	1,000	60,000			61,000
Issuance of common stock for exercise of warrants/options			345,000	1,000	50,000			51,000
Issuance of common stock for cashless exercise of warrants			309,000					
Issuance of common stock for salaries			1,052,702	1,000	210,000			211,000
Common stock issuable for services								
Net (loss) For the year ended December 31, 2004							(703,000)	(703,000)
	135	$	32,834,458	$ 33,000	$ 9,279,000	$ (161,000)	$ (9,651,000)	$ (500,000)

The accompanying notes are an integral part of these financial statements

NMXS.com, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Rounded to the nearest thousand)

	For the years ended December 31, 2004	2003
Cash flows from operating activities		
Net (loss)	$(703,000)	$(884,000)
Adjustments to reconcile net (loss) to net cash provided (used) by operating activities:		
Common stock issued for salaries	211,000	89,000
Common stock issued for services	82,000	133,000
Common stock issued/(cancelled) for bonuses	(9,000)	11,000
Stock options issued for services	-	83,000
Warrants issued for services	-	67,000
Depreciation and amortization	72,000	86,000
Impairment of goodwill	75,000	-
Changes in operating assets and liabilities:		
Accounts receivable	17,000	193,000
Inventory	(4,000)	(3,000)
Prepaid expenses and other assets	(5,000)	21,000
Officer advances	-	1,000
Security deposits	28,000	-
Accounts payable	(11,000)	(193,000)
Accrued expenses	(17,000)	147,000
Subscriptions payable	130,000	-
Deferred revenue	16,000	70,000
Net cash (used) by operating activities	(118,000)	(179,000)
Cash flows from investing activities		
Acquisition of fixed assets	(16,000)	(1,000)
Net cash (used) by investing activities	(16,000)	(1,000)
Cash flows from financing activities		
Proceeds from notes payable	50,000	33,000
Repayment of note payable	(50,000)	(44,000)
Net proceeds from the issuance of preferred stock	-	135,000
Net proceeds from the issuance of common stock	61,000	28,000
Net proceeds from warrants/options exercised	51,000	-
Net cash provided by financing activities	112,000	152,000
Net (decrease) in cash equivalents	(22,000)	(28,000)
Cash equivalents - beginning	11,000	39,000
Cash equivalents - ending	$(11,000)	$11,000

Supplemental disclosures:

The accompanying notes are an integral part of these financial statements

34

NOTE A - ORGANIZATION AND OPERATIONS

NMXS.com, Inc. and its wholly-owned subsidiaries New Mexico Software, Inc. ("NMS") and Working Knowledge, Inc. ("WKI") (collectively "the Company"), each operating as a business segment that develop and market proprietary internet technology-based software for the management of digital high- resolution graphic images, video clips and audio recordings. The Company believes that its software has applications for the media, advertising, publishing, medical, entertainment, e-commerce and university markets.

In August 1999, the Company effected a reverse merger in which NMXS.com, Inc. acquired all of the outstanding common stock of NMS.

NMS, a New Mexico corporation, was formed in April 1996. NMS develops and markets proprietary internet technology-based software.

During April 2000, the Company purchased 100% of the capital stock of WKI, a Kansas corporation located in California, for a total price of $152,000. The business combination has been accounted for using the purchase method. Tangible assets purchased were of nominal value. WKI provides services which are necessary to prepare, enter, and maintain the customer's data on the Company's digital asset management system. The Company recorded goodwill of $150,000 in connection with the acquisition.

The Company has received a non-binding letter of intent from a fiduciary trust, In God We Trust, to invest up to $500,000 in the Company through December 31, 2005. These funds, if made available, would provide additional working capital necessary for operations over the next twelve months and to retire long-term debt and past-due payroll taxes. Subsequent to December 31, 2004, the investor has placed $150,000 in escrow subject to clearance of a registration by state securities regulators The Company has had a long-term relationship with this investor and believe that the investor has the willingness and wherewithal to provide funds should our cash requirements exceed our abilities to generate cash elsewhere.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

[1] Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All material inter-company accounts and transactions have been eliminated.

[2] Revenue recognition:

Our revenues are generally classified into three main categories: software license revenue, custom software development revenue, and maintenance and hosting revenue.The Company recognizes revenue in accordance with Statement of Position 97-2 Software Revenue Recognition .

Revenue from proprietary software sales that does not require further commitment from the company is recognized upon shipment. These sales are generally direct purchases of a software product and there is no other involvement by the Company.

The Company offers with certain sales of its software products a software maintenance, upgrade and support arrangement. These contracts may be elements in a multiple-element arrangement or may be sold in a stand-alone basis. Revenues from maintenance and support services are recognized ratably on a straight-line basis over the term that the maintenance service is provided. Maintenance contracts typically provide for 12-month terms with maintenance contracts. The Company typically charges 17% to 21% of the software purchase price for a 12-month contract with discounts available for longer-term agreements. Charges for hosting are likewise spread ratably over the term of the hosting agreement, with

NMXS.com, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

the typical hosting agreement having a term of 12 months, with renewal on an annual basis.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Should the sale of its software involve an arrangement with multiple elements (for example, the sale of a software license along with the sale of maintenance and support to be delivered over the contract period), the Company allocates revenue to each component of the arrangement using the residual value method based on the fair value of the undelivered elements. The fair value of the separate elements is determined from vendor-specific objective evidence (VSOE), which is based on the price charged for each element when it is sold separately. The Company defers revenue from the arrangement equivalent to the fair value of the undelivered elements and recognizes the remaining amount at the time of the delivery of the product or when all other revenue recognition criteria have been met.

For contracts and revenues related exclusively to custom software development services, the Company recognizes revenue and profit as work progresses on custom content service contracts using the percentage-of-completion method. This method relies on estimates of total expected contract revenue and costs as each job progresses throughout the relevant contract period. The Company follows this method since reasonably dependable estimates of the costs applicable to various stages of a custom content service contract can be made.

From time to time, the Company effects sales of its enterprise-level software in return for barter credits for advertising. The software is valued at the same price it would have been valued if it had been sold for cash. The revenue is recognized when the software is transferred to the customer, along with a corresponding receivable for the barter credits. The advertising expense is recognized as the ads are placed. The value of any remaining barter credits is reviewed at the end of each fiscal year for possible impairment, and any such impairment loss is recorded at that time. During the fiscal year ended December 31, 2004, the Company recognized $135,000 in revenue from barter transactions. At December 31, 2004, the Company had $135,000 in barter credits receivable.

The Company also derives revenue from the sale of third party hardware and software. Revenue from installation, training and consulting services is recognized when the services are rendered.

Amounts collected prior to satisfying the above revenue recognition criteria are included in deferred revenue.

Due to uncertainties inherent in the estimation process it is at least reasonably possible that completion costs for contracts in progress will be further revised in the near- term.

The cost of services, consisting of staff payroll, outside services, equipment rental, communication costs and supplies, is expensed as incurred.

[3] Cash and cash equivalents:

The Company considers all highly liquid instruments purchased with a maturity of three months or less to be cash equivalents.

[4] Inventory:

Inventory, which is composed of component parts and finished goods, is valued at cost on a specific identity basis for those items with serial numbers. The remainder of the inventory is valued at the lower of first-in-first-out (FIFO) cost or market. On a quarterly basis, management compares the inventory on hand with our records to determine whether write-downs for excess or obsolete inventory are required.

NMXS.com, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[5] Furniture, equipment and improvements:

Furniture, equipment and improvements are recorded at cost. The cost of maintenance and repairs is charged against results of operations as incurred. Depreciation is charged against results of operations using the straight-line method over the estimated economic useful life. Leasehold improvements are amortized on a straight-line basis over the life of the related lease.

[6] Income taxes:

The Company recognizes deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax liabilities and assets are determined on the basis of the differences between the tax basis of assets and liabilities and their respective financial reporting amount ("temporary differences") at enacted tax rates in effect for the years in which the differences are expected to reverse.

[7] Per share data:

The basic and diluted per share data has been computed on the basis of the net loss available to common stockholders for the period divided by the historic weighted average number of shares of common stock. All potentially dilutive securities have been excluded from the computations since they would be antidilutive, however, these dilutive securities could potentially dilute earnings per share in the future. Options and warrants exercisable for 5,865,092 shares of common stock have been excluded from the diluted loss per share calculation for the year ended December 31, 2004, because inclusion of such would be antidilutive.

[8] Research and development expenses:

Costs of research and development activities are expensed as incurred.

[9] Advertising expenses:

The Company expenses advertising costs which consist primarily of direct mailings, promotional items and print media, as incurred. Advertising expenses amounted to $33,000 and $188,000 for the years ended December 31, 2004 and 2003, respectively.

[10] Use of estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

[11] Stock-based compensation:

Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123") allows companies to either expense the estimated fair value of stock options and warrants, or to continue following the intrinsic value method set forth in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") but disclose the pro forma effects on net loss had the fair value of the options and warrants been expensed. The Company has elected to apply APB 25 in accounting for grants to employees under its stock based incentive plans. Equity instruments issued to non-employees are measured based on their fair values.

NMXS.com, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[11] Stock-based compensation: (Continued)

Statement of Financial Accounting Standards No. 148 Accounting for Stock-Based Compensation Transition and Disclosure (SFAS 148) provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation.

Series A convertible preferred stock:

The Series A convertible preferred shares are convertible at any time by the shareholder at a rate equal to 70% of the average bid price of the common stock on the conversion date, at a minimum of $0.05 and a maximum of $.25 per share. The Series A convertible preferred stock has no preference with respect to dividends declared by New Mexico Software.

During the year ended December 31, 2003, the Company effected the following preferred convertible stock transactions:

The Company received a total of $135,000 from four individuals to purchase 135 shares of the Company s $0.001 par value preferred stock. As of August 31, 2003, the Company closed the preferred stock offering and all of the shareholders have received their preferred stock.

During the year ended December 31, 2004, the Company effected no transactions involving preferred convertible stock.

Common stock:

During the year ended December 31, 2003, the Company effected the following stock transactions:

The Company issued a total of 590,076 shares of its $0.001 par value common stock to its employees in lieu of salary which was valued at $89,000.

The Company issued a total of 1,016,954 shares of its $0.001 par value common stock to independent contractors for services rendered which were valued at $103,000.

The Company issued 250,000 shares of its $0.001 par value common stock to a director of the Company for a cash payment of $28,000.

The Company issued a total of 27,500 shares of its $0.001 par value common stock to its employees as bonuses which were valued at $11,000. The Company issued 22,500 shares in error to an employee and the shares will be returned to the Company in 2004, the amount is considered due from employee in the amount of $9,000.

The Company issued a total of 2,750,000 shares of its $0.001 par value common stock to Brian McGowan as part of a five-year consulting agreement in the amount of $165,000. The amount is considered deferred compensation. During the year ended December 31, 2003, $30,000 of the compensation was earned.

During the year ended December 31, 2004, the Company effected the following stock transactions:

The Company issued a total of 1,052,702 shares of the Company s $0.001 par value common stock to employees in lieu of salary and bonuses which were valued at $211,000.

NMXS.com, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[11] Stock-based compensation: (Continued)

The Company issued a total of 1,425,000 shares of its $0.001 par value common stock to Brian McGowan of the Company as part of a five-year consulting agreement in the amount of $86,000. The amount is considered deferred compensation. During the year ended December 31, 2004, $60,000 of the compensation was earned.

The Company issued a total of 90,000 shares the Company s $0.001 par value common stock to outside contractors in exchange for services rendered of $22,000.

The Company cancelled 22,500 shares of its $0.001 par value common stock that was erroneously issued to an employee as a bonus on December 10, 2003.

The Company issued a total of 243,000 shares of the Company s $0.001 par value common stock in exchange for cash of $61,000.

The Company issued a total of 345,000 shares of the Company s $0.001 par value common stock which were related to the exercise of options/warrants in exchange for $51,000 cash.

The Company issued a total of 309,000 shares of its $0.001 par value common stock to First Mirage for the cashless exercise of warrants. In return for the shares, First Mirage agreed to surrender 170,483 of their remaining warrants which were valued at $25,000. The Company originally issued 1,000,000 warrants to First Mirage in August 2003; therefore, First Mirage retains a total of 520,517 warrants as of December 31, 2004.

Commons stock issued in these noncash transactions are valued at the trading price of the Company s shares at the time the agreements are entered into.

Warrants:

During the year ended December 31, 2003, the Company effected the following transactions:

The Company issued 1,000,000 warrants to First Mirage (FM) at the rate of one warrant for each common share. The warrants have an exercise price of $0.08 per share and a five-year contractual life from date of issuance. The fair value of the warrants has been estimated on the date of grant using the Black-Scholes option pricing model. The weighted average fair value of these warrants was $0.06. The following assumptions were used in computing the fair value of these warrants: weighted average risk-free interest rate of 3.35%, zero dividend yield, volatility of the Company's common stock of 181% and an expected life of the warrants of five years. Approximately $67,000 of expense was included in the statement of operations for the year ended December 31, 2003.

During the year ended December 31, 2004 there were no warrants issued and 664,483 warrants exercised. These warrants were exercised on a cashless basis resulting in 309,000 shares being issued in the transaction.

The following is a summary of warrants outstanding as of December 31, 2004:

Number of Warrants	Exercise Price	Expiration Date
1,161,545	$0.21	July 24, 2012
520,517	$0.08	August 29, 2008

NMXS.com, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[11] Stock-based compensation: (Continued)

Stock options:

In 1999 the Company adopted a Stock Option Plan which permits the grant of options exercisable for shares of common stock to corporate officers, directors, employees, and consultants upon such terms, including exercise price and conditions and timing of exercise, as may be determined by the Board of Directors. The plan authorizes the grants of awards up to a maximum of 3,000,000 shares of common stock. In 2002, the Company granted 352,686 stock options under the plan. In 2003, the Company granted 2,603,475 stock options under the plan. In 2004, the Company granted no stock options under the plan. At December 31, 2004, 2,993,030 options remained outstanding and unexercised. Of these outstanding options, 2,288,697 had vested.

In 2001 the Company adopted a Stock Issuance Plan. The plan as amended permits the grant of shares of common stock to employees, non-employee members of the board, and consultants and other independent advisors who provide services to the Company, upon such terms and conditions as may be determined by the Board of Directors. The plan as amended authorizes the grants of awards up to a maximum of 5,700,000. In 2003 the Company granted 4,069,530 shares under the plan. At December 31, 2004, an aggregate of 5,518,973 shares had been granted under the plan, all of which were fully vested upon issuance.

In 2004 the Company adopted a new Stock Issuance Plan. The plan permits the grant of shares of common stock to employees, non-employee members of the board, and consultants and other independent advisors who provide services to the Company, upon such terms and conditions as may be determined by the Board of Directors. The plan authorizes the grants of awards up to a maximum of 3,000,000. In 2004 the Company granted 2,203,712 shares under the plan. At December 31, 2004, an aggregate of 2,203,712 shares had been granted under the plan, all of which were fully vested upon issuance.

Disclosures required by Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), including pro forma operating results had the Company prepared its financial statements in accordance with the fair value based method of accounting for stock- based compensation prescribed therein are shown below. Exercise prices and weighted-average contractual lives of stock options outstanding as of December 31, 2004 are as follows:

Options Outstanding		Options Exercisable	
	Weighted Average	Weighted Average	Weighted Average
Exercise Prices		Exercise Prices	Exercise Price

	Number Outstanding	Remaining Contractual Life		Number Exercisable	
$0.05-$0.30	3,963,030	6.11	$0.06	3,258,697	$0.06
$0.31-$0.50	160,000	4.38	$0.36	160,000	$0.36
$0.54-$0.83	60,000	1.33	$0.61	60,000	$0.61

40

NMXS.com, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[11] Stock-based compensation: (Continued)

Summary of Options Granted and Outstanding:

	For the Years Ended December 31,			
	2004		2003	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Options:				
Outstanding at beginning of year	6,042,824	$0.09	4,136,921	$0.37
Granted	-	$ -	3,933,920	$0.06
Cancelled	(1,699,794)	$0.10	(2,028,017)	$0.60
Exercised	(160,000)	$0.08	0	
Outstanding at end of year	4,183,030	$0.08	6,042,824	$0.09

During the year ended December 31, 2003, the Company granted the following stock options:

The Company granted 200,000 stock options to employees with an exercise price of $0.06, equal to the fair value of the common stock, with a contractual life of ten years and a two year vesting period, 50% at the end of each one year period from the date of grant. The fair value of the options has been estimated on the date of grant using the Black-Scholes option pricing model. The weighted average fair value of these options was $0.04. The following assumptions were used in computing the fair value of these option grants: weighted average risk-free interest rate of 4.00%, zero dividend yield, volatility of the Company's common stock of 163% and an expected life of the options of ten years.

The Company granted 1,000,000 stock options to the Company s legal counsel, with an exercise price of $0.06, equal to the fair value of the common stock, with a contractual life of ten years and the options vest immediately. The fair value of the options has been estimated on the date of grant using the Black-Scholes option pricing model. The weighted average fair value of these options was $0.03. The following assumptions were used in computing the fair value of these option grants: weighted average risk-free interest rate of 5.84%, zero dividend yield, volatility of the Company's common stock of 177%, and an expected life of the options of ten years. Approximately $65,000 of expense was included in the statement of operations for the year ended December 31, 2003.

The Company granted 713,475 stock options to employees with an exercise price of $0.06, equal to the fair value of the common stock, with a contractual life of ten years and a two year vesting period, 50% at the end of each one year period from the date of grant. The fair value of the options has been estimated on the date of grant using the Black-Scholes option pricing model. The weighted average fair value of these options was $0.04. The following assumptions were used in computing the fair value of these option grants: weighted average risk-free interest rate of 4.27%, zero dividend yield, volatility of the Company's common stock of 181% and an expected life of the options of ten years.

The Company granted 500,000 stock options to a director with an exercise price of $0.06, equal to the fair value of the common stock, with a contractual life of ten years and a two year vesting period, 50% at the end of each one year period from the date of grant. The fair value of the options has been estimated on the date of grant using the Black-Scholes option pricing model. The weighted average fair value of these

NMXS.com, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[11] Stock-based compensation: (Continued)

options was $0.04. The following assumptions were used in computing the fair value of these option grants: weighted average risk-free interest rate of 4.09%, zero dividend yield, volatility of the Company's common stock of 182% and an expected life of the options of ten years.

The Company granted 60,000 stock options to a contractor with an exercise price of $0.11, equal to the fair value of the common stock, with a contractual life of five years and the options vest immediately. The fair value of the options has been estimated on the date of grant using the Black-Scholes option pricing model. The weighted average fair value of these options was $0.09. The following assumptions were used in computing the fair value of these option grants: weighted average risk-free interest rate of 4.23%, zero dividend yield, volatility of the Company's common stock of 184% and an expected life of the options of five years.

The Company granted 130,000 stock options to an independent contractor for consulting services, with an exercise price of $0.09, equal to the fair value of the common stock, with a contractual life of five years and the options vest immediately. The fair value of the options has been estimated on the date of grant using the Black-Scholes option pricing model. The weighted average fair value of these options was $0.07. The following assumptions were used in computing the fair value of these option grants: weighted average risk-free interest rate of 4.27%, zero dividend yield, volatility of the Company's common stock of 181%, and an expected life of the options of five years. Approximately $10,500 of expense was included in the statement of operations for the year ended December 31, 2003.

During the year ended December 31, 2004, the Company granted no stock options.

The following table summarizes the pro forma operating results of the Company for December 31, 2004 and 2003 had compensation costs for the stock options granted to employees been determined in accordance with the fair value based method of accounting for stock based compensation as prescribed by SFAS No. 123.

	2004	2003
Net (loss) as reported	($703,000)	($884,000)
Pro forma effects of stock-based compensation	(30,000)	(195,000)
Net (loss) pro forma	($733,000)	($1,079,000)
(Loss) per share as reported	($0.02)	($0.03)
Pro forma effects of stock-based compensation	-	($0.01)
(Loss) per share pro forma	($0.02)	($0.04)

As of December 31, 2004, the Company has reserved 1,000,000 shares of its common stock for issuance upon exercise of stock options and warrants.

[12] Software development:

The Company accounts for computer software development costs in accordance with Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed". As such, all costs incurred prior to the product achieving technological feasibility are expensed as research and development costs. Technological feasibility is generally achieved upon satisfactory beta test results. Upon achieving technological feasibility, programming costs are capitalized and amortized over the economic useful live which is estimated to be two years. There were no capitalized software development costs as of December 31, 2004 and 2003.

NMXS.com, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[13] Goodwill:

The Financial Accounting Standards Board ("FASB") recently issued Statements of Financial Accounting Standards Nos. 141 "Business Combinations", 142 "Goodwill and Other Intangible Assets" and 144 "Accounting for the Impairment or Disposal of Long-Lived Assets". ("SFAS 141", "SFAS 142" and "SFAS 144"). All of these pronouncements are effective for fiscal years beginning after December 31, 2001. Under SFAS 141, a company must use the purchase method of accounting for all business acquisitions. SFAS 142 requires a company to periodically evaluate for impairment (as opposed to amortize) goodwill and intangible assets.

Goodwill resulting from the acquisition of Working Knowledge, Inc., accounted for as a purchase, was being amortized on a straight-line basis over 5 years through December 31, 2001. The Company adopted SFAS No. 142 effective January 1, 2002 and as such, has tested the goodwill balance for impairment at least on an annual basis. Such analysis has been based upon the expected future cash flows of Working Knowledge, Inc. In December 2004, based upon the Company s impairment analysis, the remainder of the goodwill was written off; therefore, there was $75,000 and $0 as impairment of goodwill as of December 31, 2004 and 2003.

[14] Recent pronouncements:

In November 2002, the FASB issued FASB Interpretation (FIN) No. 45, Guarantors Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees and Indebtedness of Others , an interpretation of FIN No. 5, 57 and 107, and rescission of FIN No. 34, Disclosure of Indirect Guarantees of Indebtedness of Others . FIN 45 elaborates on the disclosures to be made by the guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also requires that a guarantor recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The initial recognition and measurement provisions of this interpretation are applicable on a prospective basis to guarantees issued or modified after December 31, 2002; while, the provisions of the disclosure requirements are effective for financial statements of interim or annual periods ending after December 15, 2002. The company believes that the adoption of such interpretation will not have a material impact on its financial position or results of operations and has adopted such interpretation during fiscal year 2003, as required.

In January 2003, the FASB issued FIN No. 46, Consolidation of Variable Interest Entities , an interpretation of Accounting Research Bulletin No. 51. FIN No. 46 requires that variable interest entities be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity s activities or is entitled to receive a majority of the entity s residual returns or both. FIN No. 46 also requires disclosures about variable interest entities that companies are not required to consolidate but in which a company has a significant variable interest. The consolidation requirements of FIN No. 46 will apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements will apply to entities established prior to January 31, 2003 in the first fiscal year or interim period beginning after June 15, 2003. The disclosure requirements will apply in all financial statements issued after January 31, 2003. The company will begin to adopt the provisions of FIN No. 46 during the first quarter of fiscal 2003 and the Company believes that the adoption of such interpretation will not have a material impact on its financial position or results of operations.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity. SFAS No. 150 changes the classification in the statement of financial position of certain common financial instruments from either equity or mezzanine presentation to liabilities and requires an issuer of those financial statements to recognize changes in fair value or redemption amount, as applicable, in earnings. SFAS No. 150 is effective for financial instruments

NMXS.com, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[14] Recent pronouncements: (Continued)

entered into or modified after May 31, 2003, and with one exception, is effective at the beginning of the first interim period beginning after June 15, 2003. The effect of adopting SFAS No. 150 will be recognized as a cumulative effect of an accounting change as of the beginning of the period of adoption. Restatement of prior periods is not permitted. SFAS No. 150 did not have any impact on the Company s financial position or results of operations.

In December 2004 the FASB issued a revised Statement 123 (SFAS 123R), "Accounting for Stock-Based Compensation" requiring public entities to measure the cost of employee services received in exchange for an award of equity instruments based on grant date fair value. The cost will be recognized over the period during which an employee is required to provide service in exchange for the award -- usually the vesting period. The effective date for this statement is as of the first interim period that begins after June 15, 2005. The Company is evaluating the impact of this new pronouncement and has not yet estimated the effect of implementation on the Company's financial statements.

NOTE C ACCOUNTS RECEIVABLE

During the year ended December 31, 2003, the Company elected to write off $500,000 of accounts receivable to bad debt due to one customer. The Company is no longer doing business with this customer.

NOTE D - FURNITURE, EQUIPMENT, AND IMPROVEMENTS

Furniture, equipment, and improvements as of December 31, 2004 consisted of the following:

Computers	$ 304,000
Furniture, fixtures and equipment	105,000
Automobiles	38,000
Leasehold improvements	18,000
	465,000
Accumulated depreciation	(380,000)
	$ 85,000

NOTE E - NOTE PAYABLE

During January 2001, the Company borrowed $300,000. The loan is collateralized by substantially all of the Company's assets and personally guaranteed by an officer of the Company. The note was renewed with a due date of July 24, 2002 at a current interest rate of 7%. On July 24, 2002, the Company paid $50,000 of principal and $10,525 of interest. The remaining $250,000 of principal was extended to October 24, 2002 at a current interest rate of 7%. On October 24, 2002 the Company paid $25,000 of principal and $4,555 of interest. The remaining $225,000 of principal was extended until April 24, 2003 at a current interest rate of 7%. On April 24, 2003, the Company paid $12,224 of principal and $12,768 of interest. The remaining $212,776 of principal was extended until October 15, 2003 at a current interest rate of 7%. On October 20, 2003, the Company has negotiated a payment of $25,000 in principal and $7,500 in interest and extended the note to April 23, 2004. As of December 31, 2003, the Company had a balance due of $188,000. On March 27, 2004, the Company received a notice from the bank to extend the note to October 15, 2004 upon payment of an additional $25,000 of principal and approximately $6,000 of accrued interest. On October 8, 2004, the Company paid $25,000 of principal and $6,000 of interest. The remaining $138,168 was extended until April 15, 2005. As of December 31, 2004, the Company had a balance due of $138,000 plus accrued interest of $2,000.

On April 22, 2002, the Company borrowed $50,000. The loan is due on April 23, 2003 at a current interest rate of 10% per annum. This note is secured by 500,000 shares of the Company s $0.001 par

NMXS.com, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE E - NOTE PAYABLE (CONTINUED)

value common stock. As of December 31, 2004, the Company is in default and is negotiating with the note holder. The lender filed a complaint for Breach of Contract on a Promissory Note against us on November 25, 2003 (see Note K for discussion of legal proceedings).

In April 2002, the Company borrowed $12,500. The loan is due on demand and bears no interest. As of December 31, 2004, the Company had a balance due of $12,500.

On March 1, 2003, the Company borrowed $25,000. The loan was due on September 30, 2003 at a current interest rate of 7% per annum until the due date and 18% per annum thereafter. On August 29, 2003, the note was extended to December 31, 2003. On December 31, 2003, the note was extended to April 15, 2004. On April 15, 2004, the note was extended to June 30, 2004. As of December 31, 2004, the Company had a balance due of $25,000, plus accrued interest of $5,000. On May 21, 2004, the Company borrowed an additional $50,000. The loan was due on demand at a current interest rate of 8% per annum. As of December 31, 2004, the total amount owed on the two loans was $82,000 of which $75,000 is principal and $7,000 is interest.

NOTE F - INCOME TAXES

The Company accounts for income taxes using the liability method, under which deferred tax liabilities and assets are determined based on the difference between the financial statement carrying amounts and the tax bases of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse.

As of December 31, 2004, the Company had net operating loss carryforwards of approximately $8,754,000, which expire in varying amounts between 2016 and 2024. Realization of this potential future tax benefit is dependent on generating sufficient taxable income prior to expiration of the loss carryforward. The deferred tax asset related to this potential future tax benefit has been offset by a valuation allowance in the same amount. The amount of the deferred tax asset ultimately realizable could be increased in the near term if estimates of future taxable income during the carryforward period are revised.

Deferred income tax assets of $3,501,600 and $24,000 at December 31, 2004 relate to the net operating loss carryforward and deferred compensation, respectively. The total deferred income tax asset of $3,525,600 is offset by an equal valuation allowance. The valuation allowance was increased by $286,800 in the year ended December 31, 2004.

The difference between the statutory federal income tax rate on the Company's pre-tax loss and the Company's effective income tax rate and the valuation allowance is summarized as follows:

	Rate	Valuation Allowance
Statutory federal and state income tax	(34.0%)	(287,600)
Increase in valuation allowance	34.0%	286,800
Other	0.0%	800
Effective income tax	0.0%	0

45

NMXS.com, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE G - RELATED PARTY TRANSACTIONS

Consulting agreement:

The Company entered into a consulting agreement with a stockholder to advise the CEO on business strategy and to formulate marketing ideas. The term of the employment agreement is for approximately five years commencing on July 1, 2003 and terminating on December 31, 2008. The shareholder will receive a total of 5,500,000 shares of the Company s $0.001 par value common stock valued at $330,000. As of December 31, 2004, the shareholder was paid a total of 4,175,000 shares of common stock, but he has earned only 1,500,000 shares and the difference of 2,675,000 shares is considered prepaid compensation. During the years ended December 31, 2004 and December 31, 2003, respectively, the Company has expensed $60,000 and $30,000 in consulting fees.

NOTE H - MAJOR CUSTOMERS

During the year ended December 31, 2004, five customers accounted for 55% of the Company's revenue. During the year ended December 31, 2003, seven customers accounted for 85% of the Company's revenue.

As of December 31, 2004, balances due from two customers comprised 50% of total accounts receivable. As of December 31, 2003, balances due from four customers comprised 75% of total accounts receivable.

NOTE I - REPORTABLE SEGMENTS

Management has identified the Company's reportable segments based on separate legal entities. NMS derives revenues from the development and marketing proprietary internet technology-based software and WKI provides data maintenance services related to NMS digital asset management system. Information related to the Company's reportable segments for 2004 is as follows:

	NMS	WKI	Total
Revenue	$982,000	$ 36,000	$1,018,000
Cost of services	335,000	39,000	374,000
General and administrative	826,000	166,000	992,000
Research and development	207,000	-	207,000

Impairment of goodwill	0	75,000	75,000
Operating income (loss)	(386,000)	(244,000)	(630,000)
Total assets	$528,000	$ 23,000	$ 551,000

WKI revenue consists primarily of software maintenance and scanning services.

A reconciliation of the segments' operating loss to the consolidated net loss/comprehensive loss is as follows:

Segment s operating loss	$ 630,000)
Other income (expense)	$ (73,000)
Consolidated net loss/comprehensive loss	$ (703,000)

Prior to acquisition of Working Knowledge, Inc., in April 2000, the Company operated within one business segment.

46

NMXS.com, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE I - REPORTABLE SEGMENTS (CONTINUED)

For the year ended December 31, 2004, amortization and depreciation expense amounted to $50,000 and $22,000 for NMS and WKI, respectively. Total fixed asset additions amounted to $16,000 and $0 for NMS and WKI, respectively.

For the year ended December 31, 2003, amortization and depreciation expense amounted to $62,000 and $24,000 for NMS and WKI, respectively. There were no fixed asset additions or disposals.

NOTE J COMMITMENTS AND CONTINGENCIES

Leases:

The Company leases office space in New Mexico and California expiring through April 30, 2009. The Company also leases copier equipment and one automobile. Future minimum lease payments as of December 31, 2004 are as follows:

Year	Amount
2005	92,000
2006	73,000
2007	60,000
2008	60,000
2009	20,000

Rent expense for the years ended December 31, 2004 and 2003 amounted to $85,000 and $124,000, respectively.

Employment agreement:

The Company entered into an employment and non-competition agreement with a stockholder to act in the capacity of President and Chief Executive Officer (CEO). The term of the employment agreement is for three years commencing on January 1, 2003. The agreement allows for a one-year renewal option unless terminated by either party. Base salary is $44,000 per annum with available additional cash compensation as defined in the agreement. Compensation under this agreement of $44,000 is included in general and administrative expenses for the year ended

December 31, 2004. The non-competition agreement commences upon the termination of the employment agreement for a period of one year. As of December 31, 2004, there was a total of $107,000 in accrued payroll for this executive.

Outstanding Payroll Taxes:

The Company has estimated unpaid Federal and State payroll taxes totaling $283,000 as of December 31, 2004, including estimated penalties and interest. The penalties and interest associated with this liability is estimated to be in excess of 20% of the total payroll taxes due, and the Company has accrued $75,000 in penalties and interest.

On June 1, 2003, the Company settled with the State of New Mexico and agreed to pay $1,000 per month of past due payroll taxes plus the current amount due. During the year ended December 31, 2004, the Company paid a total of $12,000 of past due payroll taxes.

On October 17, 2003, the Company settled with the IRS and agreed to pay $5,000 per month of past due payroll taxes plus the current amount due. During the year ended December 31, 2004, the Company paid a total of $65,000 of past due payroll taxes.

NMXS.com, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE K LEGAL PROCEEDINGS

Grossman Lawsuit: Kurt Paul Grossman and Ann Grossman filed a complaint for Breach of Contract on a Promissory Note against us on November 25, 2003, in the Superior Court of California, Orange County Division, case # 03CC14074. There was a question of whether the complaint was properly served and whether the California courts have jurisdiction over us. The Grossmans filed an Application for Writ of Attachment which was denied on January 30. The Grossmans asked for $55,000 ($50,000 on the promissory note plus $5,000 interest); $304.40 in costs; and $24,000 in attorney s fees. The Grossmans, through a separate entity, Doctors Telehealth Network, purchased software from us, and it has not been paid for. We filed a motion to quash the service of summons for lack of personal jurisdiction and to vacate a default judgment against us. The court tentatively ruled in favor of the Grossmans. However, after our oral argument on April 23, 2004, the court withdrew its tentative ruling and ruled in favor of us. Specifically, the court ruled that we do not have sufficient contact with California to warrant the exercise of personal jurisdiction. Based on this ruling, there is no action pending against us at this time.

Internal Revenue Service Payments: In October 2003 we entered into an interim agreement with the Internal Revenue Service concerning the repayment of federal tax deposits which we failed to pay for the six operating quarters ended September 30, 2003. We have agreed to pay $5,000 per month beginning November 1, 2003. During this interim period the IRS has agreed to withhold the filing of a federal tax lien. Consideration of filing a lien in the future will be based upon a determination of how long it may take to pay the taxes. Also, our failure to make timely federal tax deposits will default this interim agreement and necessitate the filing of the lien. Our unpaid tax returns for these quarters are being assessed by the IRS, and we expect to receive an assessment notice for each period upon completion of this assessment. We estimate that these assessments will total approximately $269,000, including penalties and interest.

Manhattan Scientifics Lawsuit: On March 9, 2004, our legal counsel received a letter from an attorney representing Manhattan Scientifics. The letter threatened litigation against us for alleged breach of contract and against Richard Govatski for alleged tortious interference with contract. This is based on the fact that we were alleged to have declined to honor Manhattan Scientifics request for a cashless exercise of 150,000 of our Common Stock Purchase Warrants (the Warrants) allegedly issued to Manhattan Scientifics. It is our position that the Warrants, among other things, were issued in a transaction that was not an arms-length transaction and therefore, the Warrants should be cancelled, and that in any event, the alleged cashless exercise was not properly done and itself is a nullity. In May 2004, Manhattan Scientifics filed a suit in Federal Court in New York against us and Mr. Govatski for damages in this matter. The case was dismissed by the Federal Court due to a lack of diversity jurisdiction. On June 25, 2004, we were served with a complaint filed in the Supreme Court of the State New York, County of New York, Index No. 601793/04, asserting the same claims. Manhattan Scientifics seeks damages against us for an alleged breach of contract for failure to allow the cashless exercise, in an amount of $1.5 million, and alleges a tortious interference claim against Mr. Govatski.

We served our Answer to the Complaint on August 16, 2004. Mr. Govatski is seeking dismissal of the claim against him for lack of personal jurisdiction and for failure to state a claim. Mr. Govatski s motion to dismiss has been fully submitted to the court, but has not yet been decided. Along with our Answer, we are asserting Counterclaims against Manhattan Scientifics for monies owed by Manhattan Scientifics and for a declaratory judgment, and against a former Company Director, Marvin Maslow for fraud and breach of fiduciary duty due to his persuading the Company to enter into the Warrant transaction with Manhattan Scientifics, which we contend was done for the benefit of Maslow and Manhattan Scientifics, and not for the benefit of the Company. We believe that due to the fact that Mr. Maslow and a second former Company director (Scott Bach), were also Directors of Manhattan Scientifics at the time of the transactions in dispute, and constituted two of the Company s three Directors at the time, Mr. Maslow and Mr. Bach should have excused themselves from participating in negotiating and voting on the issue of whether to approve the Warrants. Messrs. Maslow and Bach resigned as our Directors in December 2002. It is our position that such financial conflicts include Mr. Maslow s causing the Company to pay for

48

NMXS.com, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE K LEGAL PROCEEDINGS (CONTINUED)

third-party consulting services provided to Manhattan Scientifics, while stating that such services would be provided to, and were needed by, the Company as part of the transaction. It is our position that Mr. Maslow also misrepresented the fairness of the transaction in dispute at the time to us, which we contend was being done for the benefit of Mr. Maslow and Manhattan Scientifics, to the detriment of the Company In our counterclaims, we are seeking, among other relief, a determination that the Warrants should be declared null and void from inception, plus damages against Mr. Maslow. It is further our position that even if the Warrants were properly issued (we contend they were not), the Warrants were never properly exercised by Manhattan Scientifics. Manhattan Scientifics and Mr. Maslow have moved to dismiss certain of our Counterclaims alleged against them. That motion too has been fully submitted to the court, but not yet decided.

NOTE L SUBSEQUENT EVENTS

In March 2005, the Company received a demand for repayment of a note payable of $75,000 to First Mirage, Inc. An Officer of the Company had pledged 400,000 of his personal shares as collateral to secure the note. In order to effect settlement of the demand in the most expeditious manner, the Company and the Officer chose to surrender those shares as repayment of the loan and all accumulated interest. The Company will issue 400,000 shares of restricted stock to the Officer to replace the shares surrendered.

In September 2004, the Company received $25,000 from an investor to purchase common stock. The amount is included in subscriptions payable at December 31, 2004. In February 2005, the Company authorized an outside consultant to transfer 125,000 of his personal shares to the investor in order to satisfy the subscription payable in a timely manner. The Company will issue shares to the outside consultant at a rate to be determined to compensate him for the transferred shares.

During the first quarter of 2005, two preferred shareholders converted their preferred shares into common shares. The following table summarizes the conversion activity:

Preferred Shares	Preferred Value	Conversion Rate	Common Shares issued
10	$10,000.00	$0.25	40,000
30	30,000.00	0.05	600,000

49

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

During the two most recent fiscal years, there have been no disagreements with Beckstead and Watts, LLP, our independent auditor for the year ended December 31, 2003, nor with Epstein, Weber and Conover, PLC, our independent auditor for the year ended December 31, 2004 on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure.

ITEM 8A. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures

Our Chief Executive Officer and Chief Financial Officer (collectively the Certifying Officers) maintain a system of disclosure controls and procedures that are designed to ensure that information which is required to be disclosed by the Company in the reports that it files or submits under the Exchange Act (15 U.S.C. 78a et seq.) is recorded, processed, summarized and reported within the time periods specified in the Commission s rules and forms. Under the supervision and with the participation of management, as of December 31, 2004, the Certifying Officers evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule [13a-15(e)/15d-15(e)] under the Exchange Act). Furthermore, the Certifying Officers concluded that our disclosure controls and procedures in place were designed to ensure that information required to be disclosed by us, including our consolidated subsidiaries, in reports that we file or submit under the Exchange Act is (i) recorded, processed, summarized and reported on a timely basis in accordance with applicable Commission rules and regulations; (ii) accumulated and communicated to our management, including our Certifying Officers and other persons that perform similar functions, if any, to allow us to make timely decisions regarding required disclosure in our periodic filings.

Changes in internal controls

In connection with our evaluation of our internal controls during the period ended December 31, 2004, our Certifying Officers have not identified any material deficiencies or weaknesses or other factors that have materially affected or are reasonably likely to materially affect these controls, and therefore, we have not made any changes to these controls.

PART III

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS: COMPLIANCE WITH SECTION 16(A) OF THE EXCHANGE ACT

Our directors and officers, as of April 11, 2005, are set forth below. The directors hold office for their respective term and until their successors are duly elected and qualified. Vacancies in the existing board are filled by a majority vote of the remaining directors. The officers serve at the

will of the board of directors. The following is a biographical summary of our directors and officers:

Name	**Age**	**Position**	**Director Since**
Richard Govatski	60	Chairman, President & CEO	1999
Teresa B. Dickey	61	Director, Secretary & Treasurer	2003
John E. Handley	43	Director	2003

Set forth below is certain biographical information regarding our executive officers and directors:

RICHARD GOVATSKI has been the President of NMXS.com, Inc. since August 1999, and has been chairman, CEO, and President of New Mexico Software, Inc., since 1996. Mr. Govatski founded New Mexico Software in 1995 after identifying market inefficiencies in how intellectual property owners managed their image assets. Prior to New Mexico Software, Mr. Govatski spent 18 years in systems integration and publishing, both in sales management and software development. Mr. Govatski led the sales teams for Popular Electronics, Computer Shopper, Shutterbug, and MacWeek. Later he sold numerous solutions for vendors, including Kodak, Apple Computer, and Sun Microsystems. Mr. Govatski also spent several years in systems development as President of Media Publishing Group and built graphic applications for companies including Ferrari Color, Time Magazine, New York Daily News, and Getty Images. He received a Bachelor of Science Degree in Communications from Butler University, located in Indianapolis, Indiana in 1968.

TERESA B. DICKEY has been the Secretary/Treasurer of our company since August 1999. She became a member of our Board of Directors on December 19, 2002 and has held such position since such time. From 1988 until 1999 she was employed by Sandia National Laboratory as art director. Sandia National Laboratory is a U.S. Department of Energy national security laboratory. In 1964, Ms. Dickey received her Bachelor of Professional Arts from the Art Center College of Design in Pasadena, California.

JOHN E. HANDLEY has been our director since January 2003. He has been self-employed since September 2002 as a telecommunications consultant. From August 1987 until August 2002 he was employed, as an associate partner (from September 1997 until August 2000) and as a partner (September 2000 until August 2002), by Accenture LLP, a business and technology consulting and outsourcing company. He received his Bachelor of Arts degree in Psychology and Business from Roanoke College in 1983. Thereafter, he received his Masters in Business Administration from Virginia Tech in 1987.

CERTAIN LEGAL PROCEEDINGS

No director, nominee for director, or executive officer of the Company has appeared as a party in any legal proceeding material to an evaluation of his ability or integrity during the past five years.

Section 16(a) Beneficial Ownership Reporting Compliance

We have made all required filings for the fiscal year ended December 31, 2004.

ITEM 10. EXECUTIVE COMPENSATION

Compensation of Executive Officers

Summary Compensation Table. The following table sets forth information concerning the annual and long-term compensation awarded to, earned by, or paid to the named executive officer for all services rendered in all capacities to our company, or any of its subsidiaries, for the years ended December 31, 2004, 2003 and 2002:

SUMMARY COMPENSATION TABLE

		Annual Compensation			Long-Term Compensation	
Name and Principal Position	Year	Salary	Bonus	Other Annual Compensation	Restricted Stock Awards	Securities Underlying Options
Richard Govatski	2004	$44,000 (4)	-0-	$0	-0-	-0-
President and CEO	2003	$20,000 (3)	-0-	$0	-0-	-0-
	2002	$120,000 (1)	-0-	$3,600 (2)	-0-	-0-

(1) Mr. Govatski did not receive payment of any of his 2002 salary, but he did apply $26,000 of the amount of this payable toward the satisfaction of a like amount advanced by us to him in prior years. The remaining $94,000 has been booked as an account payable to him.

(2) Mr. Govatski is afforded the use of a company automobile.

(3) Mr. Govatski agreed to forgo most of his salary in 2003. In lieu thereof, Mr. Govatski received a salary of $20,000.

(4) Mr. Govatski agreed to forgo most of his salary in 2004. In lieu thereof, Mr. Govatski received a salary of $44,000.

Option Grants Table. The following table sets forth information concerning individual grants of stock options to purchase our common stock made to the executive officer named in the Summary Compensation Table during fiscal 2004.

OPTIONS GRANTS IN LAST FISCAL YEAR

(Individual Grants)

Name				Expiration date

	Number of securities underlying options granted (#)	Percent of total options granted to employees in last fiscal year	Exercise or base price ($/Share)	
Richard Govatski	-0-	N/A	N/A	N/A

52

Aggregated Option Exercises and Fiscal Year-End Option Value Table. The following table sets forth certain information regarding stock options exercised during fiscal 2004 and held as of December 31, 2004, by the executive officer named in the Summary Compensation Table.

AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR AND FISCAL YEAR-END OPTION VALUES

Name	Shares acquired on exercise (#)	Value realized ($)	Number of securities underlying unexercised options at fiscal year-end (#) Exercisable/Unexercisable	Value of unexercised in-the-money options at fiscal year-end ($) (1) Exercisable/Unexercisable
Richard Govatski	-0-	N/A	500,000/0	$55,000/$0 (2)

(1) Value is based on the closing sale price of the Common Stock on December 31, 2004, the last trading day of fiscal 2004 ($0.17), less the applicable option exercise price.

(2) Of these options, 500,000 were exercisable at $0.06 per share.

Employment Contracts

The Company entered into an employment and non-competition agreement with Mr. Govatski to act in the capacity of President and Chief Executive Officer (CEO). The term of the employment agreement is for three years commencing on January 1, 2003. The agreement allows for a one-year renewal option unless terminated by either party. Base salary is $44,000 per annum with available additional cash compensation as defined in the agreement. The non-competition agreement commences upon the termination of the employment agreement for a period of one year.

Compensation of Directors

Directors are permitted to receive fixed fees and other compensation for their services to the company, but they are not permitted to receive compensation for their services as directors. The Board of Directors has the authority to fix the compensation of directors. No amounts have been paid to, or accrued to, directors in such capacity.

Stock Option and Stock Issuance Plans

Our 1999 Stock Option Plan permits the grant of options exercisable for shares of our common stock to corporate officers, directors, employees, and consultants upon such terms, including exercise price and conditions and timing of exercise, as may be determined by the Board of Directors. The plan authorizes the grants of awards up to a maximum of 3,000,000 shares of our common stock. In 2002, we granted 352,686 stock options under the plan. In 2003, we granted 2,603,475 stock options under the plan. In 2004, we granted no stock options under the plan. At December 31, 2004, 2,993,030 remained outstanding and unexercised. Of these outstanding options, 2,538,697 had vested.

Our 2001 Stock Issuance Plan, as amended, permits the grant of shares of our common stock to employees of our company and any of its subsidiaries, non-employee members of our board or non-employee members of the board of directors of any of our subsidiaries, and consultants and other independent advisors who provide services to us or any of our subsidiaries, upon such terms and conditions as may be determined by the Board of Directors. The plan as amended authorizes the grants of awards up to a maximum of 5,700,000. In 2003 we granted 4,069,530 shares under the plan. At December 31, 2004, an aggregate of 5,518,973 shares had been granted under the plan, all of which were fully vested upon issuance.

Our 2004 Stock Issuance Plan, permits the grant of shares of our common stock to employees of our company and any of its subsidiaries, non-employee members of our board or non-employee members of the board of directors of any of our subsidiaries, and consultants and other independent advisors who provide services to us or any of our subsidiaries, upon such terms and conditions as may be determined by the Board of Directors. The plan authorizes the grants of awards up to a maximum of 3,000,000. In 2004, we granted 2,528,712 shares under the plan. At December 31, 2004, an aggregate of 2,528,712 shares had been granted under the plan, all of which were fully vested upon issuance.

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth certain information derived from the named person, or from the transfer agent, concerning the ownership of common stock as of December 31, 2004, of (i) each person who is known to us to be the beneficial owner of more than 5 percent of the common stock; (ii) all directors and executive officers; and (iii) directors and executive officers as a group:

Name and Address of Beneficial Owner	Amount and Nature of Beneficial Ownership (1)	Percent of Class (1)
Richard Govatski	4,445,500	13.54%
5021 Indian School Rd. NE	4,945,500 (2) (including	15.06%
Albuquerque, NM 87110	500,000 options)	
Teresa B. Dickey	107,563	*
	807,563 (3) (including	2.46%
	700,000 options)	
John Handley	265,000 (4)	*
	765,000 (4) (including	2.33%
	500,000 options)	
Executive Officers and Directors	4,818,063	14.67%
as a Group (3 Persons)	6,518,063 (including the	19.85% on a
	options set forth above)	fully diluted basis

* - Represents beneficial ownership of less than 1% of the total number of shares of common stock outstanding.

54

(1) All of the persons are believed to have sole voting and investment power over the shares of common stock listed or share voting and investment power with his or her spouse, except as otherwise provided. Percentage is based on 32,834,458 shares outstanding as of December 31, 2004. Fully diluted percentage includes 1,424,453 options.

(2) This number of shares includes options to purchase 500,000 shares, which options have vested and are currently exercisable. The shares underlying these options are included in the table and are considered to be outstanding for purposes of computing the percentage interest held by Mr. Govatski. The number of shares also includes 400,000 shares pledged by Mr. Govatski to First Mirage, Inc. to secure a loan to the company which was due and payable on June 30, 2004. Such shares are presently in the name of David A. Rapaport, President of First Mirage, Inc. Mr. Govatski retains the right to vote these shares until foreclosure under the terms of the pledge agreement. However, subsequent to December 31, 2004, the shares were foreclosed on by First Mirage, Inc. Therefore, Mr. Govatski s shareholdings have been reduced accordingly.

(3) This number of shares includes 107,563 shares issued to Ms. Dickey and options to purchase 700,000 shares, which options have vested and are currently exercisable. The shares underlying these options are included in the table and are considered to be outstanding for purposes of computing the percentage interest held by Ms. Dickey.

(4) This number of shares includes 265,000 shares issued to Mr. Handley and options to purchase 500,000 shares. Fifty percent of these options have vested and are currently exercisable. The remaining 50% will vest in 2005. The shares underlying these options are included in the table and are considered to be outstanding for purposes of computing the percentage held by Mr. Handley.

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

Richard Govatski, our president, director, and principal shareholder, may be deemed a promoter or founder in relation to the organization of our business. In connection with the acquisition of New Mexico Software, Mr. Govatski exchanged all 1,000 of his shares of New Mexico Software for 5,597,000 shares in the public company.

In January 2001 our wholly owned subsidiary, New Mexico Software, Inc., entered into a line of credit agreement with Los Alamos National Bank in the maximum principal amount of $300,000. It also issued a promissory note dated January 24, 2001, in the principal amount of $300,000, representing the amount that it borrowed under the line of credit. The note is secured by all of New Mexico Software s furniture, fixtures, equipment, inventory, accounts, chattel paper, tangibles and general intangibles, and a letter of credit in the amount of $250,000 issued by another bank and provided by Murray Kelly. We issued 250,000 shares to Mr. Kelly for providing this letter of credit as collateral on this note. The note was originally due on or before July 24, 2001, and was extended to July 24, 2002. At July 24, 2002, we negotiated a three-month extension until October 24, 2002, by paying $50,000, plus accrued interest. At or about October 24, 2002, we were able to negotiate an extension of the note until April 24, 2003, by paying $25,000, plus interest. The bank has continued to extend the note for six-month intervals upon payment of $25,000 of principal plus accrued interest. The note bears interest at 7%. Mr. Govatski has personally guaranteed to the bank repayment of $50,000 of this line of credit. The lease payments for our office space in Albuquerque, New Mexico, of $47,000 and improvements of approximately $28,000 were provided through the payment of 75,000 shares of our common stock to the landlord by Richard Govatski, our president, a director, and a principal shareholder. In March 2001 we issued 75,000 shares to Mr. Govatski for providing his shares to the landlord.

In March 2001 we issued 1,500,000 Series C Warrants to Manhattan Scientifics, Inc., one of our 5% shareholders. These warrants were issued in consideration of Manhattan Scientifics issuing 150,000 of its common shares to a consultant for services performed by the consultant for us.

We have granted options to Mr. Govatski under our option plan to purchase an aggregate of 500,000 shares of common stock. The options were granted in August 1999 and vest at the rate of 20% per year. Of the total options, 500,000 are exercisable at $0.06 per share.

We have granted options under our option plan to Teresa Dickey, one of our executive officers, to purchase an aggregate of 700,000 shares. Of the total options, 56,000 were granted in January 2000 and are exercisable at $0.06 per share; 56,000 were granted in July 2000 and are exercisable at $0.06 per share; 3,000 were granted in January 2001 and are exercisable at $0.06 per share; 400,000 were granted in October 2001 and are exercisable at $0.06 per share; 3,780 were granted in January 2002 and are exercisable at $0.06 per share, and 181,220 were granted in August 2003 and are exercisable at $0.06 per share. The options vest at the rate of 50% per year.

In March 2003 we borrowed $25,000 from an outside lender. To secure repayment of this loan Mr. Govatski pledged 400,000 of his personal shares as collateral. In March 2005, we received a demand notice for repayment of the loan. In order to settle the matter in the most expeditious manner, Mr. Govatski agreed to surrender his shares as repayment in full of the loan and all accumulated interest (approximately $82,000). New Mexico Software will issue 400,000 restricted shares to Mr. Govatski to replace the surrendered shares.

PART IV

ITEM 13. EXHIBITS AND REPORTS ON FORM 8-K

(a) The following documents are filed as part of this report:

1. Financial statements; see index to financial statement and schedules in Item 7 herein.

2. Financial statement schedules; see index to financial statements and schedules in Item 7 herein.

3. Exhibits: None

(a) Reports on Form 8-K.

There were no Form 8-K s filed with the SEC during the fourth quarter of 2004.

Item 14. Principal Accountant Fees and Services

56

Audit Fees

For our fiscal year ended December 31, 2004 and 2003, respectively, we were billed approximately $30,000 and $20,000 for professional services rendered for the audit of our financial statements. We also were billed approximately $8,000 for the review of financial statements included in our periodic and other reports filed with the Securities and Exchange Commission for our year ended December 31, 2004 and 2003, respectively.

Tax Fees

For our fiscal years ended December 31, 2004 and 2003, we were billed approximately $5,000 and $0 for professional services rendered for tax compliance, tax advice, and tax planning.

All Other Fees

We did not incur any other fees related to services rendered by our principal accountant for the fiscal year ended December 31, 2004.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, there unto duly authorized.

NMXS.COM, Inc.

Date: March 24, 2006 By /s/ Richard Govatski
Richard Govatski

President, Chief Executive Officer and Chairman of the Board of Directors

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacitIes and on the dates indicated.

Date: March 24, 2006 /s/ Richard Govatski
Richard Govatski, President, Chief Executive Officer and Chairman of the Board of Directors

Date: March 24, 2006 /s/ Teresa B. Dickey
Teresa B. Dickey, Director, Secretary, Treasurer and Principal Financial Officer

Date: March 24, 2006 /s/ John Handley
John E. Handley, Director

58

> 237 237 337

Commercial:					
Other	-	-	900	900	900
Consumer:					
Home equity lines of credit	-	-	20	20	36
Second mortgages	-	-	583	583	988
Total impaired loans	$-	$-	$4,554	$4,554	$5,888
September 30, 2013:					
Residential mortgage	$-	$-	$1,295	$1,295	$1,510
Construction and Development:					
Residential and commercial	-	-	209	209	297
Land	-	-	237	237	337
Commercial:					
Other	-	-	900	900	900
Consumer:					
Home equity lines of credit	-	-	34	34	50
Second mortgages	-	-	572	572	1,101
Total impaired loans	$-	$-	$3,247	$3,247	$4,195

23

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

Note 6 - Loans Receivable and Related Allowance for Loan Losses (Continued)

The following table presents the average recorded investment in impaired loans in portfolio and related interest income recognized for three months ended December 31, 2013 and 2012.

	Average Impaired Loans	Interest Income Recognized on Impaired Loans (In thousands)	Cash Basis Collection on Impaired Loans
Three Months Ended December 31, 2013:			
Residential mortgage	$1,363	$ 10	$16
Construction and Development:			
Residential and commercial	411	3	899
Land	237	3	3
Commercial:			
Other	900	7	7
Consumer:			
Home equity lines of credit	21	-	-
Second mortgages	570	6	9
Total	$3,502	$ 29	$934
Three Months Ended December 31, 2012:			
Residential mortgage	$4,162	$ 11	$18
Construction and Development:			
Residential and commercial	3,566	-	152
Commercial:			
Commercial real estate	4,874	49	70
Multi-family	176	2	2
Consumer:			
Home equity lines of credit	22	-	1
Second mortgages	524	-	1
Total	$13,324	$ 62	$244

24

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

Note 6 - Loans Receivable and Related Allowance for Loan Losses (Continued)

The following table presents the classes of the loan portfolio summarized by loans considered to be rated as pass and the categories of special mention, substandard and doubtful within the Company's internal risk rating system as of December 31, 2013 and September 30, 2013.

	Pass	Special Mention	Substandard	Doubtful	Total
			(In thousands)		
December 31, 2013:					
Residential mortgage	$244,066	$142	$ 1,931	$-	$246,139
Construction and Development:					
Residential and commercial	5,880	-	1,333	-	7,213
Land	1,911	-	237	-	2,148
Commercial:					
Commercial real estate	67,001	2,241	1,269	-	70,511
Multi-family	2,051	-	-	-	2,051
Other	4,707	306	900	-	5,913
Consumer:					
Home equity lines of credit	20,629	-	20	-	20,649
Second mortgages	51,935	14	583	-	52,532
Other	2,790	19	-	-	2,809
Total	$400,970	$2,722	$ 6,273	$-	$409,965
September 30, 2013:					
Residential mortgage	$238,461	$144	$ 1,295	$-	$239,900
Construction and Development:					
Residential and commercial	5,564	159	949	-	6,672
Land	2,202	-	237	-	2,439
Commercial:					
Commercial real estate	67,028	3,166	377	-	70,571
Multi-family	1,971	-	-	-	1,971
Other	4,363	310	900	-	5,573
Consumer:					
Home equity lines of credit	20,397	-	34	-	20,431
Second mortgages	53,790	14	728	-	54,532
Other	2,625	23	-	-	2,648
Total	$396,401	$3,816	$ 4,520	$-	$404,737

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

Note 6 - Loans Receivable and Related Allowance for Loan Losses (Continued)

The following table presents loans that are no longer accruing interest by portfolio class.

	December 31, 2013	September 30, 2013
	(In thousands)	
Non-accrual loans:		
Residential mortgage	$ 1,821	$ 1,295
Construction and Development:		
Residential and commercial	484	-
Consumer:		
Home equity lines of credit	20	34
Second mortgages	583	572
Total non-accrual loans	$ 2,908	$ 1,901

Under the Bank's loan policy, once a loan has been placed on non-accrual status, we do not resume interest accruals until the loan has been brought current and has maintained a current payment status for not less than six consecutive months. Interest income that would have been recognized on nonaccrual loans had they been current in accordance with their original terms was $46,000 and $171,000 for the three months ended December 31, 2013 and 2012, respectively. There were no loans past due 90 days or more and still accruing interest at December 31, 2013 or September 30, 2013.

26

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

Note 6 - Loans Receivable and Related Allowance for Loan Losses (Continued)

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by whether a loan payment is “current,” that is, it is received from a borrower by the scheduled due date, or the length of time a scheduled payment is past due. The following table presents the classes of the loan portfolio summarized by the aging categories as of December 31, 2013 and September 30, 2013.

	Current	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Total Loans Receivable
			(In thousands)			
December 31, 2013:						
Residential mortgage	$242,194	$1,822	$302	$1,821	$3,945	$246,139
Construction and Development:						
Residential and commercial	6,729	-	-	484	484	7,213
Land	2,148	-	-	-	-	2,148
Commercial:						
Commercial real estate	70,511	-	-	-	-	70,511
Multi-family	2,051	-	-	-	-	2,051
Other	5,913	-	-	-	-	5,913
Consumer:						
Home equity lines of credit	20,603	-	26	20	46	20,649
Second mortgages	50,694	1,132	123	583	1,838	52,532
Other	2,809	-	-	-	-	2,809
Total	$403,652	$2,954	$451	$2,908	$6,313	$409,965
September 30, 2013:						
Residential mortgage	$237,584	$820	$201	$1,295	$2,316	$239,900
Construction and Development:						
Residential and commercial	6,672	-	-	-	-	6,672
Land	2,439	-	-	-	-	2,439
Commercial:						
Commercial real estate	70,416	-	155	-	155	70,571
Multi-family	1,971	-	-	-	-	1,971
Other	5,573	-	-	-	-	5,573
Consumer:						
Home equity lines of credit	20,397	-	-	34	34	20,431
Second mortgages	52,698	1,022	240	572	1,834	54,532
Other	2,643	4	1	-	5	2,648
Total	$400,393	$1,846	$597	$1,901	$4,344	$404,737

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

Note 6 - Loans Receivable and Related Allowance for Loan Losses (Continued)

Restructured loans deemed to be TDRs in accordance with ASC 310-10-35 are typically the result of extension of the loan maturity date or a reduction of the interest rate of the loan to a rate that is below market, a combination of rate and maturity extension, or by other means including covenant modifications, forbearance and other concessions. However, the Company generally only restructures loans by modifying the payment structure to require payments of interest only for a specified period or by reducing the actual interest rate. Once a loan becomes a TDR, it will continue to be reported as a TDR during the term of the restructure.

The Company had nine and seven loans classified as TDRs with an outstanding balance of $2.1 million and $1.3 million at December 31, 2013 and September 30, 2013, respectively. Of the total TDR loans, seven loans deemed TDRs with an aggregate balance of $1.6 million at December 31, 2013 were classified as impaired; however, they were performing prior to the restructure and continued to perform under their restructured terms through December 31, 2013, and, accordingly, were deemed to be performing loans at December 31, 2013 and we continued to accrue interest on such loans through such date. At December 31, 2013, two TDRs with an aggregate balance of $484,000 were deemed non-accruing TDRs. The $484,000 of TDRs deemed non-accruing TDRs, which were also deemed impaired at December 31, 2013, were comprised of two construction and development loans at December 31, 2013. At September 30, 2013, seven loans deemed TDRs with an aggregate balance of $1.3 million were classified as impaired; however, they were performing prior to the restructure and continued to perform under their restructured terms as of September 30, 2013, and, accordingly, were deemed to be performing loans at September 30, 2013 and we continued to accrue interest on such loans through such date. At September 30, 2013, none of our TDRs were deemed non-accruing TDRs. All of such loans have been classified as TDRs since we modified the payment terms and in some cases interest rate from the original agreements and allowed the borrowers, who were experiencing financial difficulty, to make interest only payments for a period of time in order to relieve some of their overall cash flow burden. Some loan modifications classified as TDRs may not ultimately result in the full collection of principal and interest, as modified, and result in potential incremental losses. These potential incremental losses have been factored into our overall estimate of the allowance for loan losses. The level of any defaults will likely be affected by future economic conditions. A default on a troubled debt restructured loan for purposes of this disclosure occurs when the borrower is 90 days past due or a foreclosure or repossession of the applicable collateral has occurred.

The following table presents our TDR loans as of December 31, 2013 and September 30, 2013.

	Total Troubled Debt Restructurings		Troubled Debt Restructured Loans That Have Defaulted on Modified Terms YTD	
	Number of Loans	Recorded Investment	Number of Loans	Recorded Investment
	(Dollars in thousands)			
At December 31, 2013:				

Construction and Development:				
Residential and commercial	7	$993	2	$ 484
Land	1	237	-	-
Commercial:				
Other	1	900	-	-
Total	9	$2,130	2	$ 484
At September 30, 2013:				
Construction and Development:				
Residential and commercial	5	$209	-	$ -
Land	1	237	-	-
Commercial:				
Other	1	900	-	-
Total	7	$1,346	-	$ -

28

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

Note 6 - Loans Receivable and Related Allowance for Loan Losses (Continued)

The following table reports the performing status of TDR loans. The performing status is determined by the loans compliance with the modified terms.

	December 31, 2013		September 30, 2013	
	Performing	Non-Performing	Performing	Non-Performing
	(In thousands)			
Construction and Development:				
Residential and commercial	$ 509	$ 484	$ 209	$ -
Land	237	-	237	-
Commercial:				
Other	900	-	900	-
Total	$ 1,646	$ 484	$ 1,346	$ -

There was no TDR activity for the three months ended December 31, 2012. The following table shows the TDR activity for the three months ended December 31, 2013.

	December 31, 2013			December 31, 2012		
	Restructured During Period					
	Number of Loans	Pre-Modifications Outstanding Recorded Investments	Post-Modifications Outstanding Recorded Investments	Number of Loans	Pre-Modifications Outstanding Recorded Investments	Post-Modifications Outstanding Recorded Investments
	(Dollars in thousands)					
Troubled Debt Restructurings:						
Construction and Development:						
Residential and commercial	2	$ 484	$ 484	-	$ -	$ -
Total troubled debt restructurings	2	$ 484	$ 484	-	$ -	$ -

Note 7 - Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk-weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of tangible and core capital (as defined in the regulations) to total adjusted tangible assets (as defined) and of risk-based capital (as defined) to risk-weighted assets (as defined).

Management believes, as of December 31, 2013, that the Bank met all capital adequacy requirements to which it was subject including individual minimum capital ratios imposed by the Office of the Comptroller of the Currency of 8.5% Tier 1 capital to adjusted total assets, 10.5% Tier 1 risk-based capital to risk-weighted assets and 12.5% total risk-based capital to risk-weighted assets.

29

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

Note 7 - Regulatory Matters (Continued)

The Bank's actual capital amounts and ratios are also presented in the table:

	Actual			For Capital Adequacy Purposes			To be Well Capitalized under Prompt Corrective Action Provisions		
	Amount	Ratio		Amount	Ratio		Amount	Ratio	
				(Dollars in thousands)					
As of December 31, 2013:									
Tangible Capital (to tangible assets)	$64,581	11.06	%	$≥ 8,762	≥1.50	%	N/A		
Core Capital (to adjusted tangible assets)	64,581	11.06		≥23,364	≥4.00		$≥29,205	≥ 5.00	%
Tier 1 Capital (to risk-weighted assets)	64,581	18.18		≥14,213	≥4.00		≥21,320	≥ 6.00	
Total risk-based Capital (to risk-weighted assets)	69,028	19.43		≥28,426	≥8.00		≥35,533	≥10.00	
As of September 30, 2013:									
Tangible Capital (to tangible assets)	$64,524	10.91	%	$≥ 8,874	≥1.50	%	N/A		
Core Capital (to adjusted tangible assets)	64,524	10.91		≥23,664	≥4.00		$≥29,580	≥ 5.00	%
Tier 1 Capital (to risk-weighted assets)	64,524	17.72		≥14,566	≥4.00		≥21,849	≥ 6.00	
Total risk-based Capital (to risk-weighted assets)	69,084	18.97		≥29,132	≥8.00		≥36,415	≥10.00	

30

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

Note 8 - Fair Value Measurements

The Company follows FASB ASC Topic 820 “Fair Value Measurements,” to record fair value adjustments to certain assets and to determine fair value disclosures for the Company’s financial instruments. Investment and mortgage-backed securities available for sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as impaired loans, real estate owned and certain other assets. These nonrecurring fair value adjustments typically involve application of lower-of-cost-or-market accounting or write-downs of individual assets.

The Company groups its assets at fair value in three levels, based on the markets in which the assets are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1— Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2— Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3— Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect the Company’s own estimates of assumptions that market participants would use in pricing the asset.

The Company bases its fair values on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It is our policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements, in accordance with the fair value hierarchy.

Fair value measurements for assets where there exists limited or no observable market data and, therefore, are based primarily upon the Company’s or other third-party’s estimates, are often calculated based on the characteristics of the asset, the economic and competitive environment and other factors. Therefore, the results cannot be determined with precision and may not be realized in an actual sale or immediate settlement of the asset. Additionally, there may be inherent weaknesses in any calculation technique, and changes in the underlying assumptions used, including discount rates and estimates of future cash flows, could significantly affect the results of current or future valuations.

FASB ASC Topic 825 “Financial Instruments” provides an option to elect fair value as an alternative measurement for selected financial assets and financial liabilities not previously recorded at fair value. The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation.

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

Note 8 - Fair Value Measurements (Continued)

The table below presents the balances of assets measured at fair value on a recurring basis:

	December 31, 2013			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Investment securities available for sale:				
Debt securities:				
U.S. government agencies	$19,649	$-	$19,649	$-
State and municipal obligations	11,013	-	11,013	-
Single issuer trust preferred security	815	-	815	-
Corporate debt securities	1,775	-	1,775	-
Total investment securities available for sale	33,252	-	33,252	-
Mortgage-backed securities available for sale:				
FNMA:				
Adjustable-rate	1,981	-	1,981	-
Fixed-rate	17,442	-	17,442	-
FHLMC:				
Adjustable-rate	5,918	-	5,918	-
Fixed-rate	12,453	-	12,453	-
CMO, fixed-rate	52,780	-	52,780	-
Total mortgage-backed securities available for sale	90,574	-	90,574	-
Total	$123,826	$-	$123,826	$-

	September 30, 2013			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Investment securities available for sale:				
Debt securities:				
U.S. government agencies	$19,432	$-	$19,432	$-
State and municipal obligations	11,938	-	11,938	-
Single issuer trust preferred security	810	-	810	-
Corporate debt securities	1,782	-	1,782	-
Total investment securities available for sale	33,962	-	33,962	-
Mortgage-backed securities available for sale:				
FNMA:				
Adjustable-rate	2,014	-	2,014	-

Fixed-rate	18,091	-	18,091	-
FHLMC:				
Adjustable-rate	5,021	-	5,021	-
Fixed-rate	12,850	-	12,850	-
CMO, fixed-rate	52,729	-	52,729	-
Total mortgage-backed securities available for sale	90,705	-	90,705	-
Total	$124,667	$-	$124,667	$-

The Company monitors and evaluates available data to perform fair value measurements on an ongoing basis and recognizes transfers among the levels of the fair value hierarchy as of the date event or a change in circumstances that affects the valuation method chosen. There were no changes at December 31, 2013 and September 30, 2013.

32

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

Note 8 - Fair Value Measurements (Continued)

For assets measured at fair value on a nonrecurring basis that were still held at the end of the period, the following table provides the level of valuation assumptions used to determine each adjustment and the carrying value of the related individual assets or portfolios at December 31, 2013 and September 30, 2013:

	December 31, 2013			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Other real estate owned	$995	$-	$-	$995
Impaired loans	657	-	-	657
Mortgage servicing rights	370	-	370	-
Total	$2,022	$-	$370	$1,652

	December 31, 2013			
	Fair Value at December 31, 2013	Valuation Technique	Unobservable Input	Range/(Weighted Average)
	(Dollars in thousands)			
Other real estate owned	$ 995	Appraisal of collateral(1)	Collateral discounts(2)	0-6%/(1%)
Impaired loans(3)	657	Appraisal of collateral(1)	Collateral discounts(2)	3-72%/(44%)
Total	$ 1,652			

(1) Fair value is generally determined through independent appraisals of the underlying collateral primarily using comparable sales.
(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.
(3) Includes assets directly charged-down to fair value during the year-to-date period.

	September 30, 2013			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Loans held for sale	$10,367	$10,367	$-	$-
Other real estate owned	2,341	-	-	2,341
Impaired loans	1,047	-	-	1,047
Mortgage servicing rights	337	-	337	-

Total	$14,092	$10,367	$337	$3,388

	September 30, 2013			
	Fair Value at September 30, 2013	Valuation Technique	Unobservable Input	Range/(Weighted Average)
	(Dollars in thousands)			
Other real estate owned	$ 2,341	Appraisal of collateral(1)	Collateral discounts(2)	14-84%/(39%)%
Impaired loans	1,047	Appraisal of collateral(1)	Collateral discounts(2)	1-73%/(28%)
Total	$ 3,388			

(1) Fair value is generally determined through independent appraisals of the underlying collateral primarily using comparable sales.
(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.
(3) Includes assets directly charged-down to fair value during the year-to-date period.

33

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

Note 8 - Fair Value Measurements (Continued)

The following table shows quantitative information regarding significant techniques and inputs used at December 31, 2013 for assets measured using observable inputs (Level 2):

	Fair Value at December 31, 2013 (In thousands)	Valuation Technique	Observable Input	Method or Value as of December 31, 2013	
Servicing rights	$370	Discounted rate	Discount rate	11.00%	Rate used through modeling period
			Loan prepayment speeds	13.30%	Weighted-average CPR
			Servicing fees	0.25%	Of loan balance
			Servicing costs	6.25%	Monthly servicing cost per account
				$300-$400	Additional monthly servicing cost per loan on loans more than 30 days delinquent

The following table shows quantitative information regarding significant techniques and inputs used at September 30, 2013 for assets measured using observable inputs (Level 2):

	Fair Value at September 30, 2013 (In thousands)	Valuation Technique	Observable Input	Method or Value as of September 30, 2013	
Servicing rights	$337	Discounted rate	Discount rate	11.00%-12.00%	Rate used through modeling period
			Loan prepayment speeds	15.58%	Weighted-average CPR

Servicing fees	0.25%	Of loan balance
Servicing costs	6.25%	Monthly servicing cost per account
	$150	Additional monthly servicing cost per loan on loans more than 30 days delinquent

34

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

Note 8 - Fair Value Measurements (Continued)

The following disclosure of the estimated fair value of financial instruments is made in accordance with the requirements of FASB ASC 825. The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methods. However, considerable judgment is necessarily required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company would realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. FASB ASC 825 excludes certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company.

The fair value estimates presented herein are based on pertinent information available to management as of December 31, 2013 and September 30, 2013. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since December 31, 2013 and September 30, 2013 and, therefore, current estimates of fair value may differ significantly from the amounts presented herein.

The following assumptions were used to estimate the fair value of the Company’s financial instruments:

Cash and Cash Equivalents—These assets are carried at historical cost. The carrying amount is a reasonable estimate of fair value because of the relatively short time between the origination of the instrument and its expected realization.

Investment Securities—Investment and mortgage-backed securities available for sale (carried at fair value) and held to maturity (carried at amortized cost) are measured at fair value on a recurring basis. Fair value measurements for these securities are typically obtained from independent pricing services that we have engaged for this purpose. When available, we, or our independent pricing service, use quoted market prices to measure fair value. If market prices are not available, fair value measurement is based upon models that incorporate available trade, bid and other market information and for structured securities, cash flow and, when available, loan performance data. Because many fixed income securities do not trade on a daily basis, our independent pricing service’s applications apply available information through processes such as benchmark curves, benchmarking of like securities, sector groupings and matrix pricing to prepare evaluations. For each asset class, pricing applications and models are based on information from market sources and integrate relevant credit information. All of our securities available for sale are valued using either of the foregoing methodologies to determine fair value adjustments recorded to our financial statements. The Company had no Level 1 or Level 3 securities as of December 31, 2013 or September 30, 2013.

Loans Receivable— We do not record loans at fair value on a recurring basis. As such, valuation techniques discussed herein for loans are primarily for estimating fair value for FASB ASC 825 disclosure purposes. However, from time to time, we record nonrecurring fair value adjustments to loans to reflect partial write-downs for impairment or the full charge-off of the loan carrying value. The valuation of impaired loans is discussed below. The fair value estimate for FASB ASC 825 purposes differentiates loans based on their financial characteristics, such as product classification, loan category, pricing features and remaining maturity. Prepayment and credit loss estimates are evaluated by loan type and rate. The fair value of loans is estimated by discounting contractual cash flows using discount rates based on current industry pricing, adjusted for prepayment and credit loss estimates.

Loans Held-For-Sale—The fair values of mortgage loans originated and intended for sale in the secondary market are based on current quoted market prices. There were no loans held for sale at December 31, 2013. The loans held for sale at September 30, 2013 were sold in a bulk transaction to one purchaser in October 2013, they were not sold in the secondary market for residential mortgage loans.

Impaired Loans—Impaired loans are valued utilizing independent appraisals that rely upon quoted market prices for similar assets in active markets. These appraisals include adjustments to comparable assets based on the appraisers' market knowledge and experience. The appraisals are adjusted downward by management, as necessary, for changes in relevant valuation factors subsequent to the appraisal date and are considered level 3 inputs.

35

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

Note 8 - Fair Value Measurements (Continued)

Accrued Interest Receivable—This asset is carried at historical cost. The carrying amount is a reasonable estimate of fair value because of the relatively short time between the origination of the instrument and its expected realization.

Restricted Stock—Although restricted stock is an equity interest in the FHLB, it is carried at cost because it does not have a readily determinable fair value as its ownership is restricted and it lacks a market. The estimated fair value approximates the carrying amount.

Other Real Estate Owned—Assets acquired through foreclosure or deed in lieu of foreclosure are recorded at estimated fair value less estimated selling costs when acquired, thus establishing a new cost basis. Fair value is generally based on independent appraisals. These appraisals include adjustments to comparable assets based on the appraisers' market knowledge and experience, and are considered level 3 inputs. When an asset is acquired, the excess of the loan balance over fair value, less estimated selling costs, is charged to the allowance for loan losses. If the estimated fair value of the asset declines, a write-down is recorded through expense. The valuation of foreclosed assets is subjective in nature and may be adjusted in the future because of, among other factors, changes in the economic conditions.

Deposits—Deposit liabilities are carried at cost. As such, valuation techniques discussed herein for deposits are primarily for estimating fair value for FASB ASC 825 disclosure purposes. The fair value of deposits is discounted based on rates available for borrowings of similar maturities. A decay rate is estimated for non-time deposits. The discount rate for non-time deposits is adjusted for servicing costs based on industry estimates.

Long-Term Borrowings—Advances from the FHLB are carried at amortized cost. However, we are required to estimate the fair value of long-term debt under FASB ASC 825. The fair value is based on the contractual cash flows discounted using rates currently offered for new notes with similar remaining maturities.

Accrued Interest Payable—This liability is carried at historical cost. The carrying amount is a reasonable estimate of fair value because of the relatively short time between the origination of the instrument and its expected realization.

Commitments to Extend Credit and Letters of Credit—The majority of the Company's commitments to extend credit and letters of credit carry current market interest rates if converted to loans. Because commitments to extend credit and letters of credit are generally unassignable by either the Bank or the borrower, they only have value to the Company and the borrower. The estimated fair value approximates the recorded deferred fee amounts, which are not significant.

Mortgage Servicing Rights—The fair value of mortgage servicing rights is based on observable market prices when available or the present value of expected future cash flows when not available. Assumptions, such as loan default rates, costs to service, and prepayment speeds significantly affect the estimate of future cash flows. Mortgage servicing rights are carried at the lower of cost or fair value.

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

Note 8 - Fair Value Measurements (Continued)

The carrying amount and estimated fair value of the Company's financial instruments as of December 31, 2013 and September 30, 2013 are presented below:

	December 31, 2013				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
			(In thousands)		
Financial assets:					
Cash and cash equivalents	$22,670	$22,670	$22,670	$-	$-
Investment securities available for sale	123,826	123,826	-	123,826	-
Loans receivable, net	407,306	408,519	-	-	408,519
Accrued interest receivable	1,438	1,438	-	1,438	-
Restricted stock	3,236	3,236	-	3,236	-
Mortgage servicing rights	286	370	-	370	-
Financial liabilities:					
Savings accounts	43,050	43,050	-	43,050	-
Checking and NOW accounts	113,335	113,335	-	113,335	-
Money market accounts	66,718	66,718	-	66,718	-
Certificates of deposit	247,898	253,509	-	253,509	-
FHLB advances	43,000	45,329	-	45,329	-
Accrued interest payable	133	133	-	133	-

37

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

Note 8 - Fair Value Measurements (Continued)

	September 30, 2013				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
			(In thousands)		
Financial assets:					
Cash and cash equivalents	$23,687	$23,687	$23,687	$-	$-
Investment securities available for sale	124,667	124,667	-	124,667	-
Loans receivable, net	401,857	405,802	-	-	405,802
Loans held for sale	10,367	10,367	10,367	-	-
Accrued interest receivable	1,404	1,404	-	1,404	-
Restricted stock	3,038	3,038	-	3,038	-
Mortgage servicing rights	271	337	-	337	-
Financial liabilities:					
Savings accounts	42,932	42,932	-	42,932	-
Checking and NOW accounts	112,338	112,338	-	112,338	-
Money market accounts	67,372	67,372	-	67,372	-
Certificates of deposit	261,954	267,181	-	267,181	-
FHLB advances	38,000	41,281	-	41,281	-
Accrued interest payable	139	139	-	139	-

Note 9 – Income Taxes

The following is reconciliation between the statutory federal income tax rate of 34% and the effective income tax rate on income before income taxes:

	Three Months Ended December 31,	
	2013	2012
	(In thousands)	
At federal statutory rate	$ -	$ 210
Adjustments resulting from:		
State tax, net of federal benefit	3	-
Tax-exempt interest	-	(18)
Earnings on bank-owned life insurance	-	(245)
Other	-	(1)
	$ 3	$ (54)
Effective tax rate	4.40 %	(8.76 %)

38

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

Note 9 – Income Taxes (Continued)

Deferred income taxes at December 31, 2013 and September 30, 2013 were as follows:

	December 31, 2013	September 30, 2013
	(In thousands)	
Deferred Tax Assets:		
Unrealized loss on investments available for sale	$ 1,850	$ 1,385
Allowance for loan losses	3,014	3,091
Non-accrual interest	172	87
Write-down of real estate owned	337	573
Alternative minimum tax (AMT) credit carryover	64	64
Low-income housing tax credit carryover	337	337
Supplement Employer Retirement Plan	448	435
Charitable contributions	18	202
Depreciation	177	150
State net operating loss	559	1,528
Federal net operating loss	7,276	7,046
Other	116	112
Total Deferred Tax Assets	14,368	15,010
Valuation allowance for DTA	(11,761)	(12,454)
Total Deferred Tax Assets, Net of Valuation Allowance	$ 2,607	$ 2,556
Deferred Tax Liabilities:		
Mortgage servicing rights	(97)	(92)
Total Deferred Tax Liabilities	(97)	(92)
Deferred Tax Assets, Net	$ 2,510	$ 2,464

39

Table of Contents

Item 2 – Management’s Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains certain forward looking statements (as defined in the Securities Exchange Act of 1934, as amended, and the regulations thereunder). Forward looking statements are not historical facts but instead represent only the beliefs, expectations or opinions of Malvern Bancorp, Inc. and its management regarding future events, many of which, by their nature, are inherently uncertain. Forward looking statements may be identified by the use of such words as: “believe,” “expect,” “anticipate,” “intend,” “plan,” “estimate,” or words of similar mean or future or conditional terms such as “will,” “would,” “should,” “could,” “may,” “likely,” “probably,” or “possibly.” Forward statements include, but are not limited to, financial projections and estimates and their underlying assumptions; statements regarding plans, objectives and expectations with respect to future operations, products and services; and statements regarding future performance. Such statements are subject to certain risks, uncertainties and assumptions, many of which are difficult to predict and generally are beyond the control of Malvern Bancorp, Inc. and its management, that could cause actual results to differ materially from those expressed in, or implied or projected by, forward looking statements. The following factors, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in the forward looking statements: (1) economic and competitive conditions which could affect the volume of loan originations, deposit flows and real estate values; (2) the levels of non-interest income and expense and the amount of loan losses; (3) competitive pressure among depository institutions increasing significantly; (4) changes in the interest rate environment causing reduced interest margins; (5) general economic conditions, either nationally or in the markets in which Malvern Bancorp, Inc. is or will be doing business, being less favorable than expected;(6) political and social unrest, including acts of war or terrorism; or (7) legislation or changes in regulatory requirements adversely affecting the business in which Malvern Bancorp, Inc. is or will be engaged. Malvern Bancorp, Inc. undertakes no obligation to update these forward looking statements to reflect events or circumstances that occur after the date on which such statements were made.

As used in this report, unless the context otherwise requires, the terms “we,” “our,” “us,” or the “Company” refer to Malvern Bancorp, Inc., a Pennsylvania chartered corporation, and the term the “Bank” refers to Malvern Federal Savings Bank, a federally chartered savings bank and wholly owned subsidiary of the Company. In addition, unless the context otherwise requires, references to the operations of the Company include the operations of the Bank.

General

Malvern Bancorp, Inc. (the “Company” or “Malvern Bancorp”) is a Pennsylvania corporation and registered savings and loan holding company. Malvern Federal Savings Bank (“the Bank” or “Malvern Federal Savings”) is a federally chartered savings bank and wholly owned subsidiary of the Company.

Critical Accounting Policies

In reviewing and understanding financial information for the Company, you are encouraged to read and understand the significant accounting policies used in preparing our consolidated financial statements. These policies are described in Note 2 of the notes to our consolidated financial statements included elsewhere. The accounting and financial reporting policies of the Company conform to accounting principles generally accepted in the United States of America (“GAAP”) and to general practices within the banking industry. Accordingly, the consolidated financial statements require certain estimates, judgments, and assumptions, which are believed to be reasonable, based upon the information available. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of income and expenses during the periods presented. The following accounting policies comprise those that management believes are the most critical to aid in fully understanding and evaluating our reported financial results. These policies require numerous estimates or economic assumptions that may prove inaccurate or may be subject to variations which may affect our reported results and financial condition for the period or in future periods.

40

Table of Contents

Allowance for Loan Losses. The allowance for loan losses consists of the allowance for loan losses and the reserve for unfunded lending commitments. The allowance for loan losses represents management's estimate of losses inherent in the loan portfolio as of the statement of financial condition date and is recorded as a reduction to loans. The reserve for unfunded lending commitments represents management's estimate of losses inherent in its unfunded loan commitments and is recorded in other liabilities on the consolidated statement of financial condition. The allowance for loan losses is increased by the provision for loan losses, and decreased by charge-offs, net of recoveries. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance. All, or part, of the principal balance of loans receivable are charged off to the allowance as soon as it is determined that the repayment of all, or part, of the principal balance is highly unlikely. Non-residential consumer loans are generally charged off no later than when they become 120 days past due on a contractual basis or earlier in the event of the borrower's bankruptcy, or if there is an amount deemed uncollectible. Because all identified losses are immediately charged off, no portion of the allowance for loan losses is restricted to any individual loan or groups of loans, and the entire allowance is available to absorb any and all loan losses.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management performs a quarterly evaluation of the adequacy of the allowance. The allowance is based on the Company's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, the composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as impaired. For loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers pools of loans by loan class including commercial loans not considered impaired, as well as smaller balance homogeneous loans, such as residential real estate, home equity and other consumer loans. These pools of loans are evaluated for loss exposure based upon historical loss rates for each of these categories of loans, as adjusted for qualitative factors.

An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio. Once all factor adjustments are applied, general reserve allocations for each segment are calculated, summarized and reported on the allowance for loan losses summary. Allowance for loan losses final schedules, calculations and the resulting evaluation process are reviewed quarterly by the Asset Classification Committee and the Board of Directors.

In addition, Federal bank regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses and may require the Company to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not previously have been available to management. Based on management's comprehensive analysis of the loan portfolio, management believes the level of the allowance for loan losses at December 31, 2013 was appropriate under U.S. GAAP

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and industrial loans, commercial real estate loans and commercial construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent.

41

Table of Contents

The allowance is adjusted for other significant factors that affect the collectibility of the loan portfolio as of the evaluation date including changes in lending policy and procedures, loan volume and concentrations, seasoning of the portfolio, loss experience in particular segments of the portfolio, and bank regulatory examination results. Other factors include changes in economic and business conditions affecting our primary lending areas and credit quality trends. Loss factors are reevaluated each reporting period to ensure their relevance in the current economic environment. We review key ratios such as the allowance for loan losses to total loans receivable and as a percentage of non-performing loans; however, we do not try to maintain any specific target range for these ratios.

While management uses the best information available to make loan loss allowance evaluations, adjustments to the allowance may be necessary based on changes in economic and other conditions or changes in accounting guidance. In addition, the OCC, as an integral part of its examination processes, periodically reviews our allowance for loan losses. The OCC may require the recognition of adjustments to the allowance for loan losses based on their judgment of information available to them at the time of their examinations. To the extent that actual outcomes differ from management's estimates, additional provisions to the allowance for loan losses may be required that would adversely impact earnings in future periods.

Fair Value Measurements. The Company uses fair value measurements to record fair value adjustments to certain assets to determine fair value disclosures. Investment and mortgage-backed securities available for sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as impaired loans, real estate owned and certain other assets. These nonrecurring fair value adjustments typically involve application of lower-of-cost-or-market accounting or write-downs of individual assets.

Under FASB ASC Topic 820, Fair Value Measurements, the Company groups its assets at fair value in three levels, based on the markets in which the assets are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1 – Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2 – Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 – Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect the Company's own estimates of assumptions that market participants would use in pricing the asset.

Under FASB ASC Topic 820, the Company bases its fair values on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It is our policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements, in accordance with the fair value hierarchy in FASB ASC Topic 820.

Fair value measurements for assets where there exists limited or no observable market data and, therefore, are based primarily upon the Company's or other third-party's estimates, are often calculated based on the characteristics of the asset, the economic and competitive environment and other such factors. Therefore, the results cannot be determined with precision and may not be realized in an actual sale or immediate settlement of the asset. Additionally, there may be inherent weaknesses in any calculation technique, and changes in the underlying assumptions used, including discount rates and estimates of future cash flows, that could significantly affect the results of current or future valuations. At December 31, 2013, the Company had $1.7 million of assets that were measured at fair value on a non-recurring basis using Level 3 measurements.

Income Taxes. We make estimates and judgments to calculate some of our tax liabilities and determine the recoverability of some of our deferred tax assets ("DTAs"), which arise from temporary differences between the tax and financial statement recognition of revenues and expenses. We also estimate a reserve for deferred tax assets if, based on the available evidence, it is more likely than not that some portion or all of the recorded deferred tax assets will not be realized in future periods. These estimates and judgments are inherently subjective. Historically, our estimates and judgments to calculate our deferred tax accounts have not required significant revision to our initial estimates.

42

Table of Contents

In evaluating our ability to recover deferred tax assets, we consider all available positive and negative evidence, including our past operating results and our forecast of future taxable income. In determining future taxable income, we make assumptions for the amount of taxable income, the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. These assumptions require us to make judgments about our future taxable income and are consistent with the plans and estimates we use to manage our business. Any reduction in estimated future taxable income may require us to record a valuation allowance against our deferred tax assets. An increase in the valuation allowance would result in additional income tax expense in the period and could have a significant impact on our future earnings.

Realization of a deferred tax asset requires us to exercise significant judgment and is inherently uncertain because it requires the prediction of future occurrences. Our net deferred tax asset amounted to $2.5 million at December 31, 2013 and September 30, 2013. In evaluating the need for a valuation allowance, we must estimate our taxable income in future years and viable tax planning strategies we could employ so that the asset would not go unused. Our total deferred tax assets decreased to $14.4 million at December 31, 2013 compared to $15.0 million at September 30, 2013. Our DTA valuation allowance amounted to $11.8 million at December 31, 2013 compared to $12.5 million at September 30, 2013. In the future, the DTA allowance may be reversed, depending on the Company's financial position and results of operations in the future, among other factors, and, in such event, may be available to increase future net income. There can be no assurance, however, as to when we could be in a position to recapture our DTA allowance.

Other-Than-Temporary Impairment of Securities – Securities are evaluated on a quarterly basis, and more frequently when market conditions warrant such an evaluation, to determine whether declines in their value are other-than-temporary. To determine whether a loss in value is other-than-temporary, management utilizes criteria such as the reasons underlying the decline, the magnitude and duration of the decline and whether or not management intends to sell or expects that it is more likely than not that it will be required to sell the security prior to an anticipated recovery of the fair value. The term "other-than-temporary" is not intended to indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value is not necessarily favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Once a decline in value for a debt security is determined to be other-than-temporary, the other-than-temporary impairment is separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income.

Comparison of Financial Condition at December 31, 2013 and September 30, 2013

Our total assets decreased $7.5 million or 1.2% to $594.0 million at December 31, 2013 compared to $601.6 million at September 30, 2013. The decrease was due primary to a $10.4 million decrease in loans held for sale, a decrease of $1.0 million in cash and cash equivalents and $1.5 million reduction in other real estate owned. The decrease was partially offset by a $5.4 million increase in net loans receivable. The decrease in loans held for sale was due to the completion of our bulk sale of $10.4 million of loans in October 2013. The loans sold were designated as held for sale at September 30, 2013 and were comprised of non-accruing loans, performing troubled debt restructurings ("TDRs") and classified and other loans which had an aggregate book balance of $20.4 million prior to an aggregate of $10.2 million in charge-offs taken in the quarter ended September 30, 2013.

Our total liabilities at December 31, 2013, were $519.4 million compared to $526.1 million at September 30, 2013. The $6.7 million, or 1.3% decrease in total liabilities was due primarily to a $13.6 million decrease in total deposits. Our total deposits were $471.0 million at December 31, 2013 compared to $484.6 million at September 30, 2013. The decrease was partially offset by a $5.0 million increase in FHLB advances and a $1.8 million increase in advances for borrowers for taxes and insurance. The increase in FHLB advances was due to a $5.0 million purchase of relatively lower costing advances during the first quarter of fiscal 2014.

Our shareholders' equity decreased by $793,000 to $74.6 million at December 31, 2013 compared to $75.4 million at September 30, 2013. The decrease was due primarily to a $903,000 decrease in accumulated other comprehensive income. Net income of $64,000 during the first quarter of fiscal 2014 increased retained earnings to $19.9 million at December 31, 2013. Our ratio of equity to assets was 12.56% at December 31, 2013.

43

Table of Contents

Asset Quality

The table below sets forth the amounts and categories of loans delinquent more than 30 days but less than 90 days at the dates indicated.

	December 31, 2013	September 30, 2013 (In thousands)	December 31, 2012
Loans 31-89 Days Delinquent:			
Residential mortgage	$ 2,124	$ 1,021	$ 1,260
Construction and Development:			
Residential and commercial	-	-	8,433
Commercial:			
Commercial real estate	-	155	-
Consumer:			
Home equity lines of credit	26	-	300
Second mortgages	1,255	1,262	985
Other	-	5	6
Total	$ 3,405	$ 2,443	$ 10,984

Federal regulations and our policies require that we utilize an internal asset classification system as a means of reporting problem and potential problem assets. We have incorporated an internal asset classification system, substantially consistent with Federal banking regulations, as a part of our credit monitoring system. Federal banking regulations set forth a classification scheme for problem and potential problem assets as “substandard,” “doubtful” or “loss” assets. An asset is considered “substandard” if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. “Substandard” assets include those characterized by the “distinct possibility” that the insured institution will sustain “some loss” if the deficiencies are not corrected.

Assets classified as “doubtful” have all of the weaknesses inherent in those classified “substandard” with the added characteristic that the weaknesses present make “collection or liquidation in full,” on the basis of currently existing facts, conditions, and values, “highly questionable and improbable.” Assets classified as “loss” are those considered “uncollectible” and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted. Assets which do not currently expose the insured institution to sufficient risk to warrant classification in one of the aforementioned categories but possess weaknesses are required to be designated “special mention.”

The table below sets forth information on our classified assets and assets designated special mention at the dates indicated.

	December 31, 2013	September 30, 2013 (In thousands)	December 31, 2012
Classified assets:			
Substandard(1)	$ 8,745	$ 8,482	$ 38,883
Doubtful	-	-	335

Loss		-		-		-
Total classified assets		8,745		8,482		39,218
Special mention assets		2,722		3,816		7,556
Total classified and special mention assets	$	11,467	$	12,298	$	46,774

(1) Includes other real estate owned of $2.5 million, $4.0 million and $3.8 million, at December 31, 2013, September 30, 2013

44

Table of Contents

The following table sets forth non-performing assets and performing troubled debt restructurings which are neither non-accruing nor more than 90 days past due and still accruing in our portfolio at the dates indicated. Loans are generally placed on non-accrual status when they are 90 days or more past due as to principal or interest or when the collection of principal and/or interest becomes doubtful. There were no loans past due 90 days or more and still accruing interest for the periods shown. Troubled debt restructurings ("TDR") are loans which are modified in a manner constituting a concession to the borrower, such as forgiving a portion of interest or principal making loans at a rate materially less than that of market rates, when the borrower is experiencing financial difficulty.

	December 31, 2013	September 30, 2013	December 31, 2012
		(Dollars in thousands)	
Non-accruing loans:			
Residential mortgage	$ 1,821	$ 1,295	$ 4,021
Construction or Development:			
Residential and commercial(1)	484	-	2,707
Commercial:			
Commercial real estate(2)	-	-	3,108
Other	-	-	201
Consumer:			
Home equity lines of credit	20	34	22
Second mortgages	583	572	1,128
Total non-accruing loans	2,908	1,901	11,187
Other real estate owned and other foreclosed assets:			
Residential mortgage	542	725	841
Construction or Development:			
Residential and commercial	-	675	-
Commercial:			
Commercial real estate	1,756	1,929	2,126
Multi-family	-	81	405
Other	174	174	-
Consumer:			
Second mortgages	-	378	416
Total REO	2,472	3,962	3,788
Total non-performing assets	5,380	5,863	14,975
Performing troubled debt restructurings:			
Residential mortgage	-	-	857
Construction or Development:			
Residential and commercial	509	209	-
Land	237	237	1,145
Commercial:			
Commercial real estate	-	-	4,591
Other	900	900	175
Total TDRs	1,646	1,346	6,768
	$ 7,026	$ 7,209	$ 21,743

Total non-performing assets and performing troubled debt restructurings						
Ratios:						
Total non-accrual loans as a percent of gross loans	0.71	%	0.47	%	2.48	%
Total non-performing assets as a percent of total assets	0.91	%	0.97	%	2.18	%
Total non-performing assets and performing troubled debt restructurings as a percent of total assets	1.18	%	1.20	%	3.16	%

(1) Includes two loans classified as TDRs in the aggregate amount of $484,000 at December 31, 2013 and $1.3 million at Dece
(2) At December 31, 2012, includes one loan classified as TDR in the amount of $1.4 million.

45

Table of Contents

At December 31, 2013, our total non-performing assets amounted to $5.4 million, a decrease of $483,000 compared to total non-performing assets at September 30, 2013. At December 31, 2013, the Company's total non-accruing loans amounted to $2.9 million, or 0.71% of total loans, compared to $11.2 million of non-accruing loans, or 2.48% of total loans at December 31, 2012 and $1.9 million of non-accruing loans, or 0.47% of total loans at September 30, 2013. The primary reason for the $1.0 million increase in non-accruing loans at December 31, 2013 compared to September 30, 2013 was three single-family residential loans with an aggregate outstanding balance of $645,000 becoming more than 90 days past due and being placed on non-accrual status at December 31, 2013. In addition, during November 2013 we were required to repurchase two non-accrual construction and development loans which had been included in our October 2013 bulk loan sale. The two non-accruing construction and development loans had an outstanding balance of $484,000 at December 31, 2013.

For the three months ended December 31, 2013 and 2012, additional gross interest income which would have been recorded had all of our non-accruing loans been current in accordance with their original terms amounted to $46,000 and $171,000, respectively. The amount that was included in interest income on such loans was $16,000 for the three months ended December 31, 2013.

Our non-performing assets include REO in addition to non-performing loans. At December 31, 2013, our total REO amounted to $2.5 million, a decrease of $1.5 million compared to total REO at September 30, 2013. The $1.5 million decrease in REO at December 31, 2013 compared to September 30, 2013, was due primarily to $1.5 million of sales of REO, at a net gain of $6,000.

While not considered non-performing, our performing troubled debt restructurings are closely monitored as they consist of loans that have been modified where the borrower is experiencing financial difficulty. Troubled debt restructurings may be deemed to have a higher risk of loss than loans which have not been restructured. At December 31, 2013, our total performing troubled debt restructurings amounted to $1.6 million compared to $1.3 million of performing troubled debt restructurings at September 30, 2013. The increase in troubled debt restructurings at December 31, 2013 compared to September 30, 2013 was due primarily to a $300,000 advance taken on a line of credit tied to one borrower with four relationships that are performing TDRs.

Comparison of Operating Results for the Three Months Ended December 31, 2013 and 2012

General. Our net income was $64,000 for the three months ended December 31, 2013 compared to net income of $671,000 for the three months ended December 31, 2012. On a per share basis, the net income was $0.01 per share for the quarter ended December 31, 2013, compared to net income of $0.11 per share for the quarter ended December 31, 2012. The primary reason for the $607,000 reduction in our net income in the first quarter of fiscal 2014 compared to the first quarter in fiscal 2013 was a $785,000 decrease in interest and dividend income. Our interest rate spread was 2.63% and our net interest margin was 2.76% for the three months ended December 31, 2013, compared to a net interest spread of 2.23% and a net interest margin of 2.44% for the three months ended December 31, 2012.

Table of Contents

Average Balances, Net Interest Income, and Yields Earned and Rates Paid. The following table shows for the periods indicated the total dollar amount of interest from average interest-earning assets and the resulting yields, as well as the interest expense on average interest-bearing liabilities, expressed both in dollars and rates, and the net interest margin. Tax-exempt income and yields have not been adjusted to a tax-equivalent basis. All average balances are based on monthly balances. Management does not believe that the monthly averages differ significantly from what the daily averages would be.

	Three Months Ended December 31,					
	2013			2012		
	Average Balance	Interest	Average Yield/Rate	Average Balance	Interest	Average Yield/Rate
	(Dollars in thousands)					
Interest Earning Assets:						
Loans receivable(1)	$403,781	$4,527	4.48 %	$460,882	$5,533	4.80 %
Investment securities	126,600	609	1.92	85,422	381	1.78
Deposits in other banks	22,531	15	0.27	106,916	31	0.12
FHLB stock	3,063	14	1.83	3,787	5	0.53
Total interest-earning assets	555,975	5,165	3.72	657,007	5,950	3.62
Non-interest-earning assets	39,547			35,150		
Total assets	$595,522			$692,157		
Interest Bearing Liabilities:						
Demand and NOW accounts	$86,592	22	0.10	$87,221	40	0.18
Money market accounts	66,704	45	0.27	69,172	72	0.42
Savings accounts	42,756	6	0.06	42,115	7	0.07
Time deposits	254,927	994	1.56	314,743	1,398	1.78
Total deposits	450,979	1,067	0.95	513,251	1,517	1.18
FHLB borrowings	38,841	263	2.71	48,014	430	3.58
Total interest-bearing liabilities	489,820	1,330	1.09	561,265	1,947	1.39
Non-interest-bearing liabilities	30,375			44,323		
Total liabilities	520,195			605,588		
Shareholders' equity	75,327			86,569		
Total liabilities and shareholders' equity	$595,522			$692,157		
Net interest-earning assets	$66,155			$95,742		
Net interest income; average interest rate spread		$3,835	2.63 %		$4,003	2.23 %
Net interest margin			2.76 %			2.44 %
Average interest-earning assets to average interest-bearing liabilities	113.51 %			117.06 %		

(1) Includes non-accrual loans during the respective periods. Calculated net of deferred loan fees, loan discounts, loans in process and loss
reserves.

47

Table of Contents

Interest and Dividend Income. Our interest and dividend income decreased for the three months ended December 31, 2013 by $785,000 or 13.2% over the comparable fiscal 2013 period to $5.2 million. Interest income on loans decreased in the three months ended December 31, 2013 over the prior comparable period in fiscal 2013 by $1.0 million, or 18.2%. The decrease in interest earned on loans in the first quarter of fiscal 2014 was due primarily to a $57.1 million, or 12.4%, decrease in the average balance of our outstanding loans as well as a 32 basis point decrease in the average yield earned on our loan portfolio in the first quarter of fiscal 2014 compared to the first quarter of fiscal 2013. Interest income on investment securities increased by $228,000, or 59.8%, in the first quarter of fiscal 2014 compared to the comparable prior fiscal year period. The average yield on investment securities increased 14 basis points to 1.92% for the three months ended December 31, 2013 from 1.78% for the same period ended 2012.

Interest Expense. Our interest expense for the three month period ended December 31, 2013 was $1.3 million, a decrease of $617,000 from the three month period ended December 31, 2012. The reason for the decrease in interest expense in the first quarter of fiscal 2014 compared to the first quarter of fiscal 2013 was a 23 basis point decrease in average rate paid on total deposits together with a decrease in the average balance of our total deposits of $62.3 million, or 12.1%, in the first quarter of fiscal 2014 compared to the first quarter of fiscal 2013 due primarily to a $59.8 million decrease in the average balance of certificates of deposit. The average rate paid on total deposits decreased to 0.95% for fiscal 2014 from 1.18% for fiscal 2013. Our expense on borrowings amounted to $263,000 in the first quarter of fiscal 2014 compared to $430,000 in the first quarter of fiscal 2013. The average balance of our borrowings decreased by $9.2 million in the first quarter of fiscal 2014 compared to the first quarter of fiscal 2013, and the average cost of borrowed funds decreased to 2.71% in the first quarter of fiscal 2014 compared to 3.58% in the first quarter of fiscal 2013. The reduction in our total cost and average rate paid on borrowings in the first quarter of fiscal 2014 reflects, in large part, our determination to prepay higher rate FHLB advances in the fourth quarter of fiscal 2013.

Provision for Loan Losses. The provision for loan losses was $80,000 for the three months ended December 31, 2013 compared to $400,000 for the three months ended December 31, 2012. The $320,000 difference in the provision for loan losses for the first quarter of fiscal 2014 compared to the first quarter of fiscal 2013, among other things, reflected the overall improvement in the trend of our levels of delinquent, impaired and non-performing loans during the first quarter of fiscal 2014 compared to the first quarter of fiscal 2013. Our net charge-offs for the quarter ended December 31, 2013 were $325,000 compared to $410,000 for the quarter ended December 31, 2012. Our ratio of net charge-offs to the total allowance for loan losses was 26.8% for the quarter ended December 31, 2013. As of December 31, 2013, the balance of the allowance for loan losses was $4.8 million, or 1.18% of gross loans and 166.61% of non-accruing loans, compared to an allowance for loan losses of $5.1 million or 1.26% of gross loans and 267.75% of non-accruing loans at September 30, 2013.

Table of Contents

The following table sets forth an analysis of our allowance for loan losses for the periods indicated.

	For the Three Months Ended December 31, 2013		For the Three Months Ended December 31, 2012		For the Year Ended September 30, 2013	
	(Dollars in thousands)					
Balance at beginning of period	$5,090		$7,581		$ 7,581	
Provision for loan losses	80		400		11,235	
Charge-offs:						
Residential mortgage	-		44		994	
Construction and Development						
Residential and commercial	37		50		5,768	
Land	-		-		99	
Commercial:						
Commercial real estate	-		155		6,315	
Other	-		-		94	
Consumer:						
Home equity lines of credit	14		-		-	
Second mortgages	320		184		1,042	
Other	2		4		9	
Total charge-offs	373		437		14,321	
Recoveries:						
Residential mortgage	11		-		199	
Commercial:						
Commercial real estate	2		-		117	
Other	1		21		23	
Consumer:						
Home equity lines of credit	-		1		17	
Second mortgages	33		5		235	
Other	1		-		4	
Total recoveries	48		27		595	
Net charge-offs	325		410		13,726	
Balance at end of period	$4,845		$7,571		$ 5,090	
Ratios:						
Ratio of allowance for loan losses to non-accrual loans	166.61	%	67.68	%	267.75	%
Ratio of net charge-offs to average loans outstanding, (annualized for the three-month periods ended December 31, 2013 and 2012)	0.32	%	0.36	%	3.12	%
Ratio of net charge-offs to total allowance for loan losses (annualized for the three-month periods ended December 31, 2013 and 2012)	26.84	%	21.68	%	269.67	%

49

Table of Contents

Other Income. Our other, or non-interest, income decreased by $799,000, or 61.1%, to $508,000 for the three months ended December 31, 2013 compared to $1.3 million for the three months ended December 31, 2012. The decrease in other income during the first quarter of fiscal 2014 was due primarily to a decrease in earnings on bank-owned life insurance of $577,000 due to a tax free death benefit of approximately $596,000 received in the first quarter of 2013 and a $137,000 decrease in gain on sale of loans due to decrease in the volume of loans sold.

Other Expenses. Our other, or non-interest, expenses decreased by $97,000, or 2.3%, to $4.2 million in the quarter ended December 31, 2013 compared to $4.3 million for the three months ended December 31, 2012. The slight decrease in other operating expenses in the first quarter of fiscal 2014 compared to the first quarter of fiscal 2013 was due primarily to a $412,000 decrease in other real estate owned expense and a $26,000 decrease in federal deposit insurance premiums. The decrease in other REO expense was due to the reduction of other real estate owned during the first quarter of fiscal 2014. These decreases were partially offset by a $219,000 increase in salaries and employee benefits and $121,000 increase in professional fees in the first quarter of fiscal 2014 when compared to the same period in fiscal 2013. The increase in salaries and employee benefits expense in the quarter ended December 31, 2013 primarily reflects an increase in the number of employees in our secondary market program as well as the increase in support staff in the Credit Review Department and Mortgage Loan Department, which primarily reflects our continuing efforts to strengthen our loan underwriting and credit administration policies and procedures.

Income Tax Expense. Our income tax expense was $3,000 for the three months ended December 31, 2013 compared to income tax benefit of $54,000 for the three months ended December 31, 2012. The income tax expense for the quarter ended December 31, 2013 primarily reflects the $550,000 decrease in pre-tax income during the quarter ended December 31, 2013. Our effective Federal tax rate was 4.4% and (8.8%) for the three months ended December 31, 2013 and 2012, respectively. The reason for the 4.4% effective tax rate is primarily due to state taxes. The Company did not record any federal expense for the current quarter. We evaluate our tax obligations on a quarterly basis and do not expect to resume making provisions for Federal income tax expense until we have reported net income before taxes for several consecutive fiscal quarters.

Liquidity and Capital Resources

Our primary sources of funds are from deposits, FHLB borrowings, amortization of loans, loan prepayments and the maturity of loans, mortgage-backed securities and other investments, and other funds provided from operations. While scheduled payments from the amortization of loans and mortgage-backed securities and maturing investment securities are relatively predictable sources of funds, deposit flows and loan prepayments can be greatly influenced by general interest rates, economic conditions and competition. We also maintain excess funds in short-term, interest-bearing assets that provide additional liquidity. At December 31, 2013, our cash and cash equivalents amounted to $22.7 million. In addition, at such date our available for sale investment securities amounted to $123.8 million.

In addition to cash flow from loan and securities payments and prepayments as well as from sales of available for sale securities, we have significant borrowing capacity available to fund liquidity needs. In recent years we have utilized borrowings as a cost efficient addition to deposits as a source of funds. Our borrowings consist primarily of advances from the Federal Home Loan Bank of Pittsburgh, of which we are a member. Under terms of the collateral agreement with the Federal Home Loan Bank, we pledge residential mortgage loans and mortgage-backed securities as well as our stock in the Federal Home Loan Bank as collateral for such advances.

We use our liquidity to fund existing and future loan commitments, to fund maturing certificates of deposit and demand deposit withdrawals, to invest in other interest-earning assets, and to meet operating expenses. At December 31, 2013, we had certificates of deposit maturing within the next 12 months amounting to $108.9 million. For the three months ended December 31, 2013, the average balance of our outstanding FHLB advances was $38.8 million. At December 31, 2013, we had $43.0 million in outstanding long-term FHLB advances and we had $168.5 million in potential FHLB advances available to us.

50

Table of Contents

The following table summarizes our contractual cash obligations at December 31, 2013.

	Payments Due by Period				
	To One Year	After One to Three Years	After Three to Five Years	After Five Years	Total
			(In thousands)		
Long-term debt obligations	$-	$15,000	$-	$28,000	$43,000
Certificates of deposit	108,915	91,706	41,321	5,956	247,898
Operating lease obligations	279	430	429	4,334	5,472
Total contractual obligations	$109,194	$107,136	$41,750	$38,290	$296,370

We anticipate that we will continue to have sufficient funds and alternative funding sources to meet our current commitments.

Impact of Inflation and Changing Prices

The financial statements, accompanying notes, and related financial data presented herein have been prepared in accordance with U.S. GAAP, which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of operations. Most of our assets and liabilities are monetary in nature; therefore, the impact of interest rates has a greater impact on its performance than the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

Item 3 - Quantitative and Qualitative Disclosures About Market Risk

For a discussion of the Company's asset and liability management policies as well as the methods used to manage its exposure to the risk of loss from adverse changes in market prices and rates market, see Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations – How We Manage Market Risk" in the Company's Annual Report on Form 10-K for the year ended September 30, 2013. There has been no material change in the Company's asset and liability position since September 30, 2013.

Item 4. Controls and Procedures

Our management evaluated, with the participation of our Chief Financial Officer (who was also performing the duties as acting principal executive officer as of the date of filing this Quarterly Report on Form 10-Q) the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based on such evaluation, our Chief Financial Officer (who was also performing the duties as acting principal executive officer as of the date of filing this Quarterly Report on Form 10-Q) concluded that our disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations and are operating in an effective manner.

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) or 15(d)-15(f) under the Securities Exchange Act of 1934) occurred during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II - OTHER INFORMATION

Item 1 - Legal Proceedings

Not applicable.

Item 1A - Risk Factors

See Item 1A, "Risk Factors" in the Company's Annual Report on Form 10-K for the year ended September 30, 2013. There have been no material changes from the risk factors previously disclosed in the Company's Annual Report on Form 10-K for the year ended September 30, 2013.

Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds

Not applicable.

Item 3 - Defaults Upon Senior Securities

There are no matters required to be reported under this item.

Item 4 - Mine Safety Disclosure

There are no matters required to be reported under this item.

Item 5 - Other Information

There are no matters required to be reported under this item.

Item 6 - Exhibits

31.1	Rule 13a-14(a)/15d-14(a) Section Certification
31.2	Rule 13a-14(a)/15d-14(a) Section 302 Certification
32.1	Section 1350 Certification

101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema Document.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.
101.DEF	XBRL Taxonomy Extension Definitions Linkbase Document.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MALVERN BANCORP, INC.

February 12, 2014

By: /s/ Dennis Boyle
Dennis Boyle
Senior Vice President and Chief Financial Officer
(Also authorized to sign this report as acting principal executive officer at the time this Form 10-Q is filed.)

53