VIRTRA SYSTEMS INC
Form 10KSB/A
August 20, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-KSB/A

Amendment No. 2

|X| ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934

For the Fiscal Year Ended December 31, 2005

or

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

For the transition period from _____ to _____

Commission File Number 000-28381

VIRTRA SYSTEMS, INC.

(Exact name of Registrant as specified in its Charter)

| Texas | 93-1207631 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification No.) |
| 2500 City West Blvd, Suite 300, Houston TX | 77042 |
| (Address of principal executive offices) | (Zip Code) |

(832) 242-1100

(Registrant's telephone number, including area code)

Securities registered under Section 12(b) of the Exchange Act:

None

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

Common Stock, par value $.005 per share

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

|__| Yes |X| No

The aggregate market value of the voting stock held by non-affiliates of Registrant at March 15, 2006 was approximately $4,807,971. The number of shares of Registrant's common stock outstanding on March 15, 2006 was 67,331,801. Revenue for the most recent fiscal year was $977,358.

Transitional Small Business Disclosure Format (Check one): |__| Yes; |X| No

Part I

**STATEMENT REGARDING THIS AMENDMENT**

We are amending our Annual Report on Form 10KSB/A to restate our financial statements for the years ended December 31, 2005 and the related disclosures. We have identified certain accounting errors related to the

recording of our debt arrangements. We have performed an analysis of our existing debt agreements and have concluded that we incorrectly recorded our debt obligations and associated warrants as a beneficial conversion feature pursuant to EITF 98-5. Our analysis determined that the warrants associated with our convertible notes payable are derivatives as defined under SFAS No. 133 and EITF 00-19. We also did not appropriately account for financing costs incurred as a direct result of these debt arrangements.

During February 2005 and August 2005 the Company issued $750,000 and $500,000, respectively, in convertible debentures. These debentures contained conversion features that were based upon market value and outside of the control of the Company, as a result the Company has accounted for the convertible debt and associated warrants as derivative instrument liabilities. Additionally, the embedded conversion features of the debentures have been bifurcated from the debt and accounted for separately as derivative instrument liabilities. We have amended Note 12 to disclose the derivative instrument liabilities and provide information on subsequent changes.

We are required to record the fair value of the conversion features and the warrants on our balance sheet at fair value with changes in the values of these derivatives reflected in the statement of operations as "Gain/(loss) on derivative liability." Moreover, we are now amortizing the value attributed to the conversion features as interest expense using the effective interest method over the life of the note. The effect of the (non-cash) changes related to accounting separately for these derivative instrument liabilities and amortization on our statement of operations for the twelve months ended December 31, 2005 was a decrease of $326,786 in our net loss attributable to common shareholders, for a restated net loss of $1,668,270. Basic loss attributable to common shareholders per share for the year ended December 31, 2005 was not materially affected by the restatement. The cumulative effect on our balance sheet was to increase total current liabilities by $378,732 and to reduce shareholders deficit by the same amount.

In all other material respects, this Amended Annual Report on Form 10-KSB/A-2 is unchanged from the Amended Annual Report on Form 10-KSB/A previously filed by us on May 23, 2007. This Amended Annual Report on Form 10-KSB-2 does not attempt to modify or update any other disclosures set forth in the Form 10-KSB and Form 10-KSB/A previously filed or discuss any other developments after the respective dates of those filings except to reflect the effects of the restatements described above, certain risk factor disclosure and except as otherwise specifically identified herein.

**Item 1. Description of Business**

**BUSINESS OVERVIEW**

Our principal business began in 1993 with the organization of Ferris Productions, Inc. Ferris designed, developed, distributed, and operated virtual reality products for the entertainment, simulation, promotion, and education markets.

Virtual reality is a generic term associated with computer systems that create a real-time visual/audio/haptic (touch and feel) experience. Virtual reality immerses participants into a three-dimensional real-time synthetic environment generated or controlled by one (or several) computer(s).

In September of 2001, Ferris merged into GameCom, Inc., a publicly held Texas company whose principal business at the time was the development and marketing of an internet-enabled video game system.

Our historic areas of application have included the entertainment/amusement, advertising/promotion, and training/simulation markets.

Our *"immersive virtual reality™"* devices are computer-based, and allow participants to view and manipulate graphical representations of physical reality. Stimulating the senses of sight, sound, touch, and smell simultaneously, our virtual reality devices envelop the participant in dynamic filmed or computer-generated imagery, and allow the participant to interact with what he or she sees using simple controls and body motions. Virtual reality products have traditionally employed head-mounted displays that combine high-resolution miniature image source monitors, wide field-of-view optics, and tracking sensors in a unit small and light enough to be worn on the head. These products usually surround the participant with dynamic three-dimensional imagery, allowing the

user to change perspective on the artificial scenes by simply moving his or her head. Virtual reality devices have in the past been used primarily in connection with electronic games, as, by surrounding the player with the sights, sounds, and smells he or she would experience in the real world, play is made far more realistic than it would be if merely presented in a two-dimensional flat screen display.

In 2003, we made the strategic decision to take our 360-degree core technology from headset-based systems to larger, more complex projection-based systems.

We currently manufacture, market, and sell our *immersive virtual reality* products in two distinct markets: training/simulation and advertising/promotion. Within the training and simulation market, we offer two different versions of our patent-pending IVR™ 360-degree high-definition firearms training simulators: the IVR HD™, launched in March of 2004, for use in marksmanship, conflict resolution, and situational awareness training of law enforcement and security officers, and the IVR 4G™, launched in December of 2004, for use in military firearms/marksmanship training, situational awareness, and fourth-generation squad-based training.

Within the advertising/promotion market, we market the patented Immersa-Dome® personal *immersive virtual reality* theater, featuring the sensations of sight, sound, touch, and smell, and our 3-D multisensory theater, a product offering customized three-dimensional projected content in high-definition, with multisensory effects, for multiple viewers.

We maintain our corporate office at 2500 City West Blvd., Suite 300, Houston, Texas 77042, and our telephone number is (832) 242-1100. We also maintain engineering, technical, and production offices, and a demonstration facility, at 5631 South 24th Street, Phoenix, Arizona 85040, with a phone number of (602) 470-1177.

***Entertainment/Amusement***

The entertainment/amusement market was the original market for our products. Our *"immersive virtual reality™"* devices were designed to produce a highly-realistic experience at a significantly lower cost than traditional virtual reality technology. Historically, the software for virtual reality games and other applications was separately created for each application. Our systems were developed using our patented Universe Control Board™, which, when installed in an ordinary PC, makes it possible to quickly adapt PC games for the arcade market, permitting easy conversion of PC games to behave as coin-operated arcade games, and allows the operator to change from one game to another without expensive hardware replacement.

Within the entertainment/amusement market, we installed and operated virtual reality entertainment centers known as VR Zones in over a dozen theme parks and high-traffic visitor locations, such as:

.

Six Flags,

.

Paramount Parks,

.

Busch Gardens, and

.

Carnival Cruise Lines.

These VR Zones were equipped with systems we developed and manufactured, and were operated by our employees on a revenue-share basis with the theme park locations. We sold our VR Zones and effectively left this market in the spring of 2003, in order to more fully focus on the advertising/promotional and training/simulation markets.

***Advertising/Promotion***

We entered the advertising/promotion market, our second, with our 2000 “Drive With Confidence Tour™” for Buick, featuring a virtual reality “test-drive” of a Buick LeSabre with PGA professional Ben Crenshaw accompanying the participant. This project led us to additional projects within this market, such as:

.

a virtual reality bi-plane experience for Red Baron® Pizza,

.

a virtual reality ski jump promotional program for Chevrolet in conjunction with its *“Olympic Torch City Celebration Tour™,”*

.

an interactive promotional project for Shell Oil Product's Pennzoil® division's *"Vroom Tour*™", which featured Jay Leno "inside" an automobile engine demonstrating how oil functions inside an automobile engine, and ended with the visitor driving Pennzoil's Formula One car around the Las Vegas Motor Speedway at speeds in excess of 220 miles per hour,

.

a 50-seat, 3-D immersive theater for Red Baron® Pizza's *"3-D Flying Adventure*™*,"* which featured special glasses, Dolby® 5.1 sound, and special effects that literally "jump" off the screen,

.

a virtual reality recruitment tool for the United States Army, in which participants ride in an Army Black Hawk helicopter performing an exciting rescue mission, and

.

a 3-D immersive theater project for Sea-Doo®, using our 3-D technology for 2-D to 3-D video conversion and 3-D computer animation, for 1) a motion simulator utilizing polarized glasses, 2) a theater-style presentation utilizing anaglyph (cyan-blue) glasses, and 3) a web-suitable version utilizing 3-D anaglyph glasses, all in connection with Bombardier's launch of its new 2004 Sea-Doo® 3D™ personal watercraft.

The year 2004 witnessed the completion of a strategic move from headset-based to projection-based technology, evidenced by the development and launch of our patented Immersa-Dome®, featuring a domed-shaped screen which surrounds the seated viewer and delivers a high-definition resolution virtual reality experience.

The May 3, 2004, launch of the Immersa-Dome product was rapidly followed by several new projects:

.

a mobile promotional experience for Buick's new Terraza™ and LaCrosse™ vehicles, using four Immersa-Dome units installed in two of Buick's event-marketing trailers. This was our second collaboration with Buick's event marketing agency, Momentum Detroit,

.

a sale of three Immersa-Domes to the United States Army Recruiting Command in Fort Knox, Kentucky, for installation in mobile recruiting trailers traveling the United States to major events, high schools, and universities in connection with the Army's recruiting efforts,

.

the installation of three Immersa-Domes at the new Red Baron® Museum in Marshall, Minnesota, providing the visual experience of flying an acrobatic bi-plane with the Red Baron® Pizza Squadron™ in an 180-degree multisensory experience,

2005 advertising/promotion projects included projects for both new and returning customers. In addition, 2005 witnessed a new custom project that adapted our IVR™ product for use in the treatment of patients, and training of clinicians, for speech disorders. This speech disorder project represented the application of our *immersive virtual reality* technology into a new market medical treatment and training.

Returning customers during 2005 requested license renewals and/or upgrades of previous projects, including:

.

the Schwan Food Company s renewal and upgrade of both its promotions for the Red Baron Pizza Squadron's 2005 air show season; renewal of the *Red Baron Flight Club*™ virtual reality experience, and integration of the Red Baron brand's *3-D Flying Adventure*™, a 3-D multisensory theater promotion, inside of a new, standard 18-wheel trailer, and

.

Buick renewed and upgraded its Immersa-Dome® promotional experience for the 2006 Lucerne™ luxury sedan ,with new high-definition content featuring professional golfer Tiger Woods promoting Buick's new Lucerne automobile, which was installed into two themed trailers traveling throughout North America, stopping at Buick special events and selected PGA Tour events.

In addition, two new projects were received in 2005:

.

An Immersa-Dome® promotional tour for Pfizer Pharmaceuticals trade show activities, featuring three specially themed Immersa-Domes delivering customized promotional content describing newly-developed drugs, and

.

the sale of a specially-modified IVR 180 to Case Western Reserve University s speech pathology department, for researching the efficacy of virtual reality to treat patients for, and educate clinicians in, diagnoses of speech disorders.

We currently have proposals under submission to a number of advertising/promotional and government agencies, Fortune 500 companies, and governmental agencies in conjunction with pending advertising/promotional campaigns and customized projects.

***Training/Simulation***

In 2004, we unveiled our IVR™ line of projection-based training simulators for judgmental use-of-force, situational awareness, combat-readiness, and tactical judgment objectives. The two IVR product lines provide the law enforcement, military, and security markets with 360-degree immersive training environments.

Our IVR HD™ series, designed primarily for law enforcement objectives, was completed in January of 2004, and was publicly debuted to the domestic law enforcement market in late March of 2004, at the industry's Trexpo West trade show in Long Beach, California.

Our military-oriented IVR 4G™ system, designed to train soldiers for "fourth generation" warfare, was debuted at the industry-leading I/ITSEC trade show in Orlando, Florida in December of 2004. " Fourth generation warfare, as discussed in the October, 1988 *Marine Corps Gazette,* is characterized by transnational groups without territorially-based armies, engaging in highly irregular practices such as guerilla warfare, terrorist tactics, and low-intensity, close quarter conflict, enabling groups that are weaker militarily to defeat larger, stronger forces. Fourth-generation battlefields may include the whole of the enemy's society, where small, well-trained, highly maneuverable forces may tend to dominate.

In 2005, the installation base of our IVR HD and IVR 4G models grew both internationally and domestically, as we gained new military and law enforcement customers. We sold or installed IVR HD law enforcement simulators to law enforcement agencies in Washington County, Utah; Manistee, Michigan; Duluth, Georgia; and Charleston, South Carolina. In addition, our IVR 4G military version simulators were sold or installed, both domestically and abroad, at MacDill AFB, Florida: Fort Hood, Texas; and at two Mexican locations.

We announced our initial sale in this market in September of 2003, and, as of March 15, 2006, we had sold 36 systems, all variations of the IVR series, to the United States Air Force, the United States Army, a classified Department of Defense customer, several domestic law enforcement agencies, and state police and security organizations in Malaysia, Mexico, and India. Our initial IVR series installation was accomplished in March of 2004. We have recently received several confidential purchase commitments, both domestically and internationally, and we have numerous additional confidential proposals currently under review.

**Virtual Reality Products**

Our *"immersive virtual reality™"* products include:

**Training/Simulation Products**

The IVR HD™ and IVR 4G™ series, designed for law enforcement and military use, respectively, are projection-based, multi-screened, high-definition resolution, combat-readiness and judgmental use-of-force firearms training simulators. The IVR™ series simulators use company-produced high-definition filmed content as well as our Hybrid-CGI™ content. Our Hybrid-CGI software combines film content with computer-generated images, allowing users to create their own customized 360-degree training scenarios by combining "green-screen video, panoramic photorealistic images, computer-generated images, and 3-D sound. Green-screen filming is the technique of filming actors and other visual elements in the foreground against an evenly-colored green background, and subsequently extracting the actors and other visual elements and placing them onto a new panoramic background specifically suited to the user s needs and locale.

The IVR systems use off-the-shelf computer equipment, extremely-accurate laser-based weapons tracking, 360-degree video and audio, and ultra-high resolution interactive graphics. The systems deliver both photorealistic and computer-generated imagery -based video for training scenarios. The systems support one to six users, and have the option to be reconfigured into a 20-lane, military-approved, virtual shooting range for realistic marksmanship training.

Trainees step into the simulator, and then interact with a training scenario selected by the instructor, using their weapon of choice. The training scenarios teach combat-readiness, situational awareness, fourth-generation warfare tactics, and judgmental use-of-force with both lethal and non-lethal weapons currently used by military, law enforcement, and security agencies.

The IVR 4G military series of simulator products are offered in four different configurations:

.

the IVR 4G-base™ is a single-screen model, and its compact size offers portability and supports one to four trainees.

.

the IVR 4G-180™ offers an 180-degree field-of-view for more realistic combat training and marksmanship. It supports one to four trainees.

.

the IVR 4G-300™ delivers 300-degree field-of-view for more realistic combat scenarios and marksmanship training, and supports one to five trainees.

.

the IVR 4G-360™ offers a 360-degree field-of-view for combat and marksmanship training, and supports one to six trainees.

The IVR HD law enforcement series is offered in four different configurations:

.

the IVR HD-base™ is a single-screen model, offering portability, and supports one to four trainees.

.

the IVR HD-180™ offers an 180-degree field-of-view for more realistic training and target tracking. It supports one to four trainees.

.

the IVR HD-300™ delivers 300-degree use-of-force scenarios, and supports one to five trainees.

.

the IVR-360™ HD offers 360-degree firearms training, and supports one to six trainees.

We also have developed and market proprietary training accessories for use with both our IVR product lines, as well as those manufactured by third-parties:

.

the wireless Threat-Fire™ belt permits the simulator's instructor to deliver an electric "stun" to the trainee, simulating the sensation of being shot, thus enhancing the multi-directional experience of our IVR simulators by increasing the seriousness and stress of training scenarios.

.

our Hybrid-CGI™ scenario creation software integrates "green-screen" video, panoramic photorealistic images, computer-generated images, and 3-D sound, decreasing both cost and time of scenario production. Our Hybrid-CGI software offers the end-user more custom scenario options than traditional scenario production methods and other forms of training software.

.

a wireless/tetherless drop-in recoil conversion kit, which transforms a live weapon into an accurate and safe training weapon. It features 1) a laser-based tracking mechanism, 2) self-contained, tetherless pneumatic recoil, and 3) instructor-controlled weapon malfunction capability to simulate a jammed weapon in the field. The system provides no possibility of chambering a live bullet while in training mode.

.

laser-based pneumatic recoil conversion kits for most military and law enforcement handguns, assault rifles, and shotguns.

.

less-lethal, laser-based training tools, including Taser® and canister OC pepper spray.

.

TMaR (Trainee Monitor and Recording) debriefing product, which records and plays back the trainee s actions in the simulator, allowing systematic review of the trainee s performance.

.

wireless/tetherless handgun training conversion drop-in recoil kits, which transform a handgun into a safe training weapon, allowing modification of a trainee's sidearm for training in our IVR simulators.

**Advertising/Promotional Products**

.

the Immersa-Dome® is a patented projection-based virtual reality system, which uses a domed-shaped screen to surround the viewer. The Immersa-Dome offers photorealistic environments with 180-degree

field-of-view and high-definition resolution. The system is composed of the dome's base, the viewer's seat, and a separate projector/mirror stand.

.

the 3-D Multisensory Theater™ is a portable-seat, high-capacity (50-100 viewers) 3-D theater with special effects packages, including fog, wind, and simulated lighting, among others. This theater system features 3-D, high-resolution imagery on a large projected screen. Participants wear polarized glasses, which facilitate 3-D depth in the screen images. This system also features time-triggered smells, wind simulation, and a Dolby® 5.1 sound system. The 3-D Multisensory Theater uses a silver screen and two projectors. Three-dimensional filming techniques are used and processed to finalize the 3-D experience. Computer-generated 3-D imagery is an alternative development method to 3-D filming.

.

the 360-degree headset-based virtual reality system delivers photorealistic content. In addition, the user, while seated, is tracked in 360 degrees. The multisensory system incorporates off-the-shelf computer equipment, gyroscopic head-tracking, stereo sound, wind simulation, and smell. The system comes standard for one user.

**Competition**

Competition within each of our markets is intense.

There are several large competitors in the general field of high-tech simulation. For instance, the January 7, 2002 edition of Forbes magazine contains a feature story on L3 Communications, Inc., a company purportedly doing in excess of $5 billion in business with the United States government in this market. L3 has so far focused on other types of simulators (such as aircraft motion simulators) and to-date we have never directly competed against L3, and may never compete with them regarding our IVR simulators. Other companies have made essentially the same single-screen style simulator for the past 15 years or longer.

As our virtual reality experiences are usually custom applications, and we deal primarily with advertising agencies, or directly with the client, it is difficult to quantify the competition. Sometimes companies are able to penetrate one or two particular high-tech promotions. With over 13 years in the marketplace, we currently are not aware of any other virtual reality-based advertising/promotion company with similar products similar to ours.

Some general competitors within the virtual reality industry that promote substitute and similar technologies are as follows:

.

**Advanced Interactive Systems, Inc. ( AIS )--**has been a provider of interactive simulation systems designed to provide training for law enforcement, military, and security agencies since 1993. Its line of products uses primarily video production in judgmental training scenarios. AIS also markets to anti-terrorist and other special application training facilities for military and special operations groups. Its systems have historically used only single screen technology.

.

**Cubic Defense Applications** performing in a wide range of industries, including military simulation, Cubic currently produces a product (EST-2000) which was developed several years ago as mainly a marksmanship training system, with limited immersive combat training capabilities. Due to its size and corporate strength, Cubic could become a formidable competitor if it chose to focus on firearms training.

.

**Firearms Training Systems, Inc. ( FATS )--**claims to have over 4,000 training systems installed worldwide by military, law enforcement, and commercial customers. FATS is a full service training/simulation company that also uses video scenarios with single-screen technology. FATS also produces other types of simulators and recoil weapons. AIS, Cubic and FATS products are similar in many respects, although FATS has been in the market longer.

.

**IES Interactive Training, Inc. (IES)**--a supplier of basic simulation equipment to law enforcement. Having fielded several hundred single screen systems in the law enforcement marketplace, it is mainly focused on the law enforcement marketplace.

.

**Straylight**--has focused on the use of virtual reality in the promotions and conventions market. .

Our recent patent applications may hamper or halt potential plans by our competitors to enter the multi-screen simulator industry to compete with our IVR simulator.

The above summaries of competition are by no means exhaustive, since these industries are fluid and, at times, rapidly expanding.

## Marketing

Marketing within the training/simulation market is conducted primarily through trade shows, trade journal advertisements, search engine strategies, and one-on-one demonstrations. We recently completed and publicly unveiled the IVR HD™ series of law enforcement-focused advanced training simulators at the Trexpo West trade show in March of 2004, and we publicly unveiled the military-oriented IVR 4G™ fourth generation warfare simulators at the I/ITSEC trade show in December of 2004. We have demonstrated the IVR simulators to high-level officers in the United States military, the Department of Defense, as well as to municipal, state, and federal agencies both domestically and internationally. In addition to our 25 announced sales to foreign governmental agencies, we have also sold 11 systems to domestic military and law enforcement agencies, and we have been advised that our IVR simulators are in the budgeting stages for branches of the United States Armed Forces, municipal and state law enforcement agencies, and several foreign governments. Of the 36 IVR™ systems we have sold, 12 have been fully installed, two have been shipped and are awaiting installation, and the remainder are contracted for future delivery.

Marketing within the advertising/promotional market is conducted primarily by web-based search engine strategies and by the face-to-face sales efforts of our vice-president of advertising and promotion. Our Immersa-Dome demonstration unit uses high-definition content from our projects for Pennzoil, Buick, Red Baron® Pizza, Chevrolet, and the U.S. Army. Marketing within this industry is conducted primarily by one-on-one appointments and demonstrations of our technology to agencies and qualified corporations. We also attend industry tradeshows to generate leads and to garner further market exposure.

## Employees

At March 15, 2006, we employed 15 people. None of our employees are members of a union, and we consider relations with our employees to be satisfactory.

**Trademarks/Patents**

We have obtained a patent for our Universe Control Board™, and various federal trademarks. We have also filed for federal registration of our “Immersive Virtual Reality™” and “IVR™” trademarks.

On December 20, 2005, we successfully registered our claim on the trademark Immersa-Dome® from the United States Patent and Trademark Office.

On March 15, 2004, we applied for a patent on our IVR™ series of advanced training simulators, seeking a patent for our “multiple screen simulation system and method for situational response training.

On May 3, 2004, we announced that we had obtained an exclusive license to the patented technology behind the Immersa-Dome.

On December 3, 2004, in advance of industry demonstration at the industry-leading Interservice/Industry Training and Simulation Education Conference in Orlando, Florida, we submitted three separate provisional patent applications for innovations in the field of firearms training. These included: 1) the Threat-Fire™ Belt, 2) our Hybrid-CGI™ software, and 3) a "drop-in" kit and magazine for wireless recoil in real weapons.

First, the Threat-Fire Belt permits the simulator's instructor to deliver an electric "stun" to the trainee, simulating the sensation of being shot, thus enhancing the multi-directional experience associated with our IVR simulators.

Second, the Hybrid-CGI software integrates "green-screen" video, panoramic images, computer-generated images, and 3-D sound. Green-screen filming is the technique of filming actors and other visual elements in the foreground against an evenly-colored green background, and subsequently extracting the actors and other visual elements and placing them onto a new panoramic background specifically suited to the user s needs and locale. Hybrid-CGI software decreases both cost and time of scenario production, and provides more scenario options to the end user than traditional production methods.

Third, the "drop-in" kit and magazine is non-permanent, and delivers wireless recoil to a real weapon. The magazine is refillable, and the aiming laser features hyper-accurate collinear placement for both immersive combat training and marksmanship qualification. Use of untethered training weaponry is highly desirable in firearms simulators.

On November 22, 2005, the provisional patent applications filed in 2004 for the Threat-Fire™ belt and Hybrid-CGI™ software were upgraded to full patent applications, submitted to the United States Patent and Trademark Office, and are currently awaiting patent office action.

In December of 2005, we decided to not proceed with a full patent application of the provisional application originally filed on December 3, 2004, relating to the "drop-in" kit and magazine recoil design, due to significant design improvements incorporated since the preparation of the original provisional patent application.

There can be no assurance that patents or trademarks will issue on these applications, or that, if issued, they will be sufficiently broad to provide meaningful protection.

**Item 2. Description of Property**

Our executive offices are located in Arlington, Texas, at the offices of Jones & Cannon, P.C. See "Certain Relationships and Related Transactions." Jones & Cannon, P.C. began charging us $1,500 per month for our office space on June 15, 2000, but to date only $9,000 has been paid, all in 2002. There is no assurance that these offices will remain sufficient for our use, or that the nature of this relationship will continue.

Our production offices are located in Phoenix, Arizona, in an office building owned by Ferris Holdings, L.L.C. See Certain Relationships and Related Transactions. Ferris Holdings has charged us $7,772.00 per month for our office space since August of 2000. We have a 25 1/2-year lease with Ferris Holdings.

**Item 3. Legal Proceedings**

On February 6, 2004, suit was filed against us in County Court at Law No. 4 of Harris County, Texas, in cause number 810288, styled *Barbara Nedry v. VirTra Systems, Inc.*, seeking payment of the principal sum of $6,000, plus accrued interest, in equipment leases allegedly entered into by Ms. Nedry with the former Ferris Productions, Inc. in 2001. We have contested the allegations. The case is currently in the pre-trial discovery phase.

On May 13, 2004, suit was filed against us in the federal district court of South Carolina, in cause number 04CP402455, styled *Garland and Leota Slagle v. VirTra Systems, Inc.*, seeking payment of the principal sum of $90,000, plus accrued interest, in equipment leases allegedly entered into by the Slagles with the former Ferris Productions, Inc. in 2001. We have contested the allegations. The parties are currently in settlement discussions.

On December 30, 2004, suit was filed against us in the federal district court of North Carolina, in cause number 4:04-CV-199-H2, styled *Edward and Linda Strickland v. VirTra Systems, Inc.*, seeking payment in the principal sum of $72,000, plus accrued interest, in equipment leases allegedly entered into by Mr. Strickland with the former Ferris Productions, Inc. 2001. We contested the allegations. In February of 2006, we entered into an agreed judgment in the amount of $85,000, with a contractual provision in the judgment that there would be no collection activity on the judgment prior to February of 2007.

**Item 4. Submission of Matters to a Vote of Security Holders**

No matters were submitted to a vote of security holders during the last quarter of the period covered by this report.

Part II

**Item 5. Market for Registrant's Common Equity and Related Stockholder Matters**

**Market Information`**

Our common stock is quoted under the symbol "VTSI" on the OTC Electronic Bulletin Board. The following table sets forth the high and low bid prices for shares of our common stock for the periods noted, as reported by the OTC Electronic Bulletin Board. Quotations reflect inter dealer prices, without retail markup, mark down, or commission, and may not represent actual transactions.

| | | BID PRICES | |
|---|---|---|---|
| YEAR | PERIOD | HIGH | LOW |
| 2003 | | | |
| | First Quarter | $0.14 | $0.09 |
| | Second Quarter | 0.15 | 0.06 |
| | Third Quarter | 0.29 | 0.07 |
| | Fourth Quarter | 0.47 | 0.21 |
| 2004 | | | |
| | First Quarter | 0.35 | 0.20 |
| | Second Quarter | 0.43 | 0.24 |
| | Third Quarter | 0.42 | 0.28 |
| | Fourth Quarter | 0.46 | 0.28 |
| 2005 | | | |
| | First Quarter | 0.43 | 0.22 |
| | Second Quarter | 0.30 | 0.13 |
| | Third Quarter | 0.24 | 0.11 |
| | Fourth Quarter | 0.20 | 0.10 |

As of April 12, 2006, the reported bid price for our common stock was $0.088 per share.

## Shareholders

As of March 15, 2006, we had 67,331,801 shares of common stock outstanding, held by 203 shareholders of record.

## Dividends

We have not paid cash dividends on our common stock in the past and we do not anticipate doing so in the foreseeable future.

### Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion contains certain forward-looking statements that are subject to business and economic risks and uncertainties, and our actual results could differ materially from those forward-looking statements. The following discussion regarding our financial statements should be read in conjunction with the financial statements and notes to those financial statements.

## Overview

Our principal business began in 1993 with the organization of Ferris Productions, Inc. Ferris designed, developed, distributed, and operated virtual reality products for the entertainment, simulation, promotion, and education markets. In September of 2001, Ferris merged into GameCom, Inc., a publicly held Texas company whose principal business at the time was the development and marketing of an internet-enabled video game system. We subsequently adopted our present name.

Prior to the merger of Ferris and GameCom, both companies had incurred substantial debt, much of which was eliminated in December of 2004 in a debt for equity conversion. However, there can be no assurances that we will be able to successfully implement our expansion plans. As we enter the training/simulation market, we face all of the risks, expenses, and difficulties frequently encountered in connection with the expansion and development of a new business, difficulties in maintaining delivery schedules if and when volume increases, the need to develop support arrangements for systems at widely-dispersed physical locations, and the need to control operating and general and administrative expenses.

In October of 2005, we announced our intention to acquire three electronic manufacturing services companies: Chrysalis Manufacturing d/b/a Altatron EMS; Dynalyst Manufacturing Corporation; and Suntech, Inc.

In December of 2005, we executed a definitive agreement with Virtra Merger Corporation to acquire three private electronics manufacturing service firms: Altatron International, Inc.; Chrysalis Manufacturing Corporation d/b/a Altatron EMS; and Dynalyst Manufacturing Corporation. Under the terms of the definitive agreement, we would acquire the three companies in a stock-for-stock merger transaction. We are currently in the due diligence phase, and there can be no assurance that the merger will be consummated.

## Critical Accounting Policies

### 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 reported amounts and related disclosures. Actual results could differ from those estimates.

### Restatements

Restatements of 2005 information previously reported were made. See Note 12 for

details.

### Revenue Recognition

Revenue from custom application contracts are recognized on a percentage-of-completion basis, measured by the percentage of costs incurred to date to total estimated costs for each contract. Contract costs include all direct material and labor costs, and those indirect costs related to contract performance, such as indirect labor, supplies, tools, repairs, and depreciation costs. General and administrative costs are charged to expense as incurred.

Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions, and estimated profitability may result in revisions to costs and income, and are recognized in the period in which the revisions are determined. An amount equal to contract costs attributable to claims is included in revenue when realization is probable and the amount can be reliably estimated.

Costs and estimated earnings in excess of billings on uncompleted contracts represent revenue recognized in excess of amounts billed. Billings in excess of costs and estimated earnings on uncompleted contracts represent amounts billed in excess of revenue recognized.

**Stock-Based Compensation**

We account for our stock compensation arrangements under the provisions of Accounting Principles Board ( APB ) No. 25 Accounting for Stock Issued to Employees. We provide disclosure in accordance with the disclosure-only provisions of Statement of Financial Accounting Standard ( SFAS ) No. 123R Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure . Effective January 1, 2006, we adopted FAS 123R using the modified prospective transition method as defined. Under the modified prospective method we will record compensation cost prospectively for the unvested portion as of January 1, 2006, of previously issued and outstanding awards over the remaining vesting period of such awards.

**Derivative Financial Instruments**

We do not use derivative instruments to hedge exposures to cash flow, market, or

foreign currency risks.

Derivative financial instruments are initially measured at their fair value. For derivative financial instruments that are accounted for as liabilities, the derivative instrument is initially recorded at it fair value and is then re−valued at each reporting date, with changes in the fair value reported as charges or credits to income. For option−based derivative financial instruments, we use the Black−Scholes model to value the derivative instruments. The classification of derivative instruments, including whether such instruments should be recorded as liabilities or as equity, is reassessed at the end of each

reporting period. Derivative instrument liabilities are classified in the balance sheet as current or non−current based on whether or not net−cash settlement of the derivative instrument could be required within 12 months of the balance sheet date.

**Results of Operations**

**Fiscal year ended December 31, 2005 compared to fiscal year ended December 31, 2004.**

Total revenue for the year ended December 31, 2005 was $977,358, compared to total revenue of $1,328,180 for the year ended December 31, 2004. This decrease of $350,822, or 26%, resulted primarily the timing of several IVR™ simulator sales which were delivered in the spring of 2006.

Cost of sales and services decreased $196,689, or 23%, to $663,376, for the year ended December 31, 2005, from $860,065 for the year ended December 31, 2004. This decrease is relatively proportionate to the change in revenue.

General and administrative expenses decreased by $859,107, or 31%, to $1,961,543 for the year ended December 31, 2005, from $2,820,650 for the year ended December 31, 2004. The decrease is primarily due to no incentive compensation being granted to senior management in 2005 while approximately $600,000 was granted in 2004. In addition, we accrued $280,000 for the potential settlement of the Legg Mason lawsuit in 2004, and there was no similar expense in 2005. In fact, the lawsuit was settled for a $50,000 cash payment in 2005, and we accordingly recorded a gain on settlement of $230,000.

Interest expense and finance charges increased to $1,321,211 for the twelve months ended December 31, 2005, a 37.9% increase over the $957,912 reported for the same period in 2004. Of this amount, $375,885 resulted from

charges relating to the expense of debt discount upon conversion of convertible debentures referred to in Note 12 to the financial statements.

During 2004, we presented an exchange offer to the holders of certain of our notes payable and obligations under product financing arrangements, whereby the debtholders were allowed to convert their principal and accrued interest to our common stock under one of three options. Under Option A, the debtholder could receive common stock equal to 0.6 shares per dollar of principal amount he or she was owed, and was not required to lock up any of the shares he or she received in the exchange. Under Option B, each debtholder could receive common stock equal to 0.9 shares per dollar of principal amount he or she was owed, but could not sell any of the shares for a period of six months, after which the shares could be sold in six equal monthly installments. During the years ended December 31, 2005 and 2004, we issued 393,400 and 5,303,258 shares, respectively, of our common stock in exchange for the following: (i) $0 and $183,500 in principal and $0 and $49,069 of accrued interest, respectively, on our notes payable, (ii) $0 and $615,531 in principal and $0 and $155,475 of accrued interest, respectively, on our notes payable to stockholders, and (iii) $159,782 and $5,792,176 of principal and interest, respectively, outstanding on our obligations under product financing arrangements. As a result of this debt exchange, we recorded $221,720 and $4,621,415 of forgiveness of debt income in the statement of operations for the years ended December 31, 2005 and 2004, respectively.

In addition to the forgiveness of debt income resulting from the debt exchange agreements, we also wrote off various notes payable and certain other notes payable to stockholders that were settled through a lawsuit settlement. Included in forgiveness of debt income in the statement of operations for the year ended December 31, 2005 and 2004 is $294,500 and $301,085, respectively, related to these settlements.

**Liquidity and Plan of Operations**

As of December 31, 2005, our liquidity position was extremely precarious. We had current liabilities of $5,308,155, including $494,372 in obligations remaining under the lease financing for the old Ferris Productions virtual reality systems, $2,560,481 in accounts payable and accrued liabilities, and short-term notes payable of $1,095,899, some of which were either demand indebtedness or were payable at an earlier date and were in default. As of December 31, 2005, there was only $185,668 in current assets available to meet those liabilities.

To date we have met our capital requirements by acquiring needed equipment under the Ferris Productions non-cancelable leasing arrangements, through capital contributions, loans from principal shareholders and officers, certain private placement offerings, and through our convertible debentures and equity line financing with Dutchess Private Equities Fund, L.P.

For the year ended December 31, 2005, our net loss was $1,668,270. After taking into account the non-cash items included in that loss, our cash requirements for operations were approximately $1,400,000. In addition, we made capital expenditures of $14,536, and repaid notes and certain advances in the amount of $475,791. To cover these cash requirements, we issued convertible debentures for $1,250,000, received proceeds from the issuance of notes payable and other advances of $405,640, and issued 246,352 shares of our common stock for net cash proceeds of $76,143.

The opinion of our independent auditor for the year ended December 31, 2005 expressed substantial doubt as to our ability to continue as a going concern. We will need substantial additional capital or new lucrative custom application projects to become profitable. In July of 2002, we entered into a financial contract with Dutchess Private Equities Fund, L.P. Under this arrangement, Dutchess is to purchase under an equity line up to $5 million of our common stock over a two-year period. The number of shares we may sell to Dutchess is based upon the trading volume of our stock. Dutchess and several other investors also participated in a private placement of $450,000 in convertible debentures, which has been repaid in full. In February of 2005, we entered into a new financial contract with Dutchess, under which Dutchess is to purchase under a new equity line up to $6 million of our common shares, similar to the 2002 agreement, which will soon be expiring. Additionally, during 2005 we completed two private placements with Dutchess for $1,250,000 in convertible debentures. Based on recent increases in the stock's trading volume following our entry into the training/simulation market, management believes that this equity line will allow us to continue our operations for at least the next 12 months.

**Item 7. Financial Statements**

**VIRTRA SYSTEMS, INC.**

**TABLE OF CONTENTS**


| | Pages(s) |
|---|---|
| Report of Independent Registered Public Accounting Firm | 14 |
| Financial Statements: | |
| Balance Sheet as of December 31, 2005 | 16 |
| Statement of Operations for the years ended December 31, 2005 and 2004 | 17 |
| Statement of Cash Flows for the years ended December 31, 2005 and 2004 | 18 |
| Statement of Stockholders Deficit for the years ended December 31, 2005 and 2004 | 20 |
| Notes to Financial Statements | 21 |

14

HAM, LANGSTON & BREZINA, L.L.P.

Certified Public Accountants

---

**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Stockholders of

VirTra Systems, Inc.

We have audited the accompanying balance sheet of VirTra Systems, Inc. (the Company ) as of December 31, 2005, and the related statements of operations, stockholders deficit and cash flows for the years ended December 31, 2005 and 2004. 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 audits.

We conducted our audits in accordance with 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 that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of VirTra Systems, Inc. as of December 31, 2005, and the results of its operations and its cash flows for the years

ended December 31, 2005 and 2004 in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming the Company will continue as a going concern. As discussed in Note 2 to the financial statements, the Company has suffered recurring losses from operations and at December 31, 2005 is in a negative working capital position and a stockholders deficit position. These factors raise substantial doubt about the Company s ability to continue as a going concern. Management s plans in regard to these matters are also described in Note 2. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As discussed in Note 3 to the financial statements, in 2004 the Company changed its method of accounting for variable interest entities.

As discussed in Note 12 to the financial statements, the Company has restated its financial statements as of and for the year ended December 31, 2005 to correct errors in its accounting for convertible notes payable and related warrants to purchase common stock.

/s/ Ham Langston & Brezina, L.L.P.

Houston, Texas

April 17, 2006, except for note 12 which is August 17, 2007

15

**VIRTRA SYSTEMS, INC.**

**BALANCE SHEET**

**December 31, 2005**

| | | **December 31, 2005** |
|---|---|---|
| **ASSETS** | | |
| Cash and cash equivalents | $ | 764 |
| Accounts receivable | | 184,904 |
| Costs and estimated earnings in excess of billings on uncompleted contracts | | - |
| Total current assets | | 185,668 |
| | | |
| Property and equipment, net | | 951,630 |
| Capitalized development cost, net | | 130,815 |
| Total non-current assets | | 1,082,445 |
| | | |
| TOTAL ASSETS | $ | 1,268,113 |
| | | |
| **LIABILITIES AND STOCKHOLDERS' DEFICIT** | | |
| LIABILITIES | | |
| Notes payable | $ | 1,095,899 |
| Obligations under product financing arrangements | | 494,372 |
| Convertible debentures, net of discount of $613,286 | | 160,760 |
| Derivative liability | | 692,848 |
| Accounts payable | | 1,232,779 |
| Accrued liabilities | | 1,327,702 |
| Advanced held on deposit | | 183,650 |
| Billings in excess of costs and estimated earnings on uncompleted contracts | | 84,650 |
| Payable to related party | | 35,495 |
| Total current liabilities | | 5,308,155 |
| | | |
| Redeemable common stock | | 1,859 |
| Total non-current liabilities | | 1,859 |
| | | |
| Total liabilities | $ | 5,310,014 |
| | | |
| SHAREHOLDERS' DEFICIT | | |
| Common stock, $.005 par value, 100,000,000 shares authorized, 65,983,600 shares issued and outstanding | | 329,918 |

| | | |
|---|---|---|
| Additional paid in capital | | 9,050,267 |
| Accumulated deficit | | (13,422,086) |
| Total shareholders' deficit | | (4,041,901) |
| TOTAL LIABILITIES AND SHAREHOLDERS' DEFICIT | $ | 1,268,113 |

See accompanying notes to financial statements.

**VIRTRA SYSTEMS, INC.**

**STATEMENT OF OPERATIONS**

**for the years ended December 31, 2005 and 2004**

| | 2005 | 2004 |
|---|---|---|
| REVENUE | | |
| Custom applications: | | |
| Training/simulation | $ 714,435 | $ 986,816 |
| Advertising/promotion | 167,969 | 296,864 |
| Other revenue | 94,954 | 44,500 |
| Total Revenues | 977,358 | 1,328,180 |
| | | |
| Cost of sales and services | 663,376 | 860,065 |
| Gross margin | 313,982 | 468,115 |
| | | |
| OPERATING EXPENSES | | |
| | | - |
| Gain on legal settlement | (230,000) | |
| General and administrative expenses | 2,137,469 | 2,820,650 |
| Loss from operations | (1,593,487) | (2,352,535) |
| | | |
| OTHER INCOME AND EXPENSE ITEMS: | | |
| Forgiveness of debt income | 516,220 | 4,922,500 |
| Interest income | 66 | 16 |
| Interest expense and finance charges | (1,321,211) | (957,912) |
| | | - |
| Gain on embedded derivative liability | 708,184 | |
| Other income | 21,958 | 500 |
| Total other income and expense items | (74,783) | 3,965,104 |
| | | |
| Net income/(loss) before accounting change | (1,668,270) | 1,612,569 |
| | | |
| | - | |
| Cumulative effect of accounting change | | (46,478) |

| | | |
|---|---|---|
| Net income/(loss) | (1,668,270) | 1,566,091 |