

FORCE PROTECTION INC  
Form 10-K/A  
October 15, 2007

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-K/A**

(Mark One)

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

For the fiscal year ended December 31, 2006

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No. 001-33253

**FORCE PROTECTION, INC.**

(Exact name of issuer as specified in its charter)

**Nevada**

(State or other jurisdiction of  
incorporation or organization)

**84-1383888**

(I.R.S. Employer  
Identification No.)

**9801 Highway 78, Building No. 1, Ladson,  
SC**

(Address of principal executive offices)

**29456**

(Zip Code)

Registrant's telephone number, including area code: **(843) 740-7015**

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

**Common Stock, par value \$0.001 per  
share.**

(Title of class)

**NASDAQ Stock Market**

(Name of Each Exchange On Which  
Registered)

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Securities registered under Section 12(g) of the Exchange Act: **None.**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  X

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes  No  X

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past twelve months (or 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

Indicate by check mark if disclosure of delinquent filers in response to Item 405 of Regulation S-K (§229.405 of this chapter) is not 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-K or any amendment to this Form 10-K  O

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. (Check one).

Large accelerated filer  O

Accelerated filer  X

Non-accelerated filer  O

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates as of March 14, 2007 was \$1,102,410,688 based on a total of 66,934,468 shares of our common stock held by non-affiliates on March 14, 2007 at the closing price of \$16.47 per share.

We had 67,817,003 shares of common stock outstanding as of March 14, 2007.

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**EXPLANATORY NOTE**

## Edgar Filing: FORCE PROTECTION INC - Form 10-K/A

Management has reassessed the effectiveness of our internal control over financial reporting as of December 31, 2006. As a result, management has concluded that our internal control over financial reporting was not effective as of December 31, 2006, because of certain material weaknesses. Management's revised assessment is contained, and the material weaknesses are described, in Item 9A of this Form 10-K/A.

As a result of that reassessment, Jaspers + Hall, PC has revised and reissued its reports with respect to our consolidated financial statements as of December 31, 2006 and with respect to management's assessment of its internal control over financial reporting, and those revised reports appear in Item 8. There are no changes, however, to the financial statements included in Item 8.

We have also made conforming changes to one Risk Factor contained in Item 1A.

### **PART I**

**ITEM 1A. RISK FACTORS**

## Edgar Filing: FORCE PROTECTION INC - Form 10-K/A

An investment in our common stock is subject to risks and uncertainties. Investors should consider the following factors, in addition to the other information contained or incorporated by reference in this Annual Report on Form 10-K, as well as our other filings with the SEC, before deciding to purchase our securities.

**We depend on the U.S. government for a substantial amount of our sales. If we do not find acceptance of our products within the U.S. government, our business may fail.**

We serve the defense market and our sales are highly concentrated within the U.S. government. The customer relationship with the U.S. government involves certain risks that are unique such as the ongoing development of high-technology products, price, availability and quality of materials and suppliers.

U.S. defense spending has historically been cyclical. Defense budgets have received their strongest support when perceived threats to national security raise the level of concern over the country's safety. As these threats subside, spending on the military tends to decrease. Accordingly, while Department of Defense funding has grown rapidly over the past few years, there is no assurance that this trend will continue. Rising budget deficits, the cost of the Global War on Terrorism and increasing costs for domestic programs continue to put pressure on all areas of discretionary spending, which could ultimately impact the defense budget. Wartime support for defense spending could wane if the country's troop deployments in support of operations in Iraq and Afghanistan are reduced. A decrease in U.S. government defense spending or changes in spending allocation could result in one or more of our programs being reduced, delayed or terminated. Reductions in our existing programs, unless offset by other programs and opportunities, could adversely affect our ability to sustain and grow our future sales and earnings.

**U.S. government contracts generally are not fully funded at inception and are subject to termination. If the U.S. government does not order as many vehicles as we anticipate, our business will be adversely affected.**

Government contracts and subcontracts typically involve long purchase and payment cycles, competitive bidding, qualification requirements, delays or changes in funding, extensive specification development, price negotiations and milestone requirements. Each government agency also maintains its own rules and regulations with which we must comply and which can vary significantly among agencies. Governmental agencies also often retain some portion of fees payable upon completion of a project and collection of these fees may be delayed for several months or even years, in some instances.

In addition, an increasing number of government contracts are fixed price contracts which may prevent us from recovering costs incurred in excess of our budgeted costs. Fixed price contracts require us to estimate the total project cost based on preliminary projections of the project's requirements. The financial viability of any given project depends in large part on our ability to estimate such costs accurately and complete the project on a timely basis. In the event actual costs exceed the fixed contractual cost, we may not be able to recover the excess costs.

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Some government contracts are also subject to termination or renegotiation at the convenience of the government, which could result in a large decline in revenue in any given quarter. Although government contracts have provisions providing for the reimbursement of costs associated with termination, the termination of a material contract at a time when our funded backlog does not permit redeployment of staff could result in a reduction in the number of employees. In addition, the timing of payments from government contracts is also subject to significant fluctuation and potential delay, depending on the government agency involved. Any such delay could result in a temporary shortage in working capital.

**We must comply with environmental regulations or we may have to pay expensive penalties or clean up costs.**

We are subject to federal, state, local and foreign laws, and regulations regarding protection of the environment, including air, water, and soil. Our manufacturing business involves the use, handling, storage, and contracting for recycling or disposal of, hazardous or toxic substances or wastes, including environmentally sensitive materials, such as batteries, solvents, lubricants, degreasing agents, gasoline and resin. We must comply with certain requirements for the use, management, handling, and disposal of these materials. We do not maintain insurance for pollutant cleanup and removal. If we are found responsible for any hazardous contamination, we may have to pay expensive fines or penalties or perform costly clean-up. Even if we are charged, and later found not responsible, for such contamination or clean up, the cost of defending the charges could be high. If we do not comply with government regulations, we may be unable to ship our products or have to pay expensive fines or penalties. We are subject to regulation by county, state and federal governments, governmental agencies, and regulatory authorities from several different countries. If we fail to obtain regulatory approvals or suffer delays in obtaining regulatory approvals, we may not be able to market our products and services, and generate product and service revenues. Further, we may not be able to obtain necessary regulatory approvals. Although we do not anticipate problems satisfying any of the regulations involved, we cannot foresee the possibility of new regulations, which could adversely affect our business. Further our products are subject to export limitations and we may be prevented from shipping our products to certain nations or buyers.

**Our earnings and margins depend on our ability to perform under our contracts and if we do not perform our margins may erode.**

Our contracts require management to make various assumptions and projections about the outcome of future events over a period of several years. These projections can include future labor productivity and availability, the nature and complexity of the work to be performed, the cost and availability of materials, the impact of delayed performance, and the timing of product deliveries. If there is a significant change in one or more of these assumptions, circumstances or estimates, or if we are unable to control the costs incurred in performing under these contracts, the profitability of one or more of these contracts may be adversely affected.

**If the pricing and availability of subcontractor performance and raw materials change, our profitability may be adversely affected.**

We rely on subcontractors and other companies to provide raw materials, major components and subsystems for our products or to perform a portion of the services that we provide to our customers. Occasionally we rely on only one or two sources of supply, which, if disrupted, could have an adverse effect on our ability to meet our commitments to customers. We depend on these subcontractors and vendors to fulfill our contractual obligations in a timely and satisfactory manner in full compliance with customer requirements. If one or more of our subcontractors or suppliers are unable to satisfactorily provide on a timely basis the agreed-upon supplies or perform the agreed-upon services, our ability to perform our obligations as a prime contractor may be adversely affected.

**Some of our product components are manufactured in other foreign countries and if any of those become unstable or government regulations change, our costs may increase or we may become unable to source certain parts.**

Some of our product components are manufactured in and supplied from other foreign countries. If import tariffs or taxes increase for any reason, our cost of goods would increase. Our financial performance may be affected by changes in political, social and economic environment. The role of the central and local governments in the economy is significant. Policies toward economic liberalization, and laws and policies affecting foreign companies, foreign investment, currency exchange rates and other matters could change, resulting in greater restrictions on our ability to do business with suppliers based in other countries. The government could impose surcharges, increase tax rates, or revoke, terminate or suspend operating licenses without compensating us. Also, other countries, from time to time, experience instances of civil unrest and hostilities. Confrontations have occurred between the military, insurgent forces, and civilians. If for these or any other reason, we lose our ability to sub-contract or manufacture the components to our products, or the cost of doing business increases, our business, financial condition, and results of operations would be materially and adversely affected.



**We may be subject to personal liability claims for our products and if our insurance is not sufficient to cover such claims, our expenses may increase substantially.**

As a result, a significant lawsuit could adversely affect our business. We may be exposed to liability for personal injury or property damage claims relating to the use of the products. Any future claim against us for personal injury or property damage could materially adversely affect the business, financial condition, and results of operations and result in negative publicity. Even if we are not found liable, the costs of defending a lawsuit can be high. We do not currently maintain insurance for this type of liability. Additionally, even if we do purchase insurance, we may experience legal claims outside of our insurance coverage, or in excess of our insurance coverage, or that insurance will not cover.

**We must develop new technologies and maintain a qualified workforce in order to remain competitive.**

Virtually all of the products we produce and sell are highly engineered and require sophisticated manufacturing and system integration techniques and capabilities. Government markets in which the company operates are characterized by rapidly changing technologies. The product and program needs of our government customers change and evolve regularly. Accordingly, our future performance in part depends on our ability to identify emerging technological trends, develop and manufacture competitive products, and bring those products to market quickly at cost-effective prices. In addition, because of the highly specialized nature of our business, we must be able to hire and retain the skilled and appropriately qualified personnel necessary to perform the services required by our customers. If we are unable to develop new products that meet customers' changing needs or successfully attract and retain qualified personnel, future sales and earnings may be adversely affected.

**We rely on proprietary designs and rights and if we have to litigate those rights, our expenses could substantially increase.**

Our success and ability to compete depend, in part, on the protection of our designs and technology. In addition, our technology could infringe on patents or proprietary rights of others. We have not undertaken or conducted any comprehensive patent infringement searches or studies. If any third parties hold any conflicting rights, we may be required to stop making, using or selling our products or to obtain licenses from and pay royalties to others. Further, in such event, we may not be able to obtain or maintain any such licenses on acceptable terms, if at all. We may need to engage in future litigation to enforce intellectual property rights or the rights of customers, to protect trade secrets or to determine the validity and scope of proprietary rights of others, including customers. This litigation could result in substantial costs and diversion of resources and could materially and adversely affect our results of operations.

**We have identified material weaknesses in our internal control over financial reporting, which could adversely affect our ability to report our financial condition and results of operations accurately or on a timely basis. As a result, current and potential stockholders could lose confidence in our financial reporting, which could harm our business and the trading price of our stock.**

As required by Section 404 of the Sarbanes-Oxley Act of 2002, our management has conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2006. We previously restated our financial statements in our annual reports on Form 10-K for the fiscal years ended 2003, 2004 and 2005 and we amended our annual report on Form 10-K for the 2006 fiscal year. Following our restating and amending of our prior annual reports, we identified a number of material weaknesses in our internal control over financial reporting and have now concluded that, as of December 31, 2006, we did not maintain effective control over financial reporting. For a discussion of our internal control over financial reporting and a description of the identified material weaknesses, see Item 9A: Controls and Procedures - Management's Report on Internal Control over Financial Reporting of this Form 10-K/A.

Each of our material weaknesses results in more than a remote likelihood that a material misstatement of the annual or interim financial statements that we prepare will not be prevented or detected. As a result, we must perform extensive additional work to obtain reasonable assurance regarding the reliability of our financial statements. Even with this additional work, there is a risk of additional errors not being prevented or detected, which could result in additional restatements. Moreover, other material weaknesses may be identified.

Material weaknesses in our internal control over financial reporting could adversely impact our ability to provide timely and accurate financial information. If we are unsuccessful in implementing or following our remediation plan, or fail to update our internal control over financial reporting as our business evolves, we may be unable to report financial information timely and accurately or to

maintain effective disclosure controls and procedures. Any such failure in the future could also adversely affect the results of periodic management evaluations and annual auditor attestation reports regarding disclosure controls and the effectiveness of our internal control over financial reporting required under Section 404 of the Sarbanes-Oxley Act of 2002 and the rules promulgated thereunder. If we are unable to report financial information in a timely and accurate manner or to maintain effective disclosure controls and procedures, we could be subject to, among other things, regulatory or enforcement actions by the SEC and NASDAQ, including a delisting from the NASDAQ Stock Market, securities litigation, and a general loss of investor confidence, any one of which could adversely affect our business prospects and the valuation of our common stock.

We also have extensive work remaining to remedy the identified material weaknesses in our internal control over financial reporting and this work will continue through the balance 2007 and perhaps beyond. There can be no assurance as to when all of the material weaknesses will be remedied. Until our remedial efforts are completed, management will continue to devote significant time and attention to these efforts, and we will continue to incur expenses associated with the additional procedures and resources required to prepare our financial statements. Certain of our remedial actions, such as hiring additional qualified personnel and implementing a new operating system, will be ongoing and will result in our incurring additional costs even after our material weaknesses are remedied.

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**PART II**

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Board of Directors and  
Stockholders of Force Protection, Inc.**

We have audited the accompanying consolidated balance sheets of Force Protection, Inc. and subsidiary as of December 31, 2006, 2005 and 2004, and the related consolidated statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2006. 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 the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 Force Protection, Inc., and subsidiary as of December 31, 2006, 2005 and 2004, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the financial statements, certain errors resulting in adjustments to the Company's accounting for preferred stock and warrants issued to investors, accounting for stock-based compensation to employees and non-employees and accounting for rent expense on a straight-line basis as of December 31, 2006, 2005 and 2004, were discovered by management of the Company during the current year. Accordingly, the 2006, 2005 and 2004 financial statements have been restated to correct these errors.

/s/ JASPERS + HALL, PC

Denver, Colorado  
June 5, 2007

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and  
Stockholders of Force Protection, Inc. and Subsidiary

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that Force Protection, Inc. and subsidiary did not maintain effective internal control over financial reporting as of December 31, 2006, because of the effect of the material weakness identified in management's assessment, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Force Protection, Inc. and subsidiary's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting 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 audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weaknesses have been identified and included in management's assessment. Force Protection, Inc. and subsidiary's financial and accounting organization was not adequate to support their financial accounting and reporting needs. Specifically, they did not maintain a sufficient complement of personnel with an appropriate level of accounting knowledge, experience with the Company and training in the application of GAAP commensurate with our financial reporting requirements. Force Protection, Inc. and subsidiary did not maintain effective policies and procedures related to the accounting for specific equity issuances, including accounting for stock-based compensation in accordance with Statement of Financial Accounting Standard (SFAS) No. 123, *Share-Based Payment*, and accounting for convertible and redeemable preferred stock and warrants. In addition, Force Protection, Inc. and subsidiary did not maintain effective controls to ensure the accuracy of disclosures in their financial statements and classification of certain financial transactions in the financial statements.

This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2006 financial statements, and this report does not affect our report dated June 5, 2007 on those financial statements.

In our opinion, management's assessment that Force Protection, Inc. and subsidiary did not maintain effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, Force Protection, Inc. and subsidiary has not maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the accompanying consolidated balance sheets of Force Protection, Inc. and subsidiary as of December 31, 2006, 2005 and 2004, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006, and our report dated June 5, 2007, expressed an unqualified opinion thereon.

/s/ JASPERS + HALL, PC

Denver, Colorado  
June 5, 2007

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**FORCE PROTECTION INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENT OF OPERATIONS**  
**For the Years Ended December 31, 2006, 2005 and 2004**

	2006	2005 Restated	2004 Restated
<b>Net Sales</b>	\$ 196,017,446	\$ 49,712,829	\$ 10,272,757
Cost of sales	158,994,626	46,428,615	11,266,998
Gross Profit	37,022,820	3,284,214	(994,241 )
General and administrative expense	27,183,093	17,256,359	9,614,052
R & D expense	3,204,165	1,657,918	1,230,290
<b>Operating Profit (Loss)</b>	6,635,562	(15,630,063 )	(11,838,583 )
Other income	963,390	102,941	569,760
Interest expense	(1,728,500 )	(1,708,291 )	(684,980 )
Realized gain on derivative liability		2,830,791	
<b>Earnings (Loss) from Operations</b>	5,870,452	(14,404,622 )	(11,953,803 )
<b>Deferred Tax Benefit</b>	12,326,491		
<b>Net Earnings (Loss)</b>	\$ 18,196,943	\$ (14,404,622 )	\$ (11,953,803 )
Net earnings (loss)	\$ 18,196,943	\$ (14,404,622 )	\$ (11,953,803 )
Accretion of Series D 6% convertible preferred stock	(1,297,134 )	(2,041,697 )	
Preferred Dividends	(325,685 )	(778,530 )	
Net Earnings/(Loss) available to common shareholders	\$ 16,574,124	\$ (17,224,849 )	\$ (11,953,803 )
Basic earnings (loss) per common share	\$ 0.37	\$ (0.51 )	\$ (0.62 )
Diluted earnings (loss) per common share	\$ 0.36	\$ (0.51 )	\$ (0.62 )
<b>Weighted-average shares used to compute:</b>			
Basic earnings (loss) per share	44,786,083	33,926,573	19,357,939
Diluted earnings (loss) per share	50,428,466	33,926,573	19,357,939

The accompanying Notes are an integral part of these financial statements.



**FORCE PROTECTION INC. AND SUBSIDIARY**  
**CONSOLIDATED BALANCE SHEETS**  
**DECEMBER 31, 2006, 2005 and 2004**

	2006	2005 Restated	2004 Restated
<b>ASSETS</b>			
Current Assets:			
Cash	\$ 156,319,004	\$ 1,217,509	\$ 2,264,406
Accounts receivable, net of allowance for contractual adjustments of \$6,068,087 for 2006, \$1,018,051 for 2005, and \$0 for 2004	36,011,568	3,666,358	1,053,973
Inventories	60,396,297	32,486,776	9,029,913
Other current assets	374,051	267,189	241,910
Current Portion of Deferred Taxes	9,562,500		
Total current assets	262,663,420	37,637,832	12,590,202
Investment in Challenger Powerboats Inc, net of valuation allowance			
Long Term Portion of Deferred Taxes	2,763,991		
Property Plant and equipment, net	8,963,901	2,138,703	1,036,994
<b>Total Assets</b>	<b>\$ 274,391,312</b>	<b>\$ 39,776,535</b>	<b>\$ 13,627,196</b>
<b>LIABILITIES &amp; SHAREHOLDERS EQUITY</b>			
<b>LIABILITIES</b>			
Current Liabilities:			
Accounts payable	\$ 38,653,813	\$ 14,688,855	\$ 1,867,363
Other accrued liabilities	2,968,859	1,898,020	1,354,466
Contract liabilities	1,850,000	1,686,062	729,461
Loans payable		7,500,000	360,975
Line of Credit			4,000,000
Current portion of long term liabilities	71,685		
Deferred revenue	12,824,211	12,598,921	2,645,716
Total Current Liabilities	56,368,568	38,371,858	10,957,981
Long-term debt:			
Other long term liabilities	167,937		110,732
<b>Total Liabilities</b>	<b>56,536,505</b>	<b>38,371,858</b>	<b>11,068,713</b>
Commitment and Contingencies (See Note 7)			
Preferred stock series D, \$0.001 par value, authorized: 20,000 shares, issued and outstanding: 0,13,004, 0 shares; for the years 2006, 2005 and 2004 respectively;		7,901,438	
<b>SHAREHOLDERS EQUITY</b>			
Preferred stock: \$0.001 par value, authorized: 10,000,000 shares			
Preferred stock series B, \$0.001 par value, authorized: 25 shares issued and outstanding 0, 0, 19.5 shares; for the years 2006, 2005 and 2004 respectively;			
Preferred stock series C, \$0.001 par value, authorized: 150 shares, issued and outstanding 0,0,0 shares; for the years 2006, 2005 and 2004 respectively;			
Common stock, \$0.001 par value, authorized: 300,000,000, issued and outstanding: 66,762, 566, 36,114,216, 19,357,938 shares; for the years 2006, 2005 and 2004	66,763	36,114	19,358
Warrants		5,780,952	2,602,800
Shares to be issued	31		
Beneficial Conversion Feature			19,102,306
Additional Paid-in Capital	249,694,850	38,714,893	35,874,565
Accumulated deficit	(31,906,837)	(51,028,720)	(55,040,546)
<b>Total Shareholders Equity</b>	<b>217,854,807</b>	<b>(6,496,761)</b>	<b>2,558,483</b>
<b>Total Liabilities and Shareholders Equity</b>	<b>\$ 274,391,312</b>	<b>\$ 39,776,535</b>	<b>\$ 13,627,196</b>

The accompanying Notes are an integral part of these financial statements.



**FORCE PROTECTION INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY**  
**For the Years Ended December 31, 2006, 2005 and 2004**

	Series B Preferred Stock		Series C Preferred Stock		Common Stock	
	Shares	Par \$.001	Shares	Par \$.001	Shares	Par \$.001
<b>Balance, December 31, 2003</b>	10	\$ 0	132	\$ 0	10,190,021	\$ 10,190
Issuance of common stock for cash	0	0	0	0	2,982,717	2,983
Issuance of common stock for services Third Parties	0	0	0	0	163,501	163
Issuance of common stock for Compensation Directors & Employees	0		0		616,682	617
Issuance of common stock for cash (Warrant net change)	0		0		2,757,618	2,758
Cancellation of Common shares					(304,167 )	(304 )
Issuance of common shares for Debt					20,421	20
Conversion of preferred stock to common stock	(1 )		(80 )		2,931,145	2,931
Conversion between preferred Series B and Series C	11		(105 )		0	0
Change in Beneficial Conversion Feature	0		0			
Issuance of Preferred Stock for Cash	0		1		0	0
Issuance of preferred stock for compensation	0		38		0	0
Issuance of preferred stock for conversion of debt	0		20		0	0
Rescinded and Redemption of preferred stock	0		(6 )		0	0
Net loss	0		0		0	0
<b>Balance, December 31, 2004</b>	20	\$ 0	0	\$ 0	19,357,938	\$ 19,358
Issuance of common stock for cash	0	0	0	0	185,321	185
Issuance of common stock for compensation	0	0	0	0	51,616	52
Issuance of common stock for settlement agreements	0	0	0	0	53,467	53
Issuance of common stock for interest	0	0	0	0	14,876	15
Issuance of Common Stock as Series D dividend shares	0	0	0	0	281,697	282
Issuance of Common Stock to round up post split shares	0	0	0	0	3,079	3
Issuance of common stock for cash-warrants	0	0	0	0	114,376	114
Warrant issued for Series D placement	0	0	0	0		
Conversion of Series Series D preferred stock to common stock	0	0	0	0	1,331,429	1,331
Accretion of Series D Preferred Stock	0	0	0	0		
Reclassification of Series D Warrants from Liability	0	0	0	0		
Dividends for Series D-cash	0	0	0	0		
Dividends for Series D-accrued						
Conversion of Series B preferred stock to common stock	(20 )	0	0	0	14,803,750	14,804
Beneficial Conversion Feature	0	0	0	0		
Common Share Grants cancelled	0	0	0	0	(83,333 )	(83 )
Stock Based Compensation (FAS 123R)						
Warrants-net (expired & issued) not including Series D	0	0	0	0		
Net loss	0	0	0	0	0	0
<b>Balance, December 31, 2005</b>	0	\$ 0	0	\$ 0	36,114,216	\$ 36,114
Issuance of common stock for cash (PIPE s)	0		0		21,250,000	21,250
Issuance of common stock for stock options exercised					1,000	1
Issuance of common stock for compensation	0		0		313,644	314
Issuance of common stock for settlement agreements	0		0		30,000	30
Issuance of common stock for dividends on Series D	0		0		8,937	9
Issuance of Cash for dividends on Series D					0	0

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Accretion of Series D Preferred Stock	0	0	0	0		
Issuance of common stock for cash warrants					2,852,140	2,852
Conversion of Series D preferred stock to common stock					6,192,628	6,193
Stock based compensation (FAS 123R)					0	0
Net earnings (loss)	0	0	0	0	0	0
<b>Balance, December 31, 2006</b>	0	\$ 0	0	\$ 0	66,762,565	\$ 66,763

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	Warrants	BCF	Shares to be Issued 0	Additional Paid-in Capital	Accumulated Deficit	Total
<b>Balance, December 31, 2003</b>	\$ 4,862,765	\$ 282,890	\$ 0	\$ 18,805,887	\$ (24,267,327 )	\$ (305,595 )
Issuance of common stock for cash				7,200,234	0	7,203,217
Issuance of common stock for services Third Parties				496,793	0	496,956
Issuance of common stock for Compensation Directors & Employees				1,431,187		1,431,804
Issuance of common stock for cash (Warrant net change)	(2,259,965 )			6,352,054		4,094,847
Cancellation of Common shares				304		0
Issuance of common shares for Debt				124,956		124,976
Conversion of preferred stock to common stock				(2,931 )	0	0
Conversion between preferred Series B and Series C				0	0	0
Change in Beneficial Conversion Feature		18,819,416			(18,819,416 )	0
Issuance of Preferred Stock for Cash				10,000	0	10,000
Issuance of preferred stock for compensation				1,316,081	0	1,316,081
Issuance of preferred stock for conversion of debt				200,000	0	200,000
Rescinded and Redemption of preferred stock	0			(60,000 )	0	(60,000 )
Net loss					(11,953,803 )	(11,953,803 )
<b>Balance, December 31, 2004</b>	\$ 2,602,800	\$ 19,102,306	\$ 0	\$ 35,874,565	\$ (55,040,546)	\$ 2,558,483
Issuance of common stock for cash	0			513,806	0	513,991
Issuance of common stock for compensation				125,357	0	125,409
Issuance of common stock for settlement agreements				144,842	0	144,895
Issuance of common stock for interest				20,626	0	20,641
Issuance of Common Stock as Series D dividend shares				418,148	(418,430 )	0
Issuance of Common Stock to round up post split shares				6,075	0	6,078
Issuance of common stock for cash-warrants	(122,903 )			334,418	0	211,629
Warrant issued for Series D placement	200,071			(200,071 )		0
Conversion of Series Series D preferred stock to common stock				1,440,694		1,442,025
Accretion of Series D Preferred Stock				(2,041,697 )		(2,041,697 )
Reclassification of Series D Warrants from Liability	5,173,409					5,173,409
Dividends for Series D-cash					(100,020 )	(100,020 )
Dividends for Series D-accrued					(260,080 )	(260,080 )
Conversion of Series B preferred stock to common stock	0			(14,804 )	0	0
Beneficial Conversion Feature		(19,102,306 )			19,102,306	0
Common Share Grants cancelled				(209,916 )		(209,999 )
Stock Based Compensation (FAS 123R)					92,671	92,671
Warrants-net (expired & issued) not including Series D	(2,072,425 )			2,302,850		230,425
Net loss				0	(14,404,621 )	(14,404,621 )
<b>Balance, December 31, 2005</b>	\$ 5,780,952	\$ 0	\$ 0	\$ 38,714,893	\$ (51,028,720)	\$ (6,496,761 )
Issuance of common stock for cash (PIPE s)	0	0	0	185,806,511	0	185,827,761
Issuance of common stock for stock options exercised	0	0	4	5,996	0	6,001
Issuance of common stock for compensation	0	0	27	883,248	0	883,589
Issuance of common stock for settlement agreements	0	0	0	187,470	0	187,500
Issuance of common stock for dividends on Series D	0	0	0	48,816	(48,825 )	0
Issuance of Cash for dividends on Series D	0	0	0	0	(276,860 )	(276,860 )

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Accretion of Series D Preferred Stock				(1,297,134	)	(1,297,134	)
Issuance of common stock for cash warrants	(5,780,952	)	0	16,152,672	0	10,374,572	
Conversion of Series D preferred stock to common stock	0	0	0	9,192,378	0	9,198,571	
Stock based compensation (FAS 123R)	0	0	0	0	1,250,625	1,250,625	
Net earnings (loss)	0	0	0	0	18,196,943	18,196,943	
<b>Balance, December 31, 2006</b>	\$ 0	\$ 0	\$ 31	\$ 249,694,850	\$ (31,906,837)	\$ 217,854,807	

The accompanying Notes are an integral part of these financial statements.

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**FORCE PROTECTION INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**YEAR ENDED DECEMBER 31, 2006, 2005 AND 2004**

(In dollars)

	2006	2005 Restated	2004 Restated
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net Earnings (loss) from continuing operations	\$ 18,196,943	\$ (14,404,622 )	\$ (11,953,803 )
<b>Adjustments to reconcile net loss to net cash (used in) provided by operating activities:</b>			
Depreciation and amortization	769,454	386,152	207,271
Deferred Tax Benefit	(12,326,491 )		
Realized gain on derivative liability		(2,830,791 )	
Stock issued for services and compensation	883,589	(84,590 )	3,244,841
Common stock issued for settlement	187,500	144,895	
Common stock issued for interest		20,641	
Stock based compensation	1,250,625		
<b>Change in assets and liabilities:</b>			
Decrease (increase) in accounts receivable	(32,345,210 )	(2,612,385 )	(909,041 )
Decrease (increase) in inventories	(27,909,521 )	(23,456,863 )	(8,202,576 )
Decrease (increase) in other current assets	(106,862 )	(25,279 )	(181,910 )
Increase (decrease) in accounts payable	23,964,958	12,821,492	1,152,297
Increase (decrease) in other accrued liabilities	1,125,762	543,554	1,603,942
Increase (decrease) in contract liabilities	163,938	956,601	549,077
Deferred Revenue	225,290	9,953,205	2,436,541
<b>Net cash used in operating activities</b>	<b>(25,920,025 )</b>	<b>(18,587,990 )</b>	<b>(12,053,361 )</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Purchase of property and equipment	(7,536,693 )	(1,511,337 )	(935,197 )
Proceeds from sale of assets		155,442	
<b>Net cash used in investing activities</b>	<b>(7,536,693 )</b>	<b>(1,355,895 )</b>	<b>(935,197 )</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from issuance of Private Placement common stock	185,827,761		
Proceeds from issuance of common stock		513,991	11,298,064
Proceeds from issuance of Series D preferred stock		15,305,965	
Redemption of Preferred Stock			(50,000 )
Preferred Stock Dividends paid	(276,860 )	(100,020 )	
Issuance of common stock for cash-warrants	10,374,572	211,629	
Issuance of common stock for stock options exercised	6,001		
Proceeds from (Payments on) loans, net	(7,500,000 )	7,139,025	(175,187 )
Proceeds from (Payments on) Line of Credit, net		(4,000,000 )	3,823,039
Proceeds from (Payments on) long term liabilities	239,622	(110,732 )	78,271
Payments on Capitalized lease	(112,883 )	(62,870 )	
<b>Net cash provided by Financing Activities</b>	<b>188,558,213</b>	<b>18,896,988</b>	<b>14,974,187</b>
<b>Net increase (decrease) in cash</b>	<b>155,101,495</b>	<b>(1,046,897 )</b>	<b>1,985,629</b>
<b>CASH beginning of period</b>	<b>1,217,509</b>	<b>2,264,406</b>	<b>278,777</b>
<b>CASH end of period</b>	<b>\$ 156,319,004</b>	<b>\$ 1,217,509</b>	<b>\$ 2,264,406</b>
Interest Paid	\$ 1,722,119	\$ 1,010,160	\$ 454,512
Taxes Paid			

The accompanying Notes are an integral part of these financial statements.

**FORCE PROTECTION, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

These notes are an integral part of the Company's financial statements set forth above.

**NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Restated)**

**2006 Amendment**

The financial information included in this 10-K referring to the year ended December 31, 2006 has been amended to include the effect of the updated restatement to the financial statements for the year ended 2005 (see Note 1, 2005 and 2004 Restatement), and the effect on the basic earning per shares (EPS) of accretion on preferred stock and the calculation of weighted average common shares used to compute diluted earnings per share.

**Earnings Per Share**

The Company has reviewed the Financial Accounting Standards Board's Statement of Financial Accounting Standard No. 128 Earnings Per Share (EPS) and determined that income available to common shareholders did not include the accretion related to preferred stock and the weighted average number of common shares outstanding used to calculate diluted earnings per share did not give effect to common shares issued upon conversion for the entire year.

**Effects of Amendment**

**Effects on Consolidated Balance Sheet**

	<b>2006</b>
Increase in Additional Paid-in-capital	374,309
Increase in Accumulative deficit	374,309

**Effects on Earnings Per Share**

	<b>2006</b>
Decrease in Basic earnings per common share	\$ (0.03 )
Decrease in Diluted earnings per common share	\$ (0.03 )

**2005 and 2004 Restatement**

**Restatement of Accounting for Preferred Stock and Warrants Issued to Investors**

Force Protection, Inc. (the Company) will be filing an amendment to its Annual Report on Form 10-K for the year ended December 31, 2005 to amend and restate financial statements and other information for the years 2005 and 2004. The restatement adjusts the Company's accounting for preferred stock and warrants issued to investors, accounting for stock-based compensation to employees and non-employees and accounting for rent expense on a straight-line basis. The financial information included in this 10-K referring to prior years ended December 31, 2005 and 2004 includes each accounting restatement. Given that the company is still in the process of finalizing the restatement with the SEC, there is the potential that the restated numbers may change pending final resolution. The Company believes that the restatement did not have any material impact on its 2006 financial results.

The items identified by the Company relate to the valuation method used to account for certain equity issuances which did not properly include a full analysis of the embedded conversion feature associated with such issuances as required under EITF 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios, or which were otherwise incorrectly valued. As a result, a number of shares of the Company's stock issued as compensation to certain executives and other third parties and recorded as general and administrative compensation expense appear to have been valued at less than fair value.

The Company has reviewed its accounting for preferred stock and warrants issued to investors as follows:





- Series B and Series C Convertible Preferred Stock are recorded as equity at fair value using the Black-Scholes Method at the time of issuance using a one year holding period assumption.
- A Beneficial Conversion Feature (BCF) treated as equity is created when the value received for each issuance is less than the fair value from the Black-Scholes calculation. Changes in conversion rates of Preferred Stock into Common Stock also can create a Beneficial Conversion Feature if the Preferred Stock can be converted into more common shares than at issuance or last amendment.
- Series D 6% Convertible Preferred Stock is recorded at fair value equaling the net cash proceeds from issuance minus the fair value of warrants issued in conjunction with the Series D 6% Convertible Preferred Stock. The Series D Preferred Stock falls outside the scope of SFAS No. 150 but the guidance in Rule 5-02.28 of Regulation S-X, Accounting Series Release No. 268 (ASR 268) and EITF Topic D-98: Classification and Measurement of Redeemable Securities are applicable. As such, the Company has recorded the Series D Preferred Stock as mezzanine equity on the accompanying balance sheet. Dividends for Series D 6% Convertible Preferred Stock were distributed either as Common Stock shares or in cash.
- The warrants issued in conjunction with the Series D 6% Convertible Preferred Stock were initially recorded at fair value as a liability as liquidating damages were paid as a result of a late SEC registration of the underlying Common Stock. The Black-Scholes Method was used to determine the fair value at issuance using a three year holding period. These warrants are adjusted each reporting period to the new fair value using the Black-Scholes Method until the registration was accepted by the SEC. At that point, the fair value using the Black-Scholes Method was reclassified into Equity. A realized gain on derivative liability in the amount of \$2,830,791 was recorded in 2005 as a result of the change in fair value from issuance to reclassification to equity for these warrants.
- Other warrants are recorded at fair value using the Black-Scholes Method.

#### **Restatement of Accounting for Stock-Based Compensation for Services and Compensation.**

The Company has reviewed its accounting for stock based compensation issued for services and compensation during 2005, 2004 and 2003 taking into account, where applicable, Financial Accounting Standards Board's Statement of Financial Accounting Standard No. 123. Stock based compensation issued for services and compensation were valued at the market price at the time of issuance. As a result of revaluation, a reduction in expense of \$565,035 was recorded in 2005 and additional expense of \$1,621,985 and \$2,946,137 was recorded in 2004 and 2003.

The Company has reviewed the Financial Accounting Standards Board's Statement of Financial Accounting Standard No. 123(Revised) ( SFAS 123(R) ) and has determined that the Company will adopt SFAS 123(R) as of July 1, 2005. Stock option expense of \$92,671 was recorded for 2005.

#### **Restatement of Accounting for Operating Lease Commitments**

The Company has reviewed the Financial Accounting Standards Board's Statement of Financial Accounting Standard No. 13 and has determined that in 2005, 2004 and 2003 the Company's accounting for rent expense was not recorded on a straight-line basis over the term of the Company's operating lease commitments. Several of the Company's operating leases in effect during 2005, 2004 and 2003 included certain terms which provided for several months at the beginning of the lease term whereby rents were not due. Additionally, rent escalation clauses were included within certain operating leases which previous to this filing had improperly deferred rent expense over the course of the leases. The Company has calculated the necessary adjustments for 2005, 2004 and 2003 in order to restate its financial statements and record rent expense associated with operating lease commitments for 2005, 2004 and 2003. Additional rent expense for 2005, 2004 and 2003 was recorded in the amount of \$12,039, \$79,985 and \$44,588, respectively.

In light of the restatement, readers should not rely on previously filed financial statements and other financial information for the years and for each of the quarters in the years 2005, 2004 and 2003.



**Effects of Restatement****Effects on Statements of Earnings**

	2005	2004
Increase in cost of sales	2,012,989	
Increase in general and administrative expense	669,745	1,701,970
Increase in operating loss	2,682,734	1,701,970
Increase in unrealized gain	2,830,791	
(Decrease) in non recurring warranty expense	(2,012,089 )	
Increase/(decrease) in loss from continuing operations before tax	(2,161,046 )	1,701,970
Increase/(decrease) in net (loss)	(2,161,046 )	1,701,970

**Effects on Balance Sheet**

	2005	2004
(Decrease) in accounts receivable	(367,233 )	
(Decrease) in total assets	(367,233 )	
Increase in other accrued liability	279,569	124,575
(Decrease) in contract liabilities	(367,233 )	
Increase in total liabilities	(87,654 )	124,575
Increase in mezzanine equity Series D preferred stock	7,901,438	
Increase in Warrants	5,779,452	2,601,300
Increase/(decrease) in beneficial conversion feature	(19,102,306 )	19,102,306
Increase/(decrease) in accumulated deficit	1,815,639	23,078,723
Increase/(decrease) in shareholders equity	(8,181,007 )	(124,573 )

**Nature of the Business**

Force Protection, Inc. and its subsidiaries (the Company) design, manufacture and market blast and ballistics armored vehicles for sale to military customers.

**Principles of Consolidation**

The consolidated financial statements include the accounts of Force Protection, Inc., and its two wholly-owned subsidiaries, Force Protection Industries, Inc. and Force Protection Technologies, Inc. All inter-company balances and transactions are eliminated in consolidation.

**General Statement**

The Securities and Exchange Commission, or SEC, has issued Financial Reporting Release No. 60, Cautionary Advice Regarding Disclosure About Critical Accounting Policies, or FRR 60, suggesting companies provide additional disclosure and commentary on their most critical accounting policies. In FRR 60, the SEC defined the most critical accounting policies as the ones that are most important to the portrayal of a company's financial condition and operating results, and require management to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. The methods, estimates and judgments the Company uses in applying these most critical accounting policies have a significant impact on the results the Company reports in its financial statements.

The Company believes the following critical accounting policies and procedures, among others, affect its more significant judgments and estimates used in the preparation of the Company's consolidated financial statements:

- Revenue recognition;
- Inventory cost and Associated Reserves; and
- Allocation of direct and indirect cost of sales.

**Revenue Recognition**

The Company's revenue is derived principally from the sale of its vehicles and associated spare parts and training services. Revenue from product sales and spare part sales, net of an allowance for contractual adjustments, is recognized when the products or spare parts

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are delivered to and formally accepted by the customer. The Company defines formal acceptance as taking place when a representative of the United States government signs the United States Form DD250 entitled Material Inspection and Receiving Report which under the Federal Acquisition Regulations signifies contractual inspection and acceptance of the work performed by the contractor. It also acts as the contractual invoice creating payment liability on the United States Government. In accordance with standard industry practice, there is a representative from the United States Defense Contractor Manufacturing Agency ( DCMA ) acting as a contractual representative of the United States Government present at the Company's facilities. This DCMA representative inspects each vehicle as it is delivered by the Company and upon confirmation of the vehicle's conformity with the contractual specifications the inspector signs the Form DD250 and formally accepts delivery of the vehicle. The Company only recognizes revenues arising from its U.S. Government contracts upon execution of the Form DD250 by the DCMA inspector. Under some of the Company's U.S. Government contracts, it receives performance based payments based on completion of specific milestones stipulated under the contract (for example, delivery of raw material to the Company's Ladson facility). These payments are recorded as deferred revenue and carried on the Company's balance sheet until the final delivery of the products and formal acceptance by the U.S. Government pursuant to the Form DD250. Upon acceptance of the products and the execution of the Form DD250, the Company recognizes the full sale price of the product as revenue.

Revenues from services provided are recorded in accordance with specific contractual terms. Services have historically consisted of the Company providing on-site personnel on an as-needed basis in a timely manner, and have generally been provided in foreign locations.

The Company negotiates contracts with its customers which may include revenue arrangements with multiple deliverables, as outlined by Emerging Issues Task Force No. 00-21 (EITF 00-21). The Company's accounting policies are defined such that each deliverable under a contract is accounted for separately. Historically, the Company has negotiated and signed contracts with its customers which outline the contract amount and specific terms and conditions associated with each deliverable.

#### **Allowance for Contractual Adjustments**

The Company's contracts with the U.S. Government are negotiated as a sole source or open competition bid process. A sole source process is one in which the Company is the sole bidder for the contract. An open competition could involve various bidders. Once a bid is accepted, the U.S. Government expects work to commence immediately. An open competition results in a final agreed-upon contract price which the U.S. Government has agreed to. A sole source process results in an agreed-upon contract with the U.S. Government, subject to an adjustment process at a later date, termed the definitization process. The definitization process commences upon delivery of a product, whereby the U.S. Government completes a detailed review of the Company's costs involved in the manufacturing and delivery process. The U.S. Government and the Company then work to determine an adequate and fair final contract price. As a result of the potential adjustments related to the definitization process, the Company maintains an allowance for contractual adjustments account. This account is reviewed on a monthly basis to determine adequate adjustments, if necessary. The allowance is maintained and deemed adequate based on the analysis of historical data and calculation of pro-rata percentages of current contracts in place, which remain subject to the definitization process.

Historically, the Company has not encountered sales returns. The Company does not anticipate sales returns in the future.

#### **Research and Development**

Research, development, and engineering costs are expensed as incurred, in accordance with SFAS No. 2, *Accounting for Research and Development Costs*. Research, development, and engineering expenses primarily include payroll and headcount related costs, contractor fees, infrastructure costs, and administrative expenses directly related to research and development support.

#### **Cash Equivalents**

For purposes of reporting cash flows, the Company considers all highly liquid debt instruments purchased with maturity of three months or less to be cash equivalents.

#### **Inventories**

Inventories are stated at the lower of cost or market. The cost is determined under the first-in-first-out (FIFO) valuation method. An allowance for excess or obsolete inventory is maintained by the Company. The Company determines an appropriate balance in this account based on historical data and specific identification of certain inventory items.



**Property, Plant and Equipment**

Property and equipment are stated at cost or at the value of the operating agreement. The Company capitalizes additions and improvements which include all material, labor and engineering cost to design, install or improve the asset. Routine repairs and maintenance are expensed as incurred. Depreciation and amortization are computed using the straight-line method over the following estimated useful lives:

Leasehold Improvements	2-5 years
Furniture and fixtures	3 years
Machinery and equipment	7 years
Tooling and molds	7 years
Vehicles	5 years

**Impairment of Long-Lived Assets**

The Company reviews long-lived assets to be held and used for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, the Company would recognize an impairment loss based on the estimated fair value of the asset.

**Goodwill**

Under SFAS No. 142, *Goodwill and other Intangible Assets*, all goodwill amortization ceased effective January 1, 2002. Rather, goodwill is now subject to only impairment reviews. A fair-value based test is applied at the reporting level. This test requires various judgments and estimates. A goodwill impairment loss will be recorded for any goodwill that is determined to be impaired. Goodwill is tested for impairment at least annually.

**Foreign Currency Transaction**

Assets and liabilities in foreign currencies are translated at the exchange rate prevailing at the balance sheet date. Revenues and expenses are translated at the exchange rate prevailing at the transaction date, and the resulting gains and losses are reflected in the statements of operations. Gains and losses arising from translation of a subsidiary's foreign currency financial statements are shown as a component of stockholders' equity (deficit) as accumulated comprehensive income (loss).

**Income Taxes**

The Company uses the asset and liability method of accounting for income taxes. The asset and liability method accounts for deferred income taxes by applying enacted statutory rates in effect for periods in which the difference between the book value and the tax bases of assets and liabilities are scheduled to reverse. The resulting deferred tax asset or liability is adjusted to reflect changes in tax laws or rates. The company records a valuation allowance for any deferred tax allowance that it believes will not be realized.

**Stock-Based Compensation**

The Company applied the recognition and measurement principles of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations in accounting for those plans through June 30, 2005.

In December 2004, FASB issued Statement No. 123(R), *Share-Based Payment*, which establishes accounting standards for transactions in which an entity receives employee services in exchange for (a) equity instruments of the entity or (b) liabilities that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of equity instruments. Effective on July 1, 2005, the Company adopted SFAS 123(R), which requires the Company to recognize the grant-date fair value of stock options and equity based compensation issued to employees in the statement of operations. The statement also requires that such transactions be accounted for using the fair-value-based method, thereby eliminating use of the intrinsic method of accounting in APB No. 25, *Accounting for Stock Issued to Employees*, which was permitted under Statement 123, as originally issued.

**Earnings (Loss) per Common Share**



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The Company utilizes SFAS No. 128, Earnings per Share to calculate earnings/loss per share. Basic earnings/loss per share is computed by dividing the earnings/loss available to common stockholders (as the numerator) by the weighted-average number of

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common shares outstanding (as the denominator). Diluted earnings/loss per share is computed similar to basic earnings/loss per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if all potential common stock (including common stock equivalents) had all been issued, and if such additional common shares were dilutive. Under SFAS No. 128, if the additional common shares are dilutive, they are not added to the denominator in the calculation. Where there is a loss, the inclusion of additional common shares is anti-dilutive (since the increased number of shares reduces the per share loss available to common stock holders).

### **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 reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Estimates and assumptions are periodically reviewed and the effects of revisions are reflected in the consolidated financial statements in the period they are determined to be necessary.

### **Reclassifications**

Certain reclassifications to the Company's income statement have been made in 2006, 2005, and 2004 in order for the 2006, 2005 and 2004 financial statements to conform to the presentation of these financial statements. These reclassifications are the restatement of the Research and Development expenses from General and Administrative expenses.

### **Recent Accounting Pronouncements**

In June 2006, the FASB issued FIN No. 48 *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109. This interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation, and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. FIN No. 48 is effective for Force Protection in the first quarter of fiscal 2007. The Company is currently assessing the impact that FIN No. 48 will have on the results of its operations, financial position, or cash flows.

In June 2005, the Emerging Issues Task Force, or EITF, reached a consensus on Issue 05-6, *Determining the Amortization Period for Leasehold Improvements*, which requires that leasehold improvements acquired in a business combination or purchased subsequent to the inception of a lease be amortized over the lesser of the useful life of the assets or a term that includes renewals that are reasonably assured at the date of the business combination or purchase. EITF 05-6 is effective for periods beginning after July 1, 2005. The Company does not expect the provisions of this consensus to have a material impact on the financial position, results of operations or cash flows.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* ( SFAS 154 ) which replaces Accounting Principles Board Opinions No. 20 *Accounting Changes* and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements An Amendment of APB Opinion No. 28*. SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application, or the latest practicable date, as the required method for reporting a change in accounting principle and the reporting of a correction of an error. SFAS 154 is effective for accounting changes and a correction of errors made in fiscal years beginning after December 15, 2005 and is required to be adopted by the Company in the first quarter of 2006. The Company is currently evaluating the effect that the adoption of SFAS 154 will have on its results of operations and financial condition but does not expect it to have a material impact.

In March 2005, the FASB issued FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* ( FIN 47 ). FIN 47 provides guidance relating to the identification of and financial reporting for legal obligations to perform an asset retirement activity. The Interpretation requires recognition of a liability for the fair value of a conditional asset retirement obligation when incurred if the liability's fair value can be reasonably estimated. FIN 47 also defines when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The provision is effective no later than the end of fiscal years ending after December 15, 2005. The Company will adopt FIN 47 beginning the first quarter of fiscal year 2006 and does not believe the adoption will have a material impact on its consolidated financial position or results of operations or cash flows.

### **NOTE 2 CONCENTRATIONS**

The Company's future operations and continued expansion is subject to a significant concentration risk. During the years ended December 31, 2006, 2005 and 2004, the Company's revenues from military units of the U.S. Government accounted for 84%, 90% and 97% of total revenues, respectively. The Company's accounts receivable from military units of the U.S. Government at December 31, 2006, 2005 and 2004 amounted to 81%, 60% and 95% of total accounts receivable, respectively.



**NOTE 3 ACCOUNTS RECEIVABLES & DEFINITIZATION**

The majority of the Company's contracts are with the United States Government and as such they are public sector contracts subject to the Federal Acquisition Regulations set out at Title 41 of the United States Code or FAR, and may result either from competitive bidding or may be awarded as sole source contracts subject to definitization as provided under FAR Section 252.217-7027.

Following the award of a sole source contract, a central component of the definitization process is the negotiation and finalization of the contract price between the contractor and the United States contracting officer. As part of this process, the parties make a mutual determination of the direct material and labor costs for the work based upon the bill of materials and other purchasing information and then the parties mutually agree upon rates for the indirect labor costs and the General and Administrative costs and upon a fee (or profit). While the direct material costs and labor can be established through objective evidence, the rates and fee are more subjective and are based upon an analysis of multiple factors including historical performance data and projected operational factors. The contractor has the right to submit proposed rates and fee, but these are subject to final review and approval by the contracting officer, who may insist on using alternate rates and fee. As provided in section 252.217-7027(c):

*If agreement on a definitive contract action to supersede this undefinitized contract action is not reached by the target date in paragraph (b) of this clause, or within any extension of it granted by the Contracting Officer, the Contracting Officer may, with the approval of the head of the contracting activity, determine a reasonable price or fee in accordance with subpart 15.4 and part 31 of the FAR, subject to Contractor appeal as provided in the Disputes clause.*

Finally, although both parties make an effort to definitize the contract as quickly as possible, the process is time consuming and can take months (or even years) to complete. During the definitization process the contractor is required to perform the contract work and to make deliveries under the contract before the final contract price has been established. For this reason, as part of the original letter award, the contractor provides a rough order of magnitude or ROM, price to be used for invoicing and accounting purposes pending definitization.

As a result of the potential adjustments related to the definitization process, the Company maintains an allowance for contractual adjustments account. This account is reviewed on a regular basis to determine adequate adjustments, if necessary. The allowance is evaluated and deemed adequate based on the analysis of historical data and calculation of pro-rata percentages of current contracts in place, which remain subject to the definitization process.

Below is a table detailing activity within the allowance for contractual adjustments account for the years ended December 31, 2006, 2005, and 2004 respectively.

	Year Ended Dec. 31, 2006	Year Ended Dec. 31, 2005	Year Ended Dec. 31, 2004
Beginning balance	\$ 1,018,051	\$	\$
Additions to allowance	6,317,077	1,018,051	
Reduction to allowance	(1,267,041)		
Ending balance	\$ 6,068,087	\$ 1,018,051	\$

The Company does not maintain an allowance for doubtful accounts. The Company's significant sales for the years ended December 31, 2006, 2005 and 2004 involved contracts signed with the U.S. Government. As of the date of this report all non-direct government year-end receivables have been collected. The Company does not believe an allowance for doubtful accounts is necessary due to the credit-worthiness of the U.S. Government.

Historically, the Company has not encountered sales returns. The Company does not anticipate sales returns in the future.

**NOTE 4 INVESTMENT IN CHALLENGER POWERBOATS INC.**

On June 1, 2003, and modified on September 15, 2003, the Company sold the asset associated with its boat business to Rockwell Power Systems, Inc., which subsequently merged with Xtreme Companies, Inc, now called Challenger Powerboats, Inc., a public company traded on the Over the Counter Bulletin Board. As consideration for the sale, the Company received 1/3 of Challenger Powerboats' outstanding common stock, which was distributed directly to the Company's common stock shareholders. Additionally, the Company was to receive 500 shares of Challenger Powerboats Series A preferred stock. The Company has been in communications with Challenger Powerboats but has yet to receive these shares. The Company has elected to account for the investment in Challenger Powerboats' Series A preferred stock under the cost method and has provided for a full valuation allowance against the fair market value of these shares as of December 31, 2006, 2005 and 2004, respectively.



	2006	2005	2004
Challenger Powerboats, Inc. Series A preferred stock	\$	\$	\$
Valuation Allowance			
Net Investment in Challenger Powerboats, Inc			

#### NOTE 5 INVENTORIES

Inventories at December 31, 2006, 2005 and 2004 consisted of the following:

	2006	2005	2004
Raw materials and supplies	\$ 45,131,126	\$ 15,222,503	\$ 5,268,798
Work in process	17,688,784	17,762,554	3,756,921
Finished Goods			4,194
Less: Allowance for surplus and obsolete	(2,423,613 )	(498,281 )	
Inventories, net	\$ 60,396,297	\$ 32,486,776	\$ 9,029,913

#### NOTE 6 PROPERTY, PLANT AND EQUIPMENT

Property, Plant and Equipment at December 31, 2006, 2005 and 2004 consisted of the following:

	2006	2005	2004
Furniture and fixtures	\$ 1,022,984	\$ 227,613	\$ 252,608
Leasehold improvements	1,534,057	59,928	
Machinery and equipment	6,534,550	2,024,436	983,955
Test Equipment	16,790	16,790	16,790
Manuals	104,797	104,798	104,798
Vehicles	143,464	56,464	10,110
Demo vehicles	1,095,925	425,845	192,530
Less depreciation and amortization	(1,488,666 )	(777,171 )	(523,797 )
Net property and equipment	\$ 8,963,901	\$ 2,138,703	\$ 1,036,994

Depreciation expense for the years ended December 31, 2006, 2005 and 2004 was \$769,454, \$386,152 and \$207,271 respectively.

#### NOTE 7 COMMITMENTS AND CONTINGENCIES

##### Other Accrued Liabilities

The Company's other accrued liabilities include the following:

	2006	2005	2004
Compensation and benefits	\$ 1,222,143	\$ 1,396,024	\$ 1,195,705
Vehicle Fee Payable	1,139,250		
Liquidated damage settlement	607,466		
Dividends on preferred stock		260,080	
Common Stock shares to be issued		212,606	
Other		29,310	158,761
Total	\$ 2,968,859	\$ 1,898,020	\$ 1,354,466

##### Contract Liabilities

The Company's sales contracts generally include a warranty such that the Company's products are free from defects in design, material, and workmanship for a period of 1 year from the acceptance date. The warranty does not apply to any damage or failure to perform caused by the misuse or abuse of the vehicle, combat damage, fair wear and tear items (brake shoes, track pads, wiper blades, etc.), or by the customer's failure to perform proper maintenance or service on the supplies.

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The Company routinely reviews its exposure for warranty costs and determines warranty and pricing reserves based on historical data and known events. Below is a table detailing the Company's accruals for warranty-related costs as of December 31, 2006, 2005 and 2004:

	2006	2005	2004
General warranty	\$ 1,850,000	\$ 1,686,062	\$ 228,130
Loss contingency			501,331
	\$ 1,850,000	\$ 1,686,062	\$ 729,461

### Vehicle Fees

The Company is party to a Memorandum of Understanding with Mechem, a division of Denel PTY, a South African company pursuant to which Mechem agreed for a period of five years to work exclusively with the Company and not to cede, dispose or transfer to any third party other than the Company any of its technology, IPR or other proprietary information relating to its armored vehicles systems including, but not limited to, designs, drawings, full technical specifications, test data, hardware and software designs and technologies, supplier's list, know-how and all and every piece of information and data relevant to such systems. In exchange for such exclusivity the Company agreed to pay Mechem a vehicle fee for every Buffalo, Cougar and Tempest the Company manufactures and sells. The Company is not obligated to pay a vehicle fee in respect of other vehicles it manufactures and sells. On September 13, 2006 the Company executed a new Memorandum of Agreement with Mechem, extending the period of exclusivity for an additional five years, and adding a provision that Mechem would upon request by the Company provide expertise and know-how on a work for hire basis to advise, assist and support the Company in its marketing activities. The Company also agreed to make a one time payment of \$394,500 to Mechem, representing vehicle fees in respect of Cougar vehicles previously delivered and sold by the Company during 2005 and 2006. The agreement with Mechem expires in September 2011.

The Company is also party to an agreement with CSIR Defencetek (a division of the Council for Scientific and Industrial Research) a statutory council established in accordance with the Laws of the Republic of South Africa, pursuant to which the Company is obligated to pay the CSIR a similar vehicle fee. The agreement with the CSIR expires in March 2007.

The following table is a summary of the vehicle fees to be paid per vehicle:

	Mechem	CSIR
Buffalo	\$ 5,000	\$ 3,000
Cougar	\$ 1,500	\$ 1,500
Tempest	\$ 3,000	\$ 1,500
Cheetah	\$ 0	\$ 0

### Table of Contractual Obligations

The following is a table outlining the Company's actual and projected significant contractual obligations as of December 31, 2006:

	For the Years Ended					
	2007	2008	2009	2010	2011	Total
Operating Lease Commitments	\$ 1,624,286	\$ 992,479	\$ 56,609			\$ 2,673,374
Capital Equipment Note Payments	\$ 92,608	\$ 92,608	\$ 69,456			\$ 254,672
Mechem Vehicle Fees(1)	Variable	Variable	Variable	Variable	Variable	Variable
CSIR Vehicle Fees(2)	Variable	Variable				Variable
Total	\$ 1,716,894	\$ 1,085,087	\$ 126,065			\$ 2,928,046



- (1) Refer to the Mechem vehicle fee agreement detailed above in Footnote 7, Commitments and Contingencies, Vehicle Fees.
- (2) Refer to the CSIR vehicle fee agreement detailed above in Footnote 7, Commitments and Contingencies, Vehicle Fees.

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### Contract Definitization

The Company contracts for the sale of its vehicles to the U.S. Government under fixed price sales contracts, subject to the provisions of the U.S. Federal Acquisition Regulations ( FAR ). Under FAR 52.216-25, contract awards may be made subject to future Contract Definitization pursuant to which the contractor agrees to negotiate with the Government following commencement of the contract work to finalize detailed conditions of the contract, including pricing, scheduling and other applicable requirements. As part of such negotiations, the contractor is subject to audit by the U.S. Defense Contract Audit Agency ( DCAA ) of its direct material and labor costs, manufacturing overhead and margin. Based on such audit and the negotiations with the Government, the final definitized contract price may be less than the amount originally established (see additional discussions within Footnote 1 and Footnote 3).

### Legal Proceedings

During June, 2006, the Company confirmed that two former employees had filed claims under 31 U.S.C. §3730 alleging *inter alia* that the Company had failed to comply with the terms of the JERRV contract in respect to the allocation and use of the initial contract milestone payment for such accelerated delivery costs. On August 23, 2006, the Company agreed to settle with the United States Government and with these former employees all claims relating to or arising under the JERRV contract and the payment of such accelerated delivery costs for a total of \$1,905,000 plus interest of \$23,000. As of December 31, 2006, the Company has paid \$1,297,534 under the terms of such settlement agreement and the Company has established a provision of \$607,466 for the remaining liability.

The Company may be involved from time to time in ordinary litigation that will not have a material effect on our operations or finances. Other than the litigation described above, we are not aware of any pending or threatened litigation against the company or our officers and directors in their capacity as such that could have a material impact on our operations or finances.

### NOTE 8 DEFERRED REVENUE

The Company only recognizes revenue from the sales of its vehicles upon formal acceptance by its customers. However, the Company does receive performance based payments in accordance with agreed milestones under some of its government contracts. The Company records such performance based payments as deferred revenue and carries them on its balance sheet until formal acceptance by the customer. As of December 31, 2006, 2005 and 2004 the Company had \$12,824,211, \$12,598,921 and \$2,645,716, respectively as deferred revenue resulting from its contracts with the U.S. Army and the U.S. Marines.

### NOTE 9 DEBT

On November 18, 2005, Longview Fund, LP and Longview Equity Fund, LP (collectively, Longview ) issued secured promissory notes (the Notes ) to the Company for gross proceeds of \$7,500,000. The Notes matured on February 18, 2006. Interest is payable on the Notes at the annualized rate of 24%. The Company also executed a Security Agreement that granted Longview a first preferred UCC-1 security interest in all of the Company's assets and property.

On February 18, 2006, the Company entered into a Modification and Assignment Agreement with Longview pursuant to which the Company paid \$1,250,000 against the principle balance of the Notes and extended the maturity date of the Notes for an additional 60 days. In addition, the Company consented to the assignment of \$2,500,000 of the Notes to Fort Ashford Funds LLC (the Ashford Note ). Frank Kavanaugh, a director of the Company, is the principal owner of Fort Ashford Funds and a substantial shareholder of the Company's common stock. Mr. Kavanaugh's relationship to Fort Ashford Funds LLC was fully disclosed to the Company and Mr. Kavanaugh did not participate in the negotiations or decision process in respect of the Modification and Assignment Agreement. The Company paid \$87,510 to Longview and \$50,000 to Fort Ashford in cash as compensation for the extension of the maturity dates of the Notes.

On April 20, 2006, the Company paid \$1,000,000 against the principle balance of the Notes and extended the maturity date on the Notes and the Ashford Note for an additional 60 days, through June 20, 2006. The Company paid \$55,000 to Longview and \$50,000 to Fort Ashford in cash as compensation for this extension.

On June 20, 2006, the Company paid off the principle balance and all applicable accrued interest under the Notes. Additionally, the Company extended the maturity date of the Ashford Note for an additional 30 days, through July 20, 2006. The Company paid \$50,000 to Fort Ashford in cash as compensation for the extension of the Ashford Note.

On August 9, 2006, the Company paid off the principle balance of the Ashford Note, and all applicable accrued interest under the Ashford Note.



In October 2006 the Company acquired capital equipment valued at \$234,875 using a note with implied interest of 11.25% from the supplier with a repayment based on usage of materials used with the equipment. It is expected that based on usage estimates the note payments in 2007, 2008, and 2009 will be \$92,608, \$92,608 and \$69,456, respectively.

**NOTE 10 FACTORING OF ACCOUNTS RECEIVABLE**

The Company entered into an agreement with GC Financial Services, Inc. on June 29, 2005, pursuant to which the Company agreed to sell accounts receivables under our JERRV Contract (M67854-05-D-5091) in an amount not to exceed \$63,000,000. Under the terms of such agreement, the Company received 98.1% of the value of receivables sold to the Factor within 24-48 hours of delivery of the invoice. During June 2006, the Company exceeded the agreed maximum value of receivable to be factored under the Factoring Agreement. On June 22, 2006, the Factoring Agreement was terminated and no further obligation remained between the Company and GC Financial Services, Inc.

The Company entered into an agreement with GC Financial Services, Inc. on June 28, 2004, pursuant to which the Company agreed to sell accounts receivables under our Buffalo contracts with the U.S. Army. Under the terms of such agreement, the Company receives approximately 98% of the value of receivables sold to the Factor within 24-48 hours of delivery of the invoice. The Factor was granted a security interest in the Company's assets and retained the right of full recourse against the Company. The Company terminated such agreement in January 2005.

The Company's factoring transactions in 2006, 2005 and 2004 are summarized below:

	<b>Year Ended December 31, 2006</b>	<b>Year Ended December 31, 2005</b>	<b>Year Ended December 31, 2004</b>
Sale of Receivables to Factor	\$ 44,692,632	\$ 17,170,086	\$ 11,895,363
Payments to Factor	(45,482,504 )	(16,380,214 )	(11,294,319 )
Balance at end of period	\$ 849,160	\$ 311,443	\$ 237,907
Charges by Factor			

**NOTE 11 STOCKHOLDERS' EQUITY**

The Company was originally incorporated on November 27, 1996 as a Colorado corporation. The Company incorporated Force Protection, Inc., a Nevada corporation on December 13, 2004 and effected a merger with Force Protection, Inc., a Colorado corporation, on January 1, 2005. The Colorado Corporation was dissolved upon the merger. The Company has continued its operations as the Nevada Corporation from January 1, 2005 forward. The Company has the authority to issue 310,000,000 shares, in aggregate, consisting of 300,000,000 shares of common stock and 10,000,000 shares of preferred stock, of which 1,600 have been designated Series A, 25 of which have been designated as Series B, 150 of which have been designated as Series C and 20,000 of which have been designated as Series D. At all times through December 31, 2004, the Company's stock was all issued at no par value. By shareholder's resolution effective January 1, 2005, all classes of stock were declared to have a par value of \$0.001 per share. For further information regarding Series D 6% Convertible Preferred Stock, please refer to the separate footnote disclosure in Note 12.

The preferred stock has the following characteristics:

**Dividends** Each holder of preferred stock shall be entitled to receive dividends in cash, stock or otherwise, if, when and as declared by the Company's board of directors, with the exception of the preferred stock designated as Series A, which shall not be entitled to receive dividends. However, the Company will not declare or pay a dividend to common stockholders without first declaring and paying a dividend to the preferred shareholders. Each share of Series D Preferred Stock is specifically entitled to 6% cumulative dividends, payable semi-annually in cash or common stock. See Note 12 for further details regarding Series D 6% Convertible Preferred Stock.

**Liquidation** In the event of any voluntary or involuntary liquidation, dissolution or winding-up of the Company, the assets of the Company available for distribution to its stockholders shall be distributed as follows:

- (a) Series A Preferred Stock shall rank senior to Series B Preferred Stock, Series C Preferred Stock, Series D 6% Convertible Preferred Stock and common stock;
- (b) Series B Preferred Stock shall rank junior to Series A Preferred Stock, senior to Series C Preferred Stock, Series D 6% Convertible Preferred Stock and common stock;



- (c) Series C Preferred Stock shall rank junior to Series A Preferred Stock, Series B Preferred Stock and senior to Series D 6% Convertible Preferred Stock and common stock;
- (d) Series D 6% Convertible Preferred stock shall rank junior to Series A Preferred Stock Series B Preferred Stock, Series C Preferred Stock and senior to common stock; and
- (e) Common stock shall rank junior to Series A, B, C and D 6% Convertible Preferred Stock.

Additionally, upon a liquidation event, holders of Series A Preferred Stock will receive \$1,000 per share of Series A Preferred Stock. Holders of Series B Preferred Stock will receive the greater of \$2,500 or the pro-rata share of the Company's remaining net assets to be distributed, after rank considerations. Holders of Series C Preferred Stock will receive a 150% return on the face value of the share of Series C Preferred Stock, or \$1,500, after rank considerations. In any event whereby the preceding distributions are unable to be met, the rank considerations outlined above shall be considered and the distribution of the Company's net assets shall be determined according to rank and on a pro-rata basis.

Conversion Series A Preferred Stock shall convert into common stock at a rate of \$4.00 per share, as adjusted accordingly. Each share of Series B Preferred Stock shall convert into 759,167 shares of common stock. Each share of Series C Preferred Stock shall convert into 75,917 shares of common stock. Each share of Series D 6% Convertible Preferred Stock shall convert into common stock at \$2.10 per share.

In connection with the private placement sale of the Company's common stock on January 19, 2005, the Company and the holders of Series B and Series C Preferred Stock agreed to convert all shares of the Series B and Series C Preferred Stock outstanding to shares of the Company's common stock. As a result, all shares of Series B and Series C Preferred Stock were converted into common effective January 19, 2005. The Series D 6% Convertible Preferred Stock issued in connection with the January 19, 2005 private placement remained outstanding following the conversion of the Series B and Series C Preferred Stock. All outstanding shares of the Series D 6% Convertible Preferred Stock were converted in full in 2006, and no shares of the Series D 6% Convertible Preferred Stock remain outstanding as of September 30, 2006. Series D 6% Convertible Preferred Stock has been classified as Mezzanine Equity by the Company. Please refer to Note 12 for further details regarding Series D 6% Convertible Preferred Stock.

On January 18, 2005, the Company's board of directors, acting pursuant to a resolution of the Company's shareholders, approved a reverse split of the Company's stock whereby each 12 shares of common stock outstanding on the date of record, February 4, 2005, would be exchanged for 1 new share of common stock. All references to common stock in the Company's public filings refers to post reverse split shares.

The following disclosures reference accounting guidelines and certain accounting treatments which the Company has used throughout 2006, 2005 and 2004. The Company considers the following terms and definition significant in ensuring the reader of these financial statements understands the accounting treatments applied by the Company:

- The Emerging Issues Task Force ( EITF ) provides accounting guidance and interpretations on emerging issues in business and accounting.
- Statements on Financial Accounting Standards ( SFAS ) are a primary source of accounting guidance under which many of the Company's accounting policies are based.
- Beneficial conversion feature is a topic addressed in EITF 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios* , EITF 00-19 *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock* and EITF 00-27 *Application of Issue No. 98-5 to Certain Convertible Instruments* , is an accounting term defined in EITF 98-5 that represents a situation in which a convertible security (debt or equity) is convertible into the Company's common stock at a price which is at a discount to the market, at the time the convertible security is issued.
- The Black-Scholes option pricing model (Black-Scholes) is an analytical model used to value an option to purchase a security based on certain market fundamentals such as the volatility of a security, the market for effective interest rates over a period of time and constraints placed on the option to purchase the security such as time horizons or the expiration of the option to purchase the security. The Company utilizes Black-Scholes to value stock options issued to employees, preferred stock issued to employees and service providers, preferred stock purchased by

investors and warrants issued to investors.

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**During the year ended December 31, 2006, the Company recorded the following transactions within its stockholders' equity accounts:**

**COMMON STOCK TRANSACTIONS**

On July 24, 2006, the Company closed a private placement sale and issued 8,250,000 shares of common stock to investors for gross proceeds of \$41,250,000. Net proceeds received after expenses were \$39,187,500.

On December 20, 2006, the Company closed a private placement sale and issued 13,000,000 shares of common stock to investors for gross proceeds of \$152,750,000. Net proceeds received after expenses were \$146,640,261.

The following issuances of the Company's common stock during 2006 were valued by the Company using the Company's closing bid price of its common stock as quoted on the OTC Bulletin Board market as of the date of the associated contract or the issuance date if no contract existed:

Effective January 1, 2006, the Company's board of directors granted the Company's Chief Executive Officer 300,000 shares of the Company's unregistered common stock valued at \$216,000. The shares were fully vested upon issuance.

On April 21, 2006, the board of directors adopted a resolution approving payment of annual compensation to each member of the Company's board of directors. Each member is to receive annual cash compensation of \$24,000. In addition, each member received a guarantee of an annual grant of 15,353 shares of the Company's unregistered common stock. The shares of the Company's unregistered common stock are required to be held until the individual's service as a member of the Company's board of directors is complete. The Company awarded 96,149 and issued 69,360 shares of the Company's common stock to the members of the Company's board of directors in 2006. A total of 26,789 shares of the Company's common stock were included in shares to be issued in the stockholders' equity table as of December 31, 2006 relating to this award. The value for the 96,149 shares of common stock awarded to the members of the board of directors was recorded as stock based compensation of \$445,990.

On June 2, 2006, the Company granted and issued 12,500 shares of its unregistered common stock to a member of the Company's board of directors, valued at \$40,500 as compensation due under a previous employment contract with the Company. During 2006, the Company granted and issued 165,202 shares of its unregistered common stock valued at \$405,786 under various employment agreements. Included within these issuances were common stock issuances related to certain employee agreements which were modified during 2006. A total of 233,418 shares of common stock were rescinded as a result of the modifications to employee agreements. These transactions resulted in a reduction of the total stock-based compensation for 2006 of \$224,688.

On August 8, 2006, the Company agreed to issue 30,000 shares of common stock under a settlement agreement with Atlantis Partners, Inc. The shares issued were valued at \$187,500.

During 2006, employees exercised stock options to purchase 5,348 shares of the Company's common stock valued at \$6,001. A total of 4,348 shares of the Company's common stock were included in shares to be issued in the stockholders' equity table as of December 31, 2006 related to employee exercised stock options.

The Company adopted SFAS 123R as if July 1, 2005. Total stock option expense for 2006, which is inclusive of stock grants in 2006 was \$1,250,625.

**PREFERRED STOCK TRANSACTIONS**

*Series D 6% Convertible Preferred Stock:*

- During the year ended December 31, 2006, 13,004 shares of Series D Preferred Stock were voluntarily converted to 6,192,628 shares of common stock. The fully accreted conversion value of these shares of common stock at the time converted was \$9,198,571. See Note 12 Series D 6% Convertible Preferred Stock.

- During the three month period ended June 30, 2006, 586 shares of common stock were issued in lieu of cash dividends for the holders of Series D Preferred Stock. The shares issued were valued at \$2,377 which was 85% of the average of the lowest market value for 3 of the prior 10 trading days.





- During the three month period ended September 30, 2006, 8,351 shares of common stock were issued in lieu of cash dividends for the holders of Series D Preferred Stock. The shares issued were valued at \$46,448 which was 85% of the average of the lowest market value for 3 of the prior 10 trading days.

*WARRANT TRANSACTIONS*

- During 2006, warrants associated with Series D Preferred Stock were exercised and the Company issued 2,633,333 shares of common stock for gross proceeds of \$9,874,999.
- During 2006, various warrants were exercised and the Company issued 218,807 shares of common stock for gross proceeds of \$499,573.
- As of December 31, 2006, all warrants were exercised or expired. No warrants remained outstanding as of December 31, 2006.

*SHARES TO BE ISSUED*

- During the three month period ended December 31, 2006, 26,789 shares of common stock were granted for compensation to the Company's board of directors. The shares were valued at \$210,408 but were not issued as of December 31, 2006.

*During the year ended December 31, 2005, the Company recorded the following transactions within its stockholders' equity accounts:*

*COMMON STOCK TRANSACTIONS*

In January 2005, the Company issued a total 188,400 shares of the Company's common stock at an average price of \$2.76 per share, generating \$520,069 in net proceeds pursuant to the Investment Agreement between the Company and Dutchess Private Equities Fund, L.P., dated January 26, 2004.

The following issuances of the Company's common stock during 2005 were valued by the Company using the Company's closing bid price of its common stock as quoted on the OTC Bulletin Board market as of the date of the associated contract or the issuance date if no contract existed.

- 41,666 shares of the Company's common stock valued at \$112,499 were issued to a director, a member of the board of directors, for services rendered to the Company. An expense of \$112,499 was classified as compensation of directors and was recorded in 2005.
- 9,950 shares of the Company's common stock valued at \$12,910, to the Company's former President, for services rendered to the Company. An expense of \$12,910 was classified as officer compensation and was recorded in 2005.
- The Company issued 53,467 shares of the Company's common stock pursuant to the terms of the Company's agreement with certain third parties and were valued at \$144,895. An expense of \$144,895 was classified as settlement expense and was recorded in 2005.
- The Company issued 14,876 shares of the Company's common stock pursuant to the terms of the Company's agreement with GC Financial Services, Inc. which were valued at \$20,641. An expense of \$20,641 was classified as interest expense and was recorded in 2005.
- The Company's former Chief Executive Office, agreed to rescind 83,333 shares of common stock issued in 2004 valued at \$209,999.

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A total of 114,376 shares of common stock were issued by the Company for net proceeds of \$211,629 in connection with the exercise of warrants issued through a PIPE offering completed on April 10, 2002.

The Company issued a warrant to purchase 65,833 shares of the Company's common stock on January 19, 2005 to HPC Company. The warrant was valued at \$200,071 using Black-Scholes. The Company recorded a reduction of stockholders' equity associated with services provided as a placement agent for the Company's Series D 6% Convertible Preferred Stock offering, which closed on

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January 19, 2005. The inputs for this warrant in Black-Scholes are consistent with the inputs for the warrants issued with the Series D 6% Convertible Preferred Stock.

The Company issued warrants to purchase 75,000 shares of the Company's common stock that can be exercised for \$3.75 per share in a settlement agreement with H.C. Wainwright & Co. The value as determined by Black-Scholes was expensed as settlement expense in the amount of \$158,071. The Company also issued a warrant to purchase 41,667 shares of the Company's common stock that can be exercised for \$3.96 per share in a settlement agreement with Westor Online. The value as determined by Black-Scholes was expensed as settlement expense in the amount of \$72,354. The warrants were exercised in 2006. Below is a table depicting the valuation attributes used in Black-Scholes calculations related to these warrants issued in 2005:

#### Warrant Valuation Information

##### Valuation Assumptions

Stock price on grant date	\$	2.05-\$3.00	
Number of shares of common stock convertible to		116,667	
Conversion price	\$	3.75-\$3.96	
Expected option term (in years)		1	
Vesting term (in years)		N/A	
Expected volatility		177.06	%
Risk-free interest rate		4.26	%
Expected forfeiture rate		0	%
Estimated corporate tax rate		0	%
Expected dividend yield		0	%

Outstanding warrants to purchase 2,143,085 common stock shares expired or were cancelled during 2005. The warrant valuation of \$2,302,850 was added to Additional Paid in Capital accordingly in 2005.

The Company issued 14,803,750 shares of unregistered common stock resulting for the mandatory conversion on February 8, 2005 of all the outstanding shares of the Company's Series B Convertible Preferred Stock. At the time of conversion, the conversion rate for the Series B Convertible Preferred Stock was 2% of fully diluted common stock. The beneficial conversion feature related to the Series B Convertible Preferred Stock in the amount of \$19,102,306 was relieved in full on February 8, 2005.

#### PREFERRED STOCK TRANSACTIONS

##### Series D 6% Convertible Preferred Stock:

- On January 19, 2005, the Company issued 15,800 shares of the Company's Series D 6% Convertible Preferred Stock for net cash of \$15,305,966. The issuance of the Company's Series D 6% Convertible Preferred Stock was recorded at \$7,301,766 which is the net value of the cash received of \$15,305,966 less the fair value of the associated warrants of \$8,004,200. The Company classified the Series D 6% Convertible Preferred Stock as Mezzanine Equity. Refer to Note 12 for further information regarding Series D 6% Convertible Stock.
- On May 23, 2005, 2,796 shares of the Series D Preferred Stock were voluntarily converted into 1,331,429 shares of Common Stock. The conversion value of these shares of common stock at the time of conversion was \$1,442,025.

*During the year ended December 31, 2004, the Company recorded the following transactions within its stockholders' equity accounts:*

#### COMMON STOCK TRANSACTIONS

The Company closed on a private investment in public equity (PIPE) offering on March 23, 2004. The PIPE, sold to numerous accredited investors, consisted of the following:

- Common stock issuances, 1,771,874 shares of common stock were issued for \$4,245,000 in net proceeds.
- Issuance of A warrants, 1,771,874 warrants to purchase common stock were issued in 2004, with an original exercise price of \$1.44 per warrant. A total of 219,792 shares of common stock were issued by the Company for net proceeds of \$316,497, in connection with the exercise of A warrants in 2004. The remaining A warrants expired on December 31, 2004.

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- Issuance of Green Shoe warrants, 1,771,874 warrants to purchase common stock were issued in 2004, with an original exercise price of \$2.40 per warrant. A total of 674,058 shares of common stock were issued by the Company for net proceeds of \$1,677,713, in connection with the exercise of Green Shoe warrants in 2004. The remaining Green Shoe warrants expired on December 31, 2004.

In November and December 2004, the Company issued a total 1,210,843 common shares generating \$2,958,217 in net proceeds pursuant to the Dutchess Equity agreement.

A total of 1,863,768 shares of common stock were issued by the Company for net proceeds of \$2,100,637 in connection with the exercise of warrants issued through a private investment in public equity ( PIPE ) offering dated April 10, 2002 for Regulation D Section 506 Private Placement Memorandum issued in 2003 to numerous accredited investors.

The following issuances of the Company's common stock during 2004 were valued by the Company using the Company's closing bid price of its common stock as quoted on the OTC Bulletin Board market as of the date of the associated contract or the issuance date if no contract existed.

- 163,501 shares of the Company's common stock valued at \$496,956 were issued to a third party for services rendered to the Company. An expense associated with this issuance of \$496,956 was recorded in 2004.
- 70,833 shares of the Company's common stock valued at \$127,500 were issued to a member of the board of directors, for services rendered to the Company. An expense of \$127,500 was classified as compensation of directors and was recorded in 2004.
- 91,667 shares of the Company's common stock valued at \$231,000 were issued to a member of the board of directors, for services rendered to the Company. An expense of \$231,000 was classified as compensation of directors and was recorded in 2004.
- 208,333 shares of the Company's common stock valued at \$495,000 to the Company's former Chief Executive Officer, for services rendered to the Company. An expense of \$495,000 was classified as officer compensation and was recorded in 2004.
- 125,000 shares of the Company's common stock valued at \$255,000 to the Company's former Chief Financial Officer, for services rendered to the Company. An expense of \$255,000 was classified as officer compensation and was recorded in 2004.
- 41,682 shares of the Company's common stock valued at \$145,054 to an employee, for services rendered to the Company. An expense of \$145,054 was classified as stock-based compensation and was recorded in 2004.
- 79,167 shares of the Company's common stock valued at \$178,250, to various employees for services rendered to the Company. An expense of \$178,250 was classified as stock-based compensation and was recorded in 2004.

304,167 shares of common stock issued in error in December 2003 were cancelled in the first week of January 2004.

The Company issued 20,421 shares of common stock to third parties upon the conversion of existing debts in the amount of \$124,976.

#### *PREFERRED STOCK TRANSACTIONS*

For information regarding Series D 6% Convertible Preferred Stock, please refer to the separate footnote disclosure in Note 12.

Series B and Series C Convertible Preferred Stock are in the form of shares, and have no conditional or unconditional mandatory redemption provisions obligating the Company in the future other than liquidation or company wind-up provisions. Under SFAS 150 *Accounting for Certain*

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*Financial Instruments with Characteristics of both Liabilities and Equity*, the issuances of Series B and Series C Preferred stock have been classified as equity. The conversion options are not considered derivative liabilities which must be valued at fair value under SFAS 133 or EITF 00-19. The conversion options are indexed to the Company's own stock and the host instrument is classified as equity thus meeting the paragraph 11a scope exception under SFAS No. 133 Accounting for Derivative instruments and hedging activities. The Company determined that there is no intrinsic value of the conversion options for the Series B and Series C Preferred Stock under EITF 00-27.

In accordance with EITF 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Rates, the Company records beneficial conversion feature expense when and if the Company issues debt or equity instruments which are convertible into shares of the Company's common stock, at a conversion price which is favorable to the

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holder of the debt or equity instrument. Valuation of this favorable conversion feature is based on the circumstances of each debt or equity issuance but is generally based on the actual or estimated difference between the fair market value of the underlying common stock less the cost of acquiring the common stock or a beneficial increase in conversion rates of preferred shares into common stock.

The Company issued preferred stock shares for services provided as follows:

- 4 shares of the Company's Series C Convertible Preferred Stock were issued to a member of the board of directors, for services rendered. The Company used Black-Scholes to determine the value of the shares as \$137,583.
- 20 shares of the Company's Series C Convertible Preferred Stock were issued to the Company's former Chief Executive Officer, for services rendered. The Company used Black-Scholes to determine the value of the shares as \$692,996.
- 4 shares of the Company's Series C Convertible Preferred Stock were issued to the Company's former Chief Financial Officer, for services rendered. The Company used Black-Scholes to determine the value of the shares as \$138,976.
- 10 shares of the Company's Series C Convertible Preferred Stock were issued to a member of the board of directors, for services rendered. The Company used Black-Scholes to determine the value of the shares as \$346,526.

The Company issued 20 shares of Series C Convertible Preferred Stock in exchange for existing debt in the amount of \$200,000. The Company used Black-Scholes and calculated the value of shares at issuance. A beneficial conversion feature was generated as the value of the issuance using Black-Scholes was greater than the value of the debt converted in the amount of \$385,530.

The Company issued 1 share of the Company's Series C Convertible Preferred Stock for proceeds of \$10,000. The value of this issuance was calculated using Black-Scholes and was greater than the value of the proceeds in the amount of \$22,612. The Company recorded a Beneficial Conversion Feature for this difference.

Below is a table depicting the valuation attributes used in Black-Scholes calculations related to the Series C Preferred Stock issued in 2004:

**Series C Preferred Stock Valuation Information for the Year Ended December 31, 2004**

Valuation Assumptions	
Stock price on grant date	\$1.80-\$4.08
Number of shares of common stock convertible to	2,198,276
Conversion price	\$1.80-\$4.08
Expected option term (in years)	1
Vesting term (in years)	N/A
Expected volatility	90.29%-177.06%
Risk-free interest rate	4.00%-4.29%
Expected forfeiture rate	0%
Estimated corporate tax rate	0%
Expected dividend yield	0%

The following transactions of the Company's preferred stock during 2004 were recorded:

- The Company had 5 Shares of Series C Convertible Preferred Stock voluntarily redeemed for \$60,000. A loss on redemption of \$10,000 was recorded. Additionally, the Company recorded a gain on debt extinguishment related to the recapture of beneficial conversion feature expensed in connection with the issuance of the preferred stock in 2002 of \$7,272.



- 1,330,865 shares of the Company's common stock were issued upon the voluntary conversion of 51 shares of Series C Convertible Preferred Stock. The conversion rate at the time of conversion was 0.2% of outstanding common stock. The Company recorded a gain on debt extinguishment related to the recapture of beneficial conversion feature expensed in connection with the issuance of the preferred stock in the amount of \$243,690.
- 1 share of the Company's Series C Convertible Preferred Stock was voluntarily rescinded. A gain was recognized in the amount of \$83,577 as a result. The gain was calculated using the Company's closing bid price of its common stock as quoted on the OTC Bulletin Board market as of the date the shares were rescinded and the number of shares of common stock for which the preferred

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stock was convertible into. Additionally, the Company recorded a gain on debt extinguishment related to the recapture of beneficial conversion feature expensed in connection with the issuance of the preferred stock in the amount of \$3,234.

- 1 share of the Company's Series B Convertible Preferred Stock was voluntarily converted to 10 Series C Convertible Preferred Stock. The Company used Black Scholes and calculated a beneficial conversion feature of \$269,044, associated as a result of differences between conversion rates between the two preferred stock classes.
- 416,667 shares of the Company's common stock were issued upon the conversion of 1 share of Series B Convertible Preferred Stock. The conversion rate at the time of conversion was 2% of fully diluted common stock. The Company recorded a gain on debt extinguishment related to the recapture of beneficial conversion feature expensed in connection with the issuance of the preferred stock in of \$16,324.

The conversion rate for Series C Convertible Preferred Stock changed to 0.2% of fully diluted stock on September 14, 2004. At that time, there were 144 Series C Preferred Stock shares outstanding. The Company used Black-Scholes to calculate the value of this change as \$18,558,870, which represents the beneficial conversion feature for this conversion rate increase for all outstanding Series C Preferred Stock Shares on September 14, 2004. After which, 14,263 shares of the Company's common stock were issued upon the voluntary conversion of 1 share of Series C Convertible Preferred Stock. During October 2004, all outstanding shares of the Company's Series C Preferred Convertible stock were either mandatory converted to Series B Convertible Preferred stock or into shares of common stock. The conversion rate was 10 shares of Series C Convertible Preferred stock for 1 share of Series B Convertible Preferred Stock or 0.2% of fully diluted common stock. In total, 115 shares of Series C Convertible Preferred stock were redeemed for 11.5 shares of Series B Convertible Preferred Stock. 1,169,350 shares of common stock were issued for the conversion of the remaining 28 Series C Convertible Preferred Stock. These transactions resulted in the Company recording a gain on debt extinguishment related to the recapture of beneficial conversion feature expensed in connection with the issuance of the preferred stock in the amount of \$146,120.

**NOTE 12 Series D 6% Convertible Preferred Stock**

On January 19, 2005, the Company issued 15,800 shares of Series D 6% Convertible Preferred Stock ( Series D Preferred) at \$1,000 per share pursuant to a purchase agreement (the Purchase Agreement ) for gross proceeds of \$15,800,000. Issuance costs of \$494,034 were incurred and treated as a discount to reduction of the carrying value which netted to \$15,305,966. The Series D Preferred may convert at any time, at the holder's discretion, into shares of Common Stock. The conversion price is \$2.10 per share. Each share of the Series D Preferred converts into the number of shares of Common Stock equal to \$1,000 divided by the conversion price which is approximately 467.19 shares. Additionally, the Company pays 6% dividends on the Series D Preferred in cash or Common Stock. The Series D Preferred Stock, if not converted to Common Stock, is redeemable for \$1,000 per Series D Preferred share on January 19, 2008.

In the same private placement, the Company issued Warrants to purchase 2,633,333 shares of Common Stock at an exercise price of \$3.75 per share. The Warrants expire on January 19, 2008. These warrants are further disclosed below.

The Series D Preferred falls outside the scope of SFAS No. 150 but the guidance in Rule 5-02.28 of Regulation S-X, Accounting Series Release No. 268 (ASR 268) and EITF Topic D-98: Classification and Measurement of Redeemable Securities are applicable. As such, the Company has recorded the Series D Preferred as mezzanine equity on the accompanying balance sheet.

The difference between the initial recorded amount and redemption value, the discount, is accreted to retained earnings or, in the absence of retained earnings, additional paid-in capital, over the period from the date of issuance to the earliest redemption date of the security using the interest method thus reducing net income attributable to common shareholders. This accretion is treated like a dividend on preferred stock. The accretion from the initial value to the redemption amount has been determined using T-Value based on the following inputs:

1. Rate 8.00% (reasonable rate of interest)
2. Number of payment periods 36 (three years)

The following table summarizes the transactions of the Series D Preferred:



Series D 6% Convertible Preferred stock at issuance	\$	15,800,000
Less:		
Issuance costs		494,034
Fair value of warrants at issuance (see Warrants )		8,004,200
Subtotal Carrying Value at issuance	\$	7,301,766
Plus:		
Cumulative accretion of discount to redemption value first quarter 2005		420,695
Cumulative accretion of discount to redemption value second quarter 2005		593,609
Cumulative accretion of discount to redemption value third quarter 2005		508,577
Cumulative accretion of discount to redemption value fourth quarter 2005		518,816
Less:		
Carrying Value of 2,796 Series D Preferred converted into Common Stock second quarter 2005		1,442,025
Carrying Value at December 31, 2005	\$	7,901,438
Plus:		
Cumulative accretion of discount to redemption value first quarter 2006		484,750
Cumulative accretion of discount to redemption value second quarter 2006		448,815
Cumulative accretion of discount to redemption value third quarter 2006		363,569
Less:		
Carrying Value of 4,526 Series D Preferred converted into Common Stock first quarter 2006		2,872,466
Carrying Value of 3,601 Series D Preferred converted into Common Stock second quarter 2006		2,456,119
Carrying Value of 4,877 Series D Preferred converted into Common Stock third quarter 2006		3,869,987
Carrying Value at December 31, 2006	\$	

The Series B Preferred has the following rights, preferences and privileges:

#### **Registration Rights**

The Company and the holders of Series D Preferred entered into a Registration Rights Agreement on January 19, 2005. Among other things, the Company was obligated to file a registration statement on Form S-3 within 75 days of the agreement and use its commercially reasonable efforts to cause such registration statement to become effective. The Securities & Exchange Commission accepted the Registration Statement on Form S-3 on May 11, 2005, pursuant to which the shares of Common Stock issuable upon conversion of the Series D Preferred, as well as the shares of Common Stock issuable upon the exercise of warrants, were registered for resale. The agreement provides for any liquidated damages by the Company to the Series D Preferred holders if the Company is unable to complete the registration, not filing in timely manner or maintain such effectiveness.

#### **Voting Rights**

Each holder of shares of Series D Preferred shall have no voting rights so long as the Company shall not, without the affirmative vote of the holders of Series D Preferred then outstanding, alter or change the powers, preferences or rights of the holders of Series D Preferred, authorize or create any class of stock ranking as to dividends, redemption, or distribution of assets upon liquidation senior to Series D Preferred, amend corporate documents so as to affect adversely any rights of holders or increase the authorized number of shares of Preferred Stock.

#### **Dividends**

Cumulative Dividends are payable to all holders of Series D Preferred on March 1 and September 1 beginning with the first such date after the original issue date and on any conversion date. Dividends can be paid in cash unless certain criteria are met (mainly no cash available for payment) which allows the Company to issue shares of Common stock equivalent to the amount due at 85% of the average stock price of the preceding 10 trading days to the dividend payment date. Series D Preferred dividends are recorded as a



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reduction (increase) to retained earnings (accumulated deficit) and net income (loss) available to common shareholders. Dividends, whether declared or not, are payable at a rate of six percent (6%) of the Stated Value per annum.

In the event dividends are paid on any shares of other Preferred Stock or common stock, the Company shall pay any amounts due to Series D Preferred holders before such dividend can be paid.

Dividend Transactions (per equity table)	Amount
Dividend Payment March 1, 2005 57,186 common shares issued	\$ 100,075
Dividend Payment September 1, 2005 224,511 common shares issued	318,355
Cash payment	100,020
Total Dividend for September 1, 2005	418,375
Dividend Accrued as of December 31, 2005	260,080
Dividend Payment March 1, 2006 586 common shares issued	\$ 2,377
Cash payment	117,464
Total Dividend for March 1, 2006	119,841
Dividend Payment September 1, 2006 8,351 common shares issued	46,448
Cash payment	159,396
Total Dividend for September 1, 2006	205,844

### **Conversion**

The Series D Preferred may convert at any time, at the holder's discretion, into shares of Common Stock. The conversion price is \$2.10 per share. Each share of the Series D Preferred converts into the number of shares of Common Stock equal to \$1,000 divided by the conversion price which is approximately 467.19 shares. The Company shall not effect any conversion of the Series D Preferred and the Holder shall not have the right to convert any portion of Series D Preferred to the extent that after giving effect to such conversion, the Holder (including its affiliates) would beneficially own in excess of 4.99% of the number of shares of common stock outstanding immediately after giving effect to such conversion. The Company must reserve and keep available out of its authorized and unissued shares of common stock for the purpose of issuance upon conversion of the Series D Preferred and payments of dividends on the Series D Preferred. The Company may force a conversion of Series D Preferred if the market value of the common stock for 20 consecutive trading days exceeds 180% of the conversion price effective at that time.

### **Redemptions**

On the third anniversary of the original issue date, the corporation shall redeem all remaining outstanding Series D Preferred which are not yet converted into common stock at a price equal to the Stated Value. Each holder of Series D Preferred to be so redeemed may, in lieu of redemption, convert such holder's shares of Series D Preferred Stock in whole or in part into shares of Common Stock.

The Company may be obligated to redeem the outstanding shares of Series D Preferred immediately prior to a change of control, failure to file the registration statement on or prior to 210 days after the original issue date, lapsing of the Registration Statement for more than 60 calendar days in aggregate or failure to have available the sufficient number of authorized and unreserved shares of common stock to issue upon conversion of a holder.

### **Warrants**

The Warrants represent a liability under EITF 00-19 in that the registration rights agreement contains a liquidated damages clause requiring the Company to pay cash to the holder of the instrument if the Company fails to obtain an effective registration statement timely, an event that is out of the Company's control. (Note: On April 11, 2005, the Company paid \$237,000 in liquidated damages for not filing its registration statement timely). The Warrants would not be classified as equity until the effective registration statement was obtained. As such, in accordance with EITF 00-19, the Warrant Liability is measured at its fair value at the reporting date, with the change in its fair value from issuance date reporting in the statement of operations. The fair value of the warrants has been determined using the Black-Scholes model using the following inputs:

1. Number of Warrant shares 2,633,333

2. Stock price at issuance date \$3.12 per share
3. Exercise price \$3.75 per share
4. Term 3 years
5. Discount rate 3.42%, representing the three\* year Treasury at the date of issuance
6. Volatility 259%, based on the stock prices during three\* years prior to issuance

These inputs yield a fair value of \$8,004,200.

coincides with the term of the Warrants)

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The warrants are measured at fair value both initially and in subsequent periods until the registration statement has been accepted by the Security and Exchange Commission. Subsequent changes in the fair value of the warrants until that time are recognized in current earnings under other income (expense) in the consolidated statements of operations. The decrease in fair value for the three month period ended March 31, 2005 is \$3,431,206. The fair value of the warrants at March 31, 2005 has been determined using the Black-Scholes model using the following inputs:

1. Number of Warrant shares 2,633,333
2. Stock price at reporting date \$1.84 per share
3. Exercise price \$3.75 per share
4. Term 2.75 years
5. Discount rate 3.96%, representing the three year Treasury at the reporting date
6. Volatility 245%, based on the stock prices during three years prior to the reporting date

These inputs yield a fair value of \$4,572,984 at March 31, 2005.

On May 11, 2005, the Company filed received Form 424B3 from the SEC confirming the registration of 17,008,655 common shares. As a result, the warrant liability is reclassified to equity on this date. The fair value of the warrants has been determined using the Black-Scholes model using the following inputs:

7. Number of Warrant shares 2,633,333
8. Stock price at reporting date \$2.08 per share
9. Exercise price \$3.75 per share
10. Term 2.70 years
11. Discount rate 3.96%, representing the three year Treasury at the reporting date
12. Volatility 245%, based on the stock prices during three years prior to the reporting date

These inputs yield a fair value of \$5,173,409. The \$5,173,409 was reclassified from warrant liability (Series D) to equity. The Unrealized Gain on Financial Instruments was reduced by \$600,425.

#### **NOTE 13 STOCK OPTIONS AND STOCK GRANTS**

##### ***Stock Options***

The Company does not have a formal stock option plan. However, the Company has offered its employees stock options. During 2006 and 2005, the Company issued options to purchase 1,508,125 and 652,833 shares of its unregistered common stock, respectively, to certain employees.

The Company adopted Statement of Financial Accounting Standards No. 123(R) ( SFAS 123(R)) as of July 1, 2005. SFAS 123(R) provides for mandatory expensing of the estimated value of stock options granted to the Company's employees over the period of time the stock options vest. The Company measures the total cost of each stock option grant at the date of grant using the Black Scholes option trading model. We recognize the cost of each stock option on a straight line basis over the applicable vesting period.

All stock options issued in 2005 do not carry a designated expiration date and vest over a 1 year period.



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Stock option expense recorded for 2006, 2005 and 2004 amounted to \$701,124, \$92,671 and \$0, respectively.

The Company adopted SFAS 123(R) as of July 1, 2005. Had the Company adopted SFAS 123(R) as of January 1, 2005, the pro forma impact on the 2005 net loss would have been an increase in the net loss reported by the Company of \$39,128.

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The following table summarizes stock options activity for the years ended December 31, 2006, 2005 and 2004:

**Stock Option Activity**

	Average per share Shares subject to option	Exercise price	Market price	
Balance at December 31, 2003				(a)
Options granted				(a)
Options exercised				(a)
Options terminated				(a)
Balance at December 31, 2004				
Options granted	652,833	\$ 1.50	\$ 1.50	
Options exercised				(a)
Options terminated	(196,167 )	\$ 1.50		(a)
Balance at December 31, 2005	456,666	\$ 1.50	\$ 1.50	
Options granted	1,508,125	\$ 0.72-\$7.48	\$ 0.77-\$7.48	
Options exercised	(5,348 )	\$ 1.38-\$1.50		(a)
Options terminated				(a)
Balance at December 31, 2006	1,959,443	\$ 2.53	\$ 17.98	

(a) Not applicable

The following table summarizes the attributes used in the Company's valuation of stock option grants during 2006, 2005 and 2004:

**Option Valuation Information**

	2006	2005	2004
Valuation Assumptions			
Stock price on date of grant	\$ 0.77-\$7.48	\$ 1.50	
Expected option term (in years)	2	2	
Expected duration from grant to expiration date (in years)	4 and 5	5	
Option vesting term (in years)		(a) 1	
Expected volatility	45.82%-70.31	% 48.61	%
Risk-free interest rate	4.40%-4.97	% 3.42	%
Expected forfeiture rate	5.00	% 5.00	%
Estimated corporate tax rate	40.00	% 40.00	%
Expected dividend yield	0.00	% 0.00	%

(a) Options issued in 2006 vest between 1 day and 14 months

(b) Not applicable

**Stock Grants**

The Company awarded stock grants to certain employees during 2006. The stock grants consisted of 191,016 shares of the Company's common stock valued at \$1,047,501, subject to certain vesting provisions. The stock grants vest on a schedule as shown below:

**Stock grant vesting dates**

January 1, 2007	50,000
May 4, 2007	20,513
Total for 2007	70,513
January 1, 2008	50,000
May 4, 2008	20,513

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Total for 2008	70,513
January 1, 2009	50,000
Total for 2009	50,000

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**NOTE 14 ACQUISITION AND SALE OF ASSETS**

In September 2004, the Directors of TSGI agreed to exchange all shares held by it of Technical Solutions Group Inc for the TSGI shares held by the Company, as a result of which the Company reacquired 100% of the shares of Technical Solutions Group as a wholly owned subsidiary.

**NOTE 15 CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

The Company's Chief Executive Officer, Mr. McGilton, is a principle of APT Leadership, a consulting firm the Company hired to provide various business consulting services, training seminars and certain business software. APT Leadership billed the Company \$606,817, \$225,400 and \$21,017 for the years ended December 31, 2006, 2005 and 2004, respectively.

On February 18, 2006, the Company entered into a Modification and Assignment Agreement with Longview pursuant to which the Company paid \$1,250,000 against the principle balance of the Notes and extended the maturity date of the Notes for an additional 60 days. In addition, the Company consented to the assignment of \$2,500,000 of the Notes to Fort Ashford Funds LLC ( Fort Ashford ). Frank Kavanaugh, a director of the Company, is the principal owner of Fort Ashford and a substantial shareholder of the Company's common stock. Mr. Kavanaugh's relationship to Fort Ashford Funds LLC was fully disclosed to the Company and Mr. Kavanaugh did not participate in the negotiations or decision process with respect to the Modification and Assignment Agreement. The Company paid \$87,510 to Longview and \$50,000 to Fort Ashford in cash as compensation for the extension of the maturity dates of the Notes.

On April 20, 2006, the Company paid \$1,000,000 against the principle balance of the Notes and extended the maturity date on the Notes and the Note with Fort Ashford for an additional 60 days, through June 20, 2006. The Company paid \$55,000 to Longview and \$50,000 to Fort Ashford in cash as compensation for this extension.

On June 20, 2006, the Company paid off the principle balance and all applicable accrued interest under the Notes. Additionally, the Company extended the maturity date of the Ashford Note for an additional 30 days, through July 20, 2006. The Company paid \$50,000 to Fort Ashford in cash as compensation for the extension of the Ashford Note.

On August 9, 2006, the Company paid off the principle balance of the Ashford Note, and all applicable accrued interest under the Ashford Note.

**NOTE 16 OTHER COMPREHENSIVE LOSS (Restated)**

Other comprehensive earnings/(loss) consists of the following:

	<b>2006</b>	<b>2005 Restated</b>	<b>2004 Restated</b>
<b>Net Earnings (Loss)</b>	\$ 18,196,943	\$ (13,458,599 )	\$ (11,953,803 )
Other Comprehensive Earnings, net of tax			
<b>Comprehensive Earnings (Loss)</b>	\$ 18,196,943	\$ (13,458,599 )	\$ (11,953,803 )

**NOTE 17 TAXES**

The Financial Accounting Standards Board (FASB) has issued Statement of Financial Accounting Standards Number 109 ( SFAS 109 ). Accounting for Income Taxes , which requires the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred income taxes are recognized for the tax consequences of temporary differences by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities.

The Company's net deferred tax asset as of December 31, 2006, 2005, and 2004 consisted of the following:

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	12/31/2006	12/31/2005	12/31/2004
Deferred tax assets			
Inventory reserves and inventory tax law (uniform capitalization) differences	\$ 2,544,527	\$ 894,392	\$ 401,336
Allowance for uncollectible accounts	328,224	248,942	
Difference in recognition of rent expense	52,254	52,254	47,649
Warranty and contract provisions	2,477,165	785,382	64,241
Difference in recognition of stock based compensation expense	285,232	35,447	
Payroll accruals	57,906	364,761	345,859
Deferred tax assets	5,745,308	2,381,178	859,085
Deferred tax liability			
Depreciation differences	(268,110)	(204,486)	(168,722)
Net deferred tax assets before net operating loss carryforwards	5,477,198	2,176,692	690,363
Net operating loss carryforwards SC	371,923	1,080,527	493,963
Future benefit of offset of Alternative Minimum Tax	288,943		
Net operating loss carryforwards US	6,188,427	10,928,919	7,068,047
Net deferred tax assets	12,326,491	14,186,138	8,252,373
Less valuation allowance		(14,186,138)	(8,252,373)
Deferred tax benefit	\$ 12,326,491	\$	\$

The Company has removed the valuation allowance for the deferred tax assets since it expects to realize future earnings to be offset by future tax benefits. In 2005 and 2004 the company recorded a valuation allowance for all of its net deferred tax assets. The Company's valuation allowance decreased for the year ended December 31, 2006, \$14,186,138 and increased for the years ended December 31, 2005, and 2004 \$5,933,765 and \$3,713,302, respectively.

As of December 31, 2006, 2005 and 2004, the Company has available Federal operating loss carry-forwards of \$18,611,810, \$32,868,929, and \$21,257,284, expiring through 2025, respectively, and state operating loss carry-forwards of \$7,438,470, \$21,610,537, and \$9,879,269, expiring through 2025, respectively.

The following is a reconciliation of the provision for income taxes at the U.S. federal income tax rate to the income taxes reflected in the Statement of Operations:

	December 31, 2006	December 31, 2005	December 31, 2004
Tax expense (credit) at statutory rate-federal	(35.00)%	(35.00)%	(35.00)%
State tax expense net of federal tax	(3.25)%	(3.25)%	(3.25)%
Changes in valuation allowance	(209.98)%	(38.25)%	(38.25)%
Tax expense at actual rate	209.98%	0%	0%

**NOTE 18 EARNINGS/LOSS PER SHARE**

The Company utilizes SFAS No. 128, Earnings per Share to calculate gain/loss per share. Basic earnings/loss per share is computed by dividing the earnings/loss available to common stockholders (as the numerator) by the weighted-average number of common shares outstanding (as the denominator). Diluted earnings/loss per share is computed similar to basic earnings/loss per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if all potential common stock (including common stock equivalents) had all been issued, and if such additional common shares were dilutive.

	2006
Basic Earning Per Share Computation	
Net Earnings	\$ 18,196,943
Accretion of Series D 6% convertible preferred stock	(1,297,134)
Preferred dividends	(325,685)
Net earnings available to common shareholders	\$ 16,574,124
<b>Basic Earnings per common share</b>	<b>\$ 0.37</b>
<b>Weighted-average shares used to compute:</b>	
Basic Profit/(loss) per share	44,786,083



Diluted Earning Per Share Computation:		2006
Earnings available to common shareholders		\$ 16,574,124
Add Back:		
Accretion of Series D 6% convertible preferred stock		1,297,134
Preferred Dividends		325,685
Profit/(Loss) available to common shareholders plus assumed conversions		\$ 18,196,943
Weighted-average number of common shares outstanding		44,786,083
Dilutive effect of:		
Series D preferred stock		2,369,259
Warrants		1,631,822
Stock options		1,543,458
Stock grants		97,844
<b>Weighted-average shares used to compute:</b>		
Diluted Earnings/(loss) per share		50,428,466
<b>Diluted Earnings per common share</b>		<b>\$ 0.36</b>

Under SFAS No. 128, where there is a loss, the inclusion of additional common shares is anti-dilutive (since the increased number of shares reduces the per share loss available to common stock holders), and

if the additional common shares are anti-dilutive, they are not added to the denominator in the calculation. For periods where the additional common shares are anti-dilutive, the following common stock equivalents have been excluded from the calculation of diluted loss per share:

	2005	2004
Convertible Preferred Stock Series B		10,493,939
Convertible Preferred Stock Series C		
Convertible Preferred Stock Series D	6,288,428	
Warrants	2,104,863	1,725,942
Options	323,420	
Total	8,716,711	12,219,881

Basic Earning Per Share Computation		2005	2004
		Restated	Restated
Net Loss		\$ (14,404,622 )	\$ (11,953,803 )
Accretion of Series D 6% convertible preferred stock		(2,041,697 )	
Preferred Dividends		(778,530 )	
(Loss) available to common shareholders		\$ (17,224,849 )	\$ (11,953,803 )
<b>Basic Loss per common share</b>		<b>\$ (0.51 )</b>	<b>\$ (0.62 )</b>
<b>Weighted-average shares used to compute:</b>			
Basic loss per share		33,926,573	19,357,939

Diluted Earning Per Share Computation:		2005	2004
(Loss) available to common shareholders		\$ (17,224,849 )	\$ (11,953,803 )
<b>Diluted Loss per common share</b>		<b>\$ (0.51 )</b>	<b>\$ (0.62 )</b>
<b>Weighted-average shares used to compute:</b>			
Diluted loss per share		33,926,573	19,357,939

**NOTE 19 VALUATION AND QUALIFYING ACCOUNTS AND RESERVES**

The following table summarizes information about accounts and reserves:

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Description	Balance at Beginning of Period	Additions Charged to Costs and Expenses	Writeoffs	Other	Balance at End of Period
<b>Revenue Based Provisions</b>					
2006	\$ 1,018,051	\$ 6,317,077	\$ 1,267,041	\$	\$ 6,068,087
2005(A)	\$	\$ 1,018,051	\$	\$	\$ 1,018,051
2004	\$	\$	\$	\$	\$
<b>Allowance for Inventory Losses</b>					
2006	\$ 498,281	\$ 1,925,332	\$	\$	\$ 2,423,613
2005	\$	\$ 498,281	\$	\$	\$ 498,281
2004	\$	\$	\$	\$	\$
<b>Warranty Reserve</b>					
2006	\$ 1,686,062	\$ 163,938	\$	\$	\$ 1,850,000
2005(B)	\$ 729,461	\$ 1,764,264	\$ 807,663	\$	\$ 1,686,062
2004	\$ 180,384	\$ 728,595	\$ 179,518	\$	\$ 729,461

(A) Consists of the Allowance for Contractual Adjustments, as presented on the Company's balance sheet and explained in Footnote 7 to the financial statements.

(B) Inclusive of the general warranty reserve as well as the Twin Disc Warranty Reserve of \$1,306,018 recorded in 2005.

**NOTE 20 SUMMARIZED QUARTERLY UNAUDITED FINANCIAL DATA**

	2006			
	Q1	Q2	Q3	Q4
Net Sales	\$ 34,802,585	\$ 56,074,537	\$ 42,160,858	\$ 62,979,466
Gross Profit	6,637,769	10,156,786	7,918,508	12,309,757
Operating Income	12,826	1,771,136	592,150	4,259,450
Net Earnings (Loss)	(767,449 )	973,024	602,698	17,388,670
Basic Earnings (loss) per common share	\$ (0.04 )	\$ 0.01	\$ 0.00	\$ 0.40
Diluted loss per common share	\$ (0.04 )	\$ 0.01	\$ 0.00	\$ 0.39

	2005 Restated			
	Q1	Q2	Q3	Q4
Net Sales	\$ 5,853,423	\$ 18,295,357	\$ 9,303,526	\$ 16,260,523
Gross Profit	(541,896 )	4,036,672	1,314,823	(1,525,385 )
Operating Loss	(3,528,382 )	(473,325 )	(5,321,045 )	(6,307,311 )
Net Loss	(936,306 )	(647,344 )	(5,666,483 )	(7,154,489 )
Basic Earnings (loss) per common share	(0.05 )	(0.04 )	(0.19 )	(0.23 )
Diluted Earnings (loss) per common share	(0.05 )	(0.04 )	(0.19 )	(0.23 )

**NOTE 21 SUBSEQUENT EVENTS**

On January 9, 2007, NASDAQ approved the Company's application to list its common stock on the NASDAQ Stock Market. The Company will retain its FRPT trading symbol and the listing was effective January 18, 2007.

On January 11, 2007, the Company received a letter contract from the United States Marine Corps for 15 of its Cougar Joint Explosive Ordnance Disposal Rapid Response Vehicles (JERRV). The letter contract for the vehicles, spare parts and sustainment services has a total value of approximately \$9,379,370.

On January 19, 2007, the Company's Board of Directors appointed Michael S. Durski to the position of Chief Financial Officer.



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On January 25, 2007, the Company received a four-vehicle letter contract from the U.S. Marine Corps for testing, production and sustainability for its Mine Resistant Ambush Protected (MRAP) vehicle program. The work under this contract will be performed by Force Dynamics, LLC, the Company's joint venture with General Dynamics Land Systems, Inc.

On February 14, 2007, the Company received a contract award from the U.S. Marine Corps for 125 vehicles as part of the Mine Resistant Ambush Protected (MRAP) vehicle program. The work under the contract will be performed by Force Dynamics, LLC, the Company's joint venture with General Dynamics Land Systems, Inc. The contract award has a total value of approximately \$67 million. Under the contract award, Force Dynamics will produce 65 vehicles for Category I and 60 vehicles for Category II of the

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MRAP program. The vehicles are to be delivered within 120 days from the delivery of the contract and will be used by all branches of the U.S. armed forces.

On February 20, 2007, the Company's Mastiff contract with the British Ministry of Defense was modified to add 22 additional Mastiff vehicles increasing the total to be delivered to 108.

On March 9, 2007, the Company received a delivery order from the U.S. Marine Corps for an additional 19 Buffalo mine-protected vehicles worth an estimated \$16.2 million. Under a November 2006 contract award administered by the Marine Corps Systems Command, the Company expects to deliver the 19 Buffalo vehicles by December 2007.

On March 9, 2007, the Company purchased the Research and Developmental Testing Facility of NEWTEC Services Group, Inc., located near Edgefield, SC. The facility will be used to expand the Company's research and development activities and support the verification and quality control validation of the Company's armored vehicles used to protect military personnel against explosive threats.

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## ITEM 9A. CONTROLS AND PROCEDURES

### DISCLOSURE CONTROLS AND PROCEDURES

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act )) as of the end of the period covered by this Annual Report on Form 10-K/A. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures were not effective as of December 31, 2006 to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act (i) is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Our disclosure controls and procedures are designed to provide reasonable assurance that such information is accumulated and communicated to our management. Our management concluded so because of the material weaknesses discussed in Management's Report on Internal Control Over Financial Reporting below. Our disclosure controls and procedures include components of our internal control over financial reporting.

### MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange. Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes those policies and procedures that:

- (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets;
- (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of our management and directors; and
- (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Internal control over financial reporting includes the controls themselves, monitoring and internal auditing practices and actions taken to correct deficiencies identified.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control - Integrated Framework*.

Based on this assessment, our management identified the following material weaknesses in the Company's internal control over financial reporting as of December 31, 2006:

Our financial and accounting organization was not adequate to support our financial accounting and reporting needs. Specifically, we did not maintain a sufficient complement of personnel with an appropriate level of accounting knowledge, experience with the Company and training in the application of GAAP commensurate with our financial reporting requirements. The lack of a sufficient complement of personnel with an appropriate level of accounting knowledge, experience with our Company and training contributed to the control deficiencies noted below.

- (1) We did not maintain effective policies and procedures related to the accounting for specific equity issuances, including accounting for stock-based compensation in accordance with Statement of Financial Accounting Standard ( SFAS ) No. 123, *Share-Based Payment*, and accounting for convertible and redeemable preferred stock and warrants.

This deficiency resulted in errors in the Company's accounting and disclosures for these equity issuances and related earnings per share calculations.

(2) We did not maintain effective controls to ensure the accuracy of disclosures in our financial statements and classification of certain financial transactions in the financial statements. Specifically, we failed to classify the allowance for

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contractual adjustments as a reduction in receivables and had incorrect or inadequate disclosures in financial statement disclosures related to the non-recurring warranty, statement of shareholders' equity, deferred tax assets, liabilities and related income tax expense, contingency losses, discontinued operations, receivables and factoring accounts, debt and the statement of cash flows in our financial statements.

The control deficiency described above in (1) resulted in the restatement of our annual consolidated financial statements for 2005, 2004, and 2003. The control deficiency described in (2) required amendment of our annual financial statements for the years 2005, 2004 and 2003 which are included in our amended 2005 Form 10-K filing. The control deficiency related to earnings per share in (1) resulted in restatement of the 2006 earnings per share calculations in the annual financial statements in the amended 2006 Form 10-K. Additionally, these control deficiencies could result in a misstatement in our annual or interim consolidated financial statements that would not be prevented or detected. Management has determined that each of the control deficiencies described above constitutes a material weakness.

These deficiencies result in more than a remote likelihood that a material misstatement of the Company's annual or interim financial statements would not be prevented or detected. Management has taken or plans to take steps to improve our internal control over financial reporting (see below).

As a result of the material weaknesses, our management has concluded that our internal control over financial reporting was not effective as of December 31, 2006.

The Company's independent auditor, Jaspers+Hall, PC, an independent registered public accounting firm, has issued an attestation report on our assessment of our internal control over financial reporting as of December 31, 2006. This attestation report "Report of Independent Registered Public Accounting Firm" appears on page 6.

Plan for Remediation of Material Weaknesses: We believe the steps described below, some of which we have already taken as noted herein, together with others that we plan to take, will remediate the material weaknesses which existed at December 31, 2006.

We have taken or plan to take the following steps to improve our internal control over financial reporting:

- We hired a new chief financial officer during the first quarter of 2007.
- We have engaged a professional service organization which specializes in the assessment and the enhancement of the effectiveness of internal controls over financial reporting.
- We are implementing a comprehensive electronic business operating system along with a supporting integrated ERP computer system which will significantly enhance our processes and internal control environment, and change the manner of collection, reporting and management of accounting data resulting in a further strengthening of the overall reliability of financial data of the Company.

#### CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluates any changes in our internal control over financial reporting that occurred during each fiscal quarter that have materially affected, or are reasonably likely to materially affect, such internal control over financial reporting. There was no change in internal control over financial reporting (as defined in Rule 13a-15(f) of the Securities Exchange Act of 1934) that occurred during the fourth quarter of 2006 that materially affected or was reasonably likely to materially affect our internal control over financial reporting.

*Chief Executive Officer and Chief Financial Officer Certifications.* The certifications of our Chief Executive Officer and Chief Financial Officer, which are attached as Exhibits 31.1 and 31.2 to this report, include information about our disclosure controls and procedures and internal control over financial reporting. These certifications should be read in conjunction with the information contained in this Item 9A for a more complete understanding of the matters covered by the certifications.

**PART IV**

**ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES.**

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NUMBER	DESCRIPTION
2.1	Agreement and Plan of Merger (included as Attachment A to Exhibit 99.2 to the Form DEF 14A filed November 19, 2004, and incorporated herein by reference).
3.1	Articles of Incorporation (included as Attachment B to Exhibit 99.2 to the Form DEF 14A filed November 19, 2004, and incorporated herein by reference).
3.2	By-Laws (included as Attachment C to Exhibit 99.2 to the Form DEF 14A filed November 19, 2004, and incorporated herein by reference).
3.3	Amended Articles of Incorporation (included as Attachment D to Exhibit 99.2 to the Form DEF 14A filed November 19, 2004, and incorporated herein by reference).
4.1	Certificate of Designation for Series D Convertible Preferred Stock, dated January 19, 2005 (included as Exhibit 4.1 to the Form 8-K filed January 27, 2005, and incorporated herein by reference).
4.2	Form of Common Stock Purchase Warrant, dated January 19, 2005, (included as Exhibit 4.2 to the Form 8-K filed January 27, 2005, and incorporated herein by reference).
4.3	Securities Purchase Agreement, dated January 19, 2005 (included as Exhibit 4.3 to the Form 8-K filed January 27, 2005, and incorporated herein by reference).
4.4	Registration Rights Agreement, dated January 19, 2005 (included as Exhibit 4.4 to the Form 8-K filed January 27, 2005, and incorporated herein by reference).
4.5	Amended and Restated Certificate of Designation for Series B Convertible Preferred Stock (included as Exhibit 4.1 of the Form 8-K filed February 15, 2005, and incorporated herein by reference).
4.6	Amended and Restated Certificate of Designation for Series C Convertible Preferred Stock (included as Exhibit 4.2 of the Form 8-K filed February 15, 2005, and incorporated herein by reference).
4.7	Bridge Facility between the Company and GC Financial Services, Inc., dated September 29, 2005 (included as Exhibit 4.1 to the Form 8-K filed July 8, 2005, and incorporated herein by reference).
4.8	Demand Note between the Company and GC Financial Services, Inc., dated September 29, 2005 (included as Exhibit 4.2 to the Form 8-K filed July 8, 2005, and incorporated herein by reference).
10.1	Series B Convertible Preferred Stock Purchase Agreement between the Company and Ashford Capital, LLC, dated December 27, 2001 (included as Exhibit 10.1 to the Form 8-K filed January 7, 2002, and incorporated herein by reference).
10.2	Series C Convertible Preferred Stock Purchase Agreement between the Company and eFund Capital Partners, LLC, dated December 27, 2001 (included as Exhibit 10.2 to the Form 8-K filed on January 7, 2002, and incorporated herein by reference).
10.3	Letter Agreement between the Company and Ashford Capital, LLC, dated April 15, 2003 (included as Exhibit 4.9 to the Form 10-QSB filed November 18, 2003, and incorporated herein by reference).
10.4	Industrial Lease between the Company and Aerospace/Defense, Inc., dated September 2, 2003 (included as Exhibit 10.12 to the Form 10-QSB filed August 13, 2004, and incorporated herein by reference).
10.5	Modification of Business Asset Sale, License Agreement & Assignment of Rights between the Company and Rockwell Power Systems, Inc., dated September 15, 2003 (included as Exhibit 2.3 to the Form 10-QSB filed November 18, 2003, and incorporated herein by reference).
10.6	Non-Employee Directors and Consultants Retainer Stock Plan, dated March 31, 2003 (included as Exhibit 4 to the Form S-8 filed November 7, 2003, and incorporated herein by reference).

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- 10.7 Investment Agreement between the Company and Dutchess Private Equities Fund, L.P., dated January 26, 2004 (included as Exhibit 10.8 to the SB-2 filed January 27, 2004, and incorporated herein by reference).
- 10.8 Registration Rights Agreement between the Company and Dutchess Private Equities Fund, L.P., dated January 26, 2004 (included as Exhibit 10.9 to the SB-2 filed January 27, 2004, and incorporated herein by reference).
- 10.9 Placement Agent Agreement between the Company, Charleston Capital, LLC, and Dutchess Private Equities Fund, L.P., dated January 27, 2004 (included as Exhibit 10.10 to the SB-2 filed on January 27, 2004, and incorporated herein by reference).
- 10.10 Form of Subscription Agreement between the Company and Gamma Opportunity Capital Partners, LP, Longview Fund, LP, Alpha Capital Aktiengesellschaft, Domino International Ltd, Magellan International Ltd, and Mountain Ridge Capital LLC, dated March 23, 2004 (included as Exhibit 4 to the Form 8-K filed on March 26, 2004, and incorporated herein by reference).
- 10.11 Royalty Agreement between the Company and J.J. van Eck, dated April 1, 2004 (included as Exhibit 10.13 to the Form 10-QSB filed August 13, 2004, and incorporated herein by reference).
- 10.12 Contract between the Company and the U.S. Marines, dated April 21, 2004 (included as Exhibit 10.14 to the 10-QSB filed August 13, 2004, and incorporated herein by reference).
- 10.13 Term Sheet between the Company and GC Financial Services, Inc., dated September 16, 2004 (included as Exhibit 10.14 to the 10-QSB filed November 15, 2004, and incorporated herein by reference).
- 10.14 Employment Agreement between the Company and Thomas Thebes (included as Exhibit 10.10 to the Form 10-QSB filed August 13, 2004, and incorporated herein by reference).
- 10.15 Letter re: Industrial Lease Agreement between the Company and Aerospace/Defense, Inc., dated July 13, 2004 (included as Exhibit 10.11 to the Form 10-QSB filed August 13, 2004, and incorporated herein by reference).
- 10.16 Employment Agreement between the Company and Frank Kavanaugh, dated November 15, 2004 (included as Exhibit 10.15 to the 10-QSB filed November 15, 2004, and incorporated herein by reference).
- 10.17 Letter Contract awarded to the Company by the Department of the Army dated November 18, 2004 (as described in the 8-K filed November 24, 2004, and incorporated herein by reference).
- 10.18 Promissory Note between the Company and Dutchess Private Equity Fund, II, LP dated December 3, 2004 (included as Exhibit 10.1 to the Form 8-K filed December 8, 2004, and incorporated herein by reference).
- 10.19 Employment Agreement between the Company and Gordon McGilton, dated January 27, 2005 (included as Exhibit 10.22 to the Form 10-KSB/A filed April 22, 2005, and incorporated herein by reference).
- 10.20 Employment Agreement between the Company and Ted McQuinn, dated February 4, 2005 (included as Exhibit 10.23 to the Form 10-KSB/A filed April 22, 2005, and incorporated herein by reference).
- 10.21 Order for Supplies or Services between the Company and U.S. Department of Defense, dated May 13, 2005 (included as Exhibit 10.1 to the Form 8-K filed May 18, 2005, and incorporated herein by reference).
- 10.22 Order for Supplies or Services between the Company and U.S. Department of Defense, dated May 18, 2005 (included as Exhibit 10.1 to the Form 8-K filed May 23, 2005, and incorporated herein by reference).
- 10.23 Order for Supplies or Services and Delivery Order between the Company and U.S. Department of Defense, dated September 23, 2005 (included as Exhibit 10.1 to the Form 8-K filed September 27, 2005, and incorporated herein by reference).
- 10.24 Purchase and Sale Agreement the Company and GC Financial Services, Inc., dated September 29, 2005 (included as Exhibit 10.1 to the Form 8-K filed July 8, 2005, and incorporated herein by reference).



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- 10.25 Security Agreement the Company and GC Financial Services, Inc., dated September 29, 2005 (included as Exhibit 10.2 to the Form 8-K filed July 8, 2005, and incorporated herein by reference).
- 10.26 Purchase Order between the Company and Ricardo Engineering, dated September 29, 2005 (included as Exhibit 10.1 to the Form 8-K filed July 19, 2005, and incorporated herein by reference).
- 10.27 Solicitation/Contract/Order for Commercial Items and Delivery Order between the Company and the United States Marine Corps, dated September 7, 2005 (included as Exhibit 10.1 to the Form 8-K filed September 9, 2005, and incorporated herein by reference).
- 10.28 Engineering Services Agreement between the Company and TecStar, dated August 22, 2005 (included as Exhibit 10.31 to the Form 10-QSB filed November 11, 2005, and incorporated herein by reference).
- 10.29 Contract between the Company and the United States Army (included as Exhibit 10.36 to the Form 10-K filed April 13, 2006, and incorporated herein by reference).
- 10.30 Form of Common Stock Purchase Agreement dated July 24, 2006 (included as Exhibit 10.1 to the Form 8K filed on July 25, 2006, and incorporated herein by reference).
- 10.31 Production License Agreement between the Company and BAE Systems Land & Armaments, LP, dated June 13, 2006 (included as Exhibit 10.1 to the Form 10-Q filed August 14, 2006, and incorporated herein by reference).
- 10.32 Logistic Support Agreement between the Company and BAE Systems Land & Armaments, LP, dated June 13, 2006 (included as Exhibit 10.2 to the Form 10-Q filed August 14, 2006, and incorporated herein by reference).
- 10.33 Contract between the Company and the British Ministry of Defense, dated August 11, 2006 (included as Exhibit 10.1 to the Form 8-K filed August 17, 2006, and incorporated herein by reference).
- 10.34 Memorandum of Agreement and Cooperation between the Mechem, a division of Denel (PTY), Ltd., and the Company, dated September 28, 2006 (included as Exhibit 10.1 to the Form 8-K filed September 28, 2006, and incorporated herein by reference).
- 10.35 Memorandum of Understanding between the Company and General Dynamics Land Systems, Inc., dated November 9, 2006 (included as Exhibit 10.1 to the Form 8-K filed November 17, 2006, and incorporated herein by reference).
- 10.36 Memorandum of Understanding between the Company and Stewart & Stevenson Tactical Vehicle Systems LP d/b/a Tactical Vehicle Systems, a Division of Armor Holdings, Inc., dated November 10, 2006 (included as Exhibit 10.1 to the Form 8-K filed November 20, 2006, and incorporated herein by reference).
- 10.37 Form of Securities Purchase Agreement, dated December 20, 2006 (included as Exhibit 10.1 to the Form 8-K filed December 21, 2006, and incorporated herein by reference).
- 10.38 Certificate of the Company's Corporate Secretary, dated January 10, 2007 (included as Exhibit 10.2 to the Form S-8 filed January 12, 2007, and incorporated herein by reference).
- 10.39 Common Stock Purchase Option issued by the Company to Gordon McGilton, dated January 10, 2006 (included as Exhibit 10.2 to the Form S-8 filed January 12, 2007, and incorporated herein by reference).
- 10.40 Common Stock Purchase Warrant issued by the Company to Gordon McGilton, dated October 31, 2006 (included as Exhibit 10.3 to the Form S-8 filed January 12, 2007, and incorporated herein by reference).
- 10.41 Letter contract issued to the Company by the U.S. Marine Corps, dated January 11, 2007 (included as Exhibit 10.1 to the Form 8-K filed January 18, 2007, and incorporated herein by reference).
- 10.42 Employment Offer Letter between the Company and Michael S. Durski, dated January 19, 2007 (included as Exhibit 10.1 to the Form 8-K filed January 25, 2007, and incorporated herein by reference).
- 10.43

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Letter Contract issued to the Company by the United States Marine Corps, dated January 25, 2007 (included as Exhibit 10.1 to the Form 8-K filed February 5, 2007, and incorporated herein by reference).

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- 10.44 Letter Contract issued to the Company by the United States Marine Corps dated February 14, 2007 (included as Exhibit 10.1 to the Form 8-K filed February 20, 2007, and incorporated herein by reference).
- 10.45 Letter Contract issued to the Company by the U. S. Marine Corps dated March 9, 2007 (included as Exhibit 10.1 to the Form 8-K filed March 15, 2007, and incorporated herein by reference).
- 10.46 Purchase and Sale Agreement between the Company and NEWTEC Services Group, Inc. dated March 9, 2007 (include as Exhibit 10.2 to the Form 8-K filed March 15, 2007, and incorporated herein by reference).
- 23.1 Consent of Jaspers + Hall, PC
- 31.1 Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Officers pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURES**

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In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: October 12, 2007

**FORCE PROTECTION, INC.**  
By: /s/ Gordon McGilton  
Gordon McGilton  
*Chief Executive Officer*

Date: October 12, 2007

By: /s/ Michael Durski  
Michael Durski  
*Chief Financial Officer*  
*Principal Accounting Officer*

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