

LENNAR CORP /NEW/  
Form 10-Q  
July 10, 2007

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

Washington, D.C. 20549

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**FORM 10-Q**

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**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF**  
**THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended May 31, 2007

Commission File Number: 1-11749

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**Lennar Corporation**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**700 Northwest 107th Avenue, Miami, Florida 33172**

(Address of principal executive offices) (Zip Code)

**(305) 559-4000**

(Registrant's telephone number, including area code)

**95-4337490**  
(I.R.S. Employer

Identification No.)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  NO

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Common stock outstanding as of June 30, 2007:

Class A	129,001,062
Class B	31,268,086

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**Part I. Financial Information****Item 1. Financial Statements****Lennar Corporation and Subsidiaries**

Condensed Consolidated Balance Sheets

(In thousands, except per share amounts)

(unaudited)

	May 31, 2007	November 30, 2006
<b>ASSETS</b>		
<b>Homebuilding:</b>		
Cash	\$ 234,256	661,662
Restricted cash	37,220	24,796
Receivables, net	179,808	159,043
Inventories:		
Finished homes and construction in progress	3,644,801	4,447,748
Land under development	3,653,729	3,011,408
Consolidated inventory not owned	406,704	372,327
Total inventories	7,705,234	7,831,483
Investments in unconsolidated entities	1,235,603	1,447,178
Goodwill	190,198	196,638
Other assets	635,011	474,090
	10,217,330	10,794,890
<b>Financial services</b>	1,324,740	1,613,376
<b>Total assets</b>	\$ 11,542,070	12,408,266
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Homebuilding:</b>		
Accounts payable	\$ 499,832	751,496
Liabilities related to consolidated inventory not owned	416,180	333,723
Senior notes and other debts payable	2,585,286	2,613,503
Other liabilities	1,340,516	1,590,564
	4,841,814	5,289,286
<b>Financial services</b>	1,060,446	1,362,215
<b>Total liabilities</b>	5,902,260	6,651,501
<b>Minority interest</b>	56,255	55,393
<b>Stockholders equity:</b>		
Preferred stock		
Class A common stock of \$0.10 par value per share		
Authorized: May 31, 2007 and November 30, 2006 300,000 shares;		
Issued: May 31, 2007 139,129 shares; November 30, 2006 136,886 shares	13,913	13,689
	3,295	3,287

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Class B common stock of \$0.10 par value per share

Authorized: May 31, 2007 and November 30, 2006 90,000 shares;

Issued: May 31, 2007 32,946 shares; November 30, 2006 32,874 shares

Additional paid-in capital	1,863,816	1,753,695
Retained earnings	4,313,001	4,539,137
Deferred compensation plan; May 31, 2007 102 Class A common shares and 10 Class B common shares; November 30, 2006 172 Class A common shares and 17 Class B common shares	(941)	(1,586)
Deferred compensation liability	941	1,586
Treasury stock, at cost; May 31, 2007 10,111 Class A common shares and 1,678 Class B common shares; November 30, 2006 9,951 Class A common shares and 1,653 Class B common shares	(609,404)	(606,395)
Accumulated other comprehensive loss	(1,066)	(2,041)
<b>Total stockholders equity</b>	<b>5,583,555</b>	<b>5,701,372</b>
<b>Total liabilities and stockholders equity</b>	<b>\$ 11,542,070</b>	<b>12,408,266</b>

See accompanying notes to condensed consolidated financial statements.

**Lennar Corporation and Subsidiaries**

## Condensed Consolidated Statements of Earnings

(In thousands, except per share amounts)

(unaudited)

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>May 31,</b>		<b>May 31,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
<b>Revenues:</b>				
Homebuilding	\$ 2,741,810	4,415,302	5,404,980	7,524,020
Financial services	134,133	162,201	263,043	294,142
<b>Total revenues</b>	<b>2,875,943</b>	<b>4,577,503</b>	<b>5,668,023</b>	<b>7,818,162</b>
<b>Costs and expenses:</b>				
Homebuilding	3,053,297	3,902,515	5,751,463	6,613,571
Financial services	119,923	127,610	232,964	248,926
Corporate general and administrative	45,817	56,532	92,736	108,423
<b>Total costs and expenses</b>	<b>3,219,037</b>	<b>4,086,657</b>	<b>6,077,163</b>	<b>6,970,920</b>
Gain on recapitalization of unconsolidated entity			175,879	
Equity in earnings (loss) from unconsolidated entities	(26,523)	14,792	(40,728)	52,982
Management fees and other income (expense), net	(12,831)	16,375	1,010	35,808
Minority interest expense, net	824	6,541	1,368	10,954
<b>Earnings (loss) before provision (benefit) for income taxes</b>	<b>(383,272)</b>	<b>515,472</b>	<b>(274,347)</b>	<b>925,078</b>
Provision (benefit) for income taxes	(139,067)	190,725	(98,765)	342,279
<b>Net earnings (loss)</b>	<b>\$ (244,205)</b>	<b>324,747</b>	<b>(175,582)</b>	<b>582,799</b>
<b>Basic earnings (loss) per share</b>	<b>\$ (1.55)</b>	<b>2.04</b>	<b>(1.12)</b>	<b>3.67</b>
<b>Diluted earnings (loss) per share</b>	<b>\$ (1.55)</b>	<b>2.00</b>	<b>(1.12)</b>	<b>3.57</b>
<b>Cash dividends per each Class A and Class B common share</b>	<b>\$ 0.16</b>	<b>0.16</b>	<b>0.32</b>	<b>0.32</b>

See accompanying notes to condensed consolidated financial statements.

## Lennar Corporation and Subsidiaries

## Condensed Consolidated Statements of Cash Flows

(Dollars in thousands)

(unaudited)

	<b>Six Months Ended May 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>Cash flows from operating activities:</b>		
Net earnings (loss)	\$ (175,582)	582,799
Adjustments to reconcile net earnings (loss) to net cash used in operating activities:		
Depreciation and amortization	24,612	22,324
Amortization of discount/premium on debt, net	1,003	3,167
Gain on recapitalization of unconsolidated entity	(175,879)	
Equity in (earnings) loss from unconsolidated entities, including \$34.0 million of valuation adjustments to the Company's investments in unconsolidated entities in 2007	40,728	(52,982)
Distributions of earnings from unconsolidated entities	92,969	73,142
Minority interest expense, net	1,368	10,954
Share-based compensation expense	20,579	17,605
Tax benefits from share-based awards	5,880	10,410
Excess tax benefits from share-based awards	(4,276)	(5,681)
Deferred income tax provision	111,390	54,244
Valuation adjustments and write-offs of option deposits and pre-acquisition costs	386,701	57,967
Changes in assets and liabilities, net of effect from acquisitions:		
Decrease in receivables	203,052	64,688
Increase in inventories, excluding valuation adjustments and write-offs of option deposits and pre-acquisition costs	(274,348)	(1,076,049)
(Increase) decrease in other assets	(293,295)	36,446
Decrease in financial services loans held-for-sale	100,410	32,288
Decrease in accounts payable and other liabilities	(473,592)	(441,538)
<b>Net cash used in operating activities</b>	<b>(408,280)</b>	<b>(610,216)</b>
<b>Cash flows from investing activities:</b>		
Increase in restricted cash	(12,424)	(12,139)
Additions to operating properties and equipment	(6,951)	(11,977)
Contributions to unconsolidated entities	(301,781)	(404,917)
Distributions of capital from unconsolidated entities	347,815	156,920
Distributions in excess of investment in unconsolidated entity	354,644	
Decrease in financial services loans held-for-investment	8,841	15,328
Purchases of investment securities	(39,851)	(54,591)
Proceeds from sales/maturities of investment securities	60,199	34,637
Acquisitions, net of cash acquired		(33,329)
<b>Net cash provided by (used in) investing activities</b>	<b>410,492</b>	<b>(310,068)</b>
<b>Cash flows from financing activities:</b>		
Net repayments under financial services debt	(288,860)	(37,629)
Net borrowings under revolving credit facility		185,000
Proceeds from issuance of 5.95% senior notes		248,665
Proceeds from issuance of 6.50% senior notes		248,933
Proceeds from other borrowings	32,316	
Principal payments on other borrowings	(91,053)	(141,181)
Net payments related to minority interests	(1,543)	(39,515)
Excess tax benefits from share-based awards	4,276	5,681



**Lennar Corporation and Subsidiaries**

Condensed Consolidated Statements of Cash Flows (Continued)

(Dollars in thousands)

(unaudited)

	<b>Six Months Ended</b>	
	<b>May 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>Common stock:</b>		
Issuances	19,909	27,967
Repurchases	(3,009)	(270,006)
Dividends	(50,554)	(50,964)
<b>Net cash provided by (used in) financing activities</b>	<b>(378,518)</b>	<b>176,951</b>
Net decrease in cash	(376,306)	(743,333)
Cash at beginning of period	778,319	1,059,343
Cash at end of period	\$ 402,013	316,010
<b>Summary of cash:</b>		
Homebuilding	\$ 234,256	164,157
Financial services	167,757	151,853
	\$ 402,013	316,010
<b>Supplemental disclosures of non-cash investing and financing activities:</b>		
Conversion of 5.125% zero-coupon convertible senior subordinated notes to equity	\$	157,894
Non-cash contributions to unconsolidated entities	\$ 3,297	20,504
Non-cash distributions from unconsolidated entities	\$ 3,993	30,437
Purchases of inventories financed by sellers	\$ 2,753	33,308

See accompanying notes to condensed consolidated financial statements.

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**Lennar Corporation and Subsidiaries**

Notes to Condensed Consolidated Financial Statements

(unaudited)

**(1) Basis of Presentation**

*Basis of Consolidation*

The accompanying condensed consolidated financial statements include the accounts of Lennar Corporation and all subsidiaries, partnerships and other entities in which Lennar Corporation has a controlling interest and variable interest entities (see Note 13) in which Lennar Corporation is deemed to be the primary beneficiary (the Company). The Company's investments in both unconsolidated entities in which a significant, but less than controlling, interest is held and in variable interest entities in which the Company is not deemed to be the primary beneficiary, are accounted for by the equity method. All intercompany transactions and balances have been eliminated in consolidation. The condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements in the Company's Annual Report on Form 10-K for the year ended November 30, 2006. In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for the fair presentation of the accompanying condensed consolidated financial statements have been made.

The Company has historically experienced, and expects to continue to experience, variability in quarterly results. The condensed consolidated statements of earnings for the three and six months ended May 31, 2007 are not necessarily indicative of the results to be expected for the full year.

*Reclassifications*

Certain prior year amounts in the condensed consolidated financial statements have been reclassified to conform with the 2007 presentation. These reclassifications had no impact on reported net earnings.

*Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

**(2) Operating and Reporting Segments**

The Company's operating segments are aggregated into reportable segments in accordance with Statement of Financial Accounting Standards (FAS) No. 131, *Disclosures About Segments of an Enterprise and Related Information*, (FAS 131) based primarily upon similar economic characteristics, geography and product type. The Company's reportable segments consist of:

(1) Homebuilding East

(2) Homebuilding Central

(3) Homebuilding West

(4) Financial Services

Information about homebuilding activities in states which are not economically similar to other states in the same geographic area is grouped under Homebuilding Other, which is not considered a reportable segment in accordance with FAS 131.

Operations of the Company's homebuilding segments primarily include the sale and construction of single-family attached and detached homes, and to a lesser extent, multi-level buildings, as well as the purchase, development and sale of residential land directly and through the Company's unconsolidated entities. The Company's reportable homebuilding segments, and all other homebuilding operations not required to be reported separately, have divisions located in the following states:

**East:** Florida, Maryland, New Jersey and Virginia

**Central:** Arizona, Colorado and Texas

**West:** California and Nevada

**Other:** Illinois, Minnesota, New York, North Carolina and South Carolina

Operations of the Financial Services segment include mortgage financing, title insurance, closing services and other ancillary services (including personal lines insurance, high-speed Internet and cable television) for both buyers of the Company's homes and others. Substantially all of the loans the Financial Services segment originates are sold in the secondary mortgage market on a servicing released, non-recourse basis; however, the Company remains liable for certain limited representations and warranties related to loan sales. The Financial Services segment operates generally in the same markets as the Company's homebuilding segments, as well as in other states.

Evaluation of segment performance is based primarily on operating earnings (loss) before provision (benefit) for income taxes. Operating earnings (loss) for the homebuilding segments consist of revenues generated from the sales of homes and land, equity in earnings (loss) from unconsolidated entities and management fees and other income (expense), net, less the cost of homes and land sold, selling, general and administrative expenses and minority interest income (expense), net. Homebuilding operating earnings (loss) for the six months ended May 31, 2007 include a \$175.9 million pretax financial statement gain on the recapitalization of an unconsolidated entity, which is included in the Company's Homebuilding West segment. Operating earnings for the Financial Services segment consist of revenues generated from mortgage financing, title insurance, closing services, and other ancillary services (including personal lines insurance, high-speed Internet and cable television) less the cost of such services and certain selling, general and administrative expenses incurred by the Financial Services segment.

Each reportable segment follows the same accounting policies described in Note 1 Summary of Significant Accounting Policies to the consolidated financial statements in the Company's 2006 Annual Report on Form 10-K. Operational results of each segment are not necessarily indicative of the results that would have occurred had the segment been an independent, stand-alone entity during the periods presented.

Financial information relating to the Company's operations was as follows:

<i>(In thousands)</i>	May 31, 2007	November 30, 2006
<b>Assets:</b>		
Homebuilding East	\$ 2,944,707	3,326,371
Homebuilding Central	1,660,784	Additional paid-in capital 57,088,000
		57,662,000
Accumulated deficit	(61,498,000)	(60,404,000)
Total stockholders' (Deficit)	(3,112,000)	(2,196,000)
Total liabilities and stockholders' (Deficit)	\$ 1,614,000	\$ 2,174,000

The accompanying notes are an integral part to these condensed financial statements

PARADIGM MEDICAL INDUSTRIES, INC.  
CONDENSED STATEMENTS OF OPERATIONS  
(UNAUDITED)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008 (Restated)	2007	2008 (Restated)	2007
Sales	\$ 213,000	\$ 260,000	\$ 443,000	\$ 656,000
Cost of Sales	122,000	149,000	264,000	375,000
Gross Profit	91,000	111,000	179,000	281,000
Operating Expenses:				
Sales and Marketing	130,000	159,000	311,000	273,000
General and administrative	258,000	309,000	484,000	496,000
Research and development	62,000	126,000	151,000	190,000
Total Operating Expenses	450,000	594,000	946,000	959,000
Operating Income (Loss)	(359,000)	(483,000)	(767,000)	(678,000)
Other Income and (Expenses):				
Interest expense - accretion of debt discount	(177,000)	(191,000)	(361,000)	(373,000)
Gain and loss of derivative valuation	66,000	745,000	187,000	(269,000)
Interest expense	(78,000)	(63,000)	(154,000)	(116,000)
Interest income	--	3,000	2,000	5,000
Settlement of liabilities	--	41,000	--	41,000
Total Other Expenses	(189,000)	535,000	(326,000)	(712,000)
Income (loss) before provision for income Provision for income taxes	(548,000)	52,000	(1,093,000)	(1,390,000)
Net income (loss)	--	--	--	--
	\$ (548,000)	\$ 52,000	\$ (1,093,000)	\$ (1,390,000)
Earnings (loss) Per Common Share - Basic	\$ (0.00)	\$ 0.00	\$ (0.00)	\$ (0.01)
Earnings (loss) Per Common Share - Diluted	\$ (0.00)	\$ 0.00	\$ (0.00)	\$ (0.01)
Weighted Average Common Share - Basic	728,001,150	206,228,383	588,474,381	204,775,000
Weighted Average Common Share - Diluted	728,001,150	239,965,666	588,474,381	204,775,000

The accompanying notes are an integral part to these condensed financial statements

PARADIGM MEDICAL INDUSTRIES, INC.  
CONDENSED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

	Six Months Ended June 30,	
	2008	2007
	(Restated)	
<b>Cash Flows from Operating Activities:</b>		
Net (loss)	\$ (1,093,000)	\$ (1,390,000)
Adjustment to Reconcile Net Loss to Net		
Cash Used In Operating Activities:		
Depreciation and Amortization	3,000	3,000
Stock Option Valuation	14,000	-
Change in Fair Value of Derivative		
Liabilities	(188,000)	269,000
Beneficial Conversion Interest	361,000	373,000
Provision for losses on receivables	-	(22,000)
(Increase) Decrease from Changes in:		
Accounts Receivable	392,000	44,000
Inventories	(66,000)	(57,000)
Prepaid and other assets	(25,000)	(79,000)
Increase (Decrease) in:		
Accounts Payable	128,000	(69,000)
Accrued Liabilities	110,000	208,000
<b>Net Cash Used in Operating Activities</b>	<b>(364,000)</b>	<b>(720,000)</b>
<b>Cash Flow from Investing Activities:</b>		
Net Cash Provided by (Used in) Investing Activities	-	-
<b>Cash Flows from Financing Activities:</b>		
Proceeds from Issuance of Convertible Notes	110,000	1,000,000
Net Cash (Used) Provided by Financing Activities	110,000	1,000,000
<b>Net Change in Cash</b>	<b>(254,000)</b>	<b>280,000</b>
Cash, Beginning of Period	321,000	206,000
Cash, End of Period	67,000	486,000
<b>Supplemental Disclosure of Cash Flow Information:</b>		
Cash Paid for Interest	\$ 1,000	\$ 1,000
Cash Paid for Income Taxes	\$ -	\$ -
<b>Non-Cash Transaction:</b>		
Notes Converted into Common Stock	\$ 186,081	\$ 66,611

The accompanying notes are an integral part to these condensed financial statements

PARADIGM MEDICAL INDUSTRIES, INC.  
NOTES TO FINANCIAL STATEMENTS  
(UNAUDITED)

#### Basis of Financial Statement Presentation

The accompanying condensed financial statements of the Company have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. These condensed financial statements reflect all adjustments (consisting only of normal recurring adjustments) that, in the opinion of management, are necessary to present fairly the results of operations of the Company for the periods presented. These condensed financial statements should be read in conjunction with the financial statements and the notes thereto included in the Company's Form 10-KSB/A for the year ended December 31, 2007. The results of operations for the six months ended June 30, 2008, are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2008.

#### Going Concern

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. Historically, the Company has not demonstrated the ability to generate sufficient cash flows from operations to satisfy its liabilities and sustain operations, and the Company has incurred significant losses. These factors raise substantial doubt about the Company's ability to continue as a going concern.

The Company's continuation as a going concern is dependent on its ability to generate sufficient income and cash flow to meet its obligations on a timely basis and/or obtain additional financing as may be required. The Company is actively seeking options to obtain additional capital and financing.

In addition, the Company has taken significant steps to reduce costs and increase operating efficiencies. Specifically, the Company has significantly reduced the use of consultants, which has resulted in a large decrease in expenses. In addition, the Company has reduced the number of its direct sales representatives, which has resulted in less payroll, travel and other expenses. Although these cost savings have significantly reduced the Company's losses and ongoing cash flow needs, if the Company is unable to obtain equity or debt financing, it may be unable to continue development of its products and may be required to substantially curtail or cease operations.

#### Net Loss Per Share

Net loss per common share is computed on the weighted average number of common and common equivalent shares outstanding during each period. Common stock equivalents consist of convertible preferred stock, common stock options and warrants. Common Stock equivalent shares are excluded from the computation when their effect is anti-dilutive. Other common stock equivalents consisting of options and warrants to purchase 75,334,392 and 46,059,392 shares of common stock and preferred stock convertible into 612,497 and 858,688 shares of common stock, and outstanding commitments to issue shares underlying the convertible notes into 27,428,785,714 and 826,857,373 shares of common stock at June 30, 2008 and 2007, respectively, have not been included in loss periods because their inclusion would have been anti-dilutive.

The following table is a reconciliation of the basic and fully diluted earnings per share for the six month periods ended June 30, 2008 and June 30, 2007:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Basic weighted average shares outstanding	728,001,150	206,228,383	588,474,381	204,775,000
Diluted weighted average shares outstanding	728,001,150	239,965,666	588,474,381	204,775,000
Net income (loss)	\$ (548,000)	\$ 52,000	\$ (1,093,000)	\$ (1,390,000)
Per share amount basic	\$ (0.00)	\$ 0.00	\$ (0.00)	\$ (0.01)
Per share amount diluted	\$ (0.00)	\$ 0.00	\$ (0.00)	\$ (0.01)

## Convertible Notes

April 27, 2005 Sale of \$2,500,000 in Convertible Notes. To obtain funding for the Company's ongoing operations, the Company entered into a securities purchase agreement with four accredited investors on April 27, 2005 for the sale of (i) \$2,500,000 in convertible notes and (ii) warrants to purchase 16,534,392 shares of its common stock. The sale of the convertible notes and warrants is to occur in three tranches and the investors provided the Company with an aggregate of \$2,500,000 as follows:

- \$850,000 was disbursed on April 27, 2005;
- \$800,000 was disbursed on June 23, 2005 after the Company filed a registration statement on June 22, 2005 to register the shares of common stock issuable upon conversion of the convertible notes and exercise of warrants; and
- \$850,000 was disbursed on June 30, 2005, the effective date of the registration statement.

Under the terms of the securities purchase agreement, the Company agreed it would not, without the prior written consent of a majority-in-interest of the investors, negotiate or contract with any party to obtain additional equity financing (including debt financing with an equity component) that involves (i) the issuance of common stock at a discount to the market price of the common stock on the date of issuance (taking into account the value of any warrants or options to acquire common stock in connection therewith), (ii) the issuance of convertible securities that are convertible into an indeterminate number of shares of common stock, or (iii) the issuance of warrants during the lock-up period beginning April 27, 2005 and ending on the later of (a) 270 days from April 27, 2005, or (b) 180 days from the date the registration statement is declared effective.

In addition, the Company agreed not to conduct any equity financing (including debt financing with an equity component) during the period beginning April 27, 2005 and ending two years after the end of the above lock-up period unless it first provided each investor an option to purchase its pro rata share (based on the ratio of each investor's purchase under the securities purchase agreement) of the securities being offered in any proposed equity financing. Each investor must be provided written notice describing any proposed equity financing at least 20 business days prior to the closing of such proposed equity financing and the option must be extended to each investor during the 15-day period following delivery of such notice.

The \$2,500,000 in convertible notes bear interest at 8% per annum from the date of issuance. Interest is computed on the basis of a 365-day year and is payable quarterly in cash, with six months of interest payable up front. The interest rate resets to zero percent for any month in which the stock price is greater than 125% of the initial market price, or \$.0945, for each trading day during that month. Any amount of principal or interest on the convertible notes that is not paid when due will bear interest at the rate of 15% per annum from the date due thereof until such amount is paid. The notes mature in three years from the date of issuance, and are convertible into the Company's common stock at the noteholders' option, at the lower of (i) \$.09 or (ii) 60% of the average of the three lowest intraday trading prices for the common stock on the OTC Bulletin Board for the 20 trading days before but not including the conversion date. Accordingly, there is no limit on the number of shares into which the notes may be converted. On June 16, 2008, the Company agreed to reduce the applicable percentage for calculating the conversion price from 60% to 45% of the average of the three lowest intraday trading prices of the Company's common stock. The Company agreed to this change as a condition to receiving further funding for its ongoing operations on June 16, 2008.

The \$2,500,000 in convertible notes are secured by the Company's assets, including the Company's inventory, accounts receivable and intellectual property. Moreover, the Company has a call option under the terms of the notes. The call option provides the Company with the right to prepay all of the outstanding convertible notes at any time, provided there is no event of default by the Company and the Company's stock is trading at or below \$.09 per share. An event of default includes the failure by the Company to pay the principal or interest on the notes when due or to timely file a registration statement as required by the Company or obtain effectiveness with the Securities and

Exchange Commission of the registration statement. Prepayment of the notes is to be made in cash equal to either (a) 125% of the outstanding principal and accrued interest for prepayments occurring within 30 days following the issue date of the notes; (b) 130% of the outstanding principal and accrued interest for prepayments occurring between 31 and 60 days following the issue date of the notes; or (c) 145% of the outstanding principal and accrued interest for prepayments occurring after the 60th day following the issue date of the notes.

The warrants are exercisable until five years from the date of issuance at a purchase price of \$.20 per share. The investors may exercise the warrants on a cashless basis if the shares of common stock underlying the warrants are not registered pursuant to an effective registration statement. In the event the investors exercise the warrants on a cashless basis, the Company will not receive any proceeds therefrom. In addition, the exercise price of the warrants will be adjusted in the event the Company issues common stock at a price below market, with the exception of any securities issued as of the date of the warrants or issued in connection with the callable secured convertible notes issued pursuant to the securities purchase agreement.

The noteholders have agreed to restrict their ability to convert their convertible notes or exercise their warrants and receive shares of the Company's common stock such that the number of shares of common stock held by them in the aggregate and their affiliates after such conversion or exercise does not exceed 4.99% of the then issued and outstanding shares of common stock. However, the noteholders may repeatedly sell shares of common stock in order to reduce their ownership percentage, and subsequently convert additional convertible notes.

As of June 30, 2008, there was an outstanding balance of \$1,256,745 in principle remaining on the convertible notes. During the six months ended June 30, 2008 and 2007, the Company issued 752,570,008 and 2,019,564 shares of common stock for the conversion of \$186,081 and \$1,711 of convertible notes, respectively.

February 28, 2006 Sale of \$1,500,000 in Convertible Notes. To obtain additional funding for the Company's ongoing operations, the Company entered into a second securities purchase agreement on February 28, 2006 with the same four accredited investors for the sale of (i) \$1,500,000 in convertible notes and (ii) warrants to purchase 12,000,000 shares of its common stock. The sale of the convertible notes and warrants is to occur in three tranches and the investors are obligated to provide the Company with an aggregate of \$1,500,000 as follows:

- \$500,000 was disbursed on February 28, 2006;
- \$500,000 was disbursed on June 28, 2006 after the Company filed a registration statement on June 15, 2006 to register the shares of common stock underlying the convertible notes. The registration statement was subsequently withdrawn on July 25, 2006 and a new registration statement was filed on September 15, 2006 to register 60,000,000 shares of common stock issuable upon conversion of the notes.
- \$500,000 was disbursed on April 30, 2007, the day prior to the effective date of the registration statement on May 1, 2007.

Under the terms of the securities purchase agreement, the Company also agreed it would not, without the prior written consent of a majority-in-interest of the investors, negotiate or contract with any party to obtain additional equity financing (including debt financing with an equity component) that involves (i) the issuance of common stock at a discount to the market price of the common stock on the date of issuance (taking into account the value of any warrants or options to acquire common stock in connection therewith), (ii) the issuance of convertible securities that are convertible into an indeterminate number of shares of common stock, or (iii) the issuance of warrants during the lock-up period beginning February 28, 2006 and ending on the later of (a) 270 days from February 28, 2006, or (b) 180 days from the date the registration statement is declared effective.

In addition, the Company agreed not to conduct any equity financing (including debt financing with an equity component) during the period beginning February 28, 2006 and ending two years after the end of the above lock-up period unless it first provided each investor an option to purchase its pro rata share (based on the ratio of each investor's purchase under the securities purchase agreement) of the securities being offered in any proposed equity financing. Each investor must be provided written notice describing any proposed equity financing at least 20 business days prior to the closing of such proposed equity financing and the option must be extended to each investor during the 15-day period following delivery of such notice.

The \$1,500,000 in convertible notes bear interest at 8% per annum from the date of issuance. Interest is computed on the basis of a 365-day year and is payable quarterly in cash, with six months of interest payable up front. The interest rate resets to zero percent for any month in which the stock price is greater than 125% of the initial market price, or \$.0275, for each trading day during that month. Any amount of principal or interest on the convertible notes that is not paid when due will bear interest at the rate of 15% per annum from the date due thereof until such amount is paid. The notes mature in three years from the date of issuance, and are convertible into the Company's common stock at the noteholders' option, at the lower of (i) \$.02 or (ii) 60% of the average of the three lowest intraday trading prices for the common stock on the OTC Bulletin Board for the 20 trading days before but not including the conversion date. Accordingly, there is no limit on the number of shares into which the notes may be converted. On June 16, 2008, the Company agreed to reduce the applicable percentage for calculating the conversion price from 60% to 45% of the average of the three lowest intraday trading prices of the Company's common stock. The Company agreed to this change as a condition to receiving further funding for its ongoing operations on June 16, 2008.

The \$1,500,000 in convertible notes are secured by the Company's assets, including the Company's inventory, accounts receivable and intellectual property. Moreover, the Company has a call option under the terms of the notes. The call option provides the Company with the right to prepay all of the outstanding convertible notes at any time, provided there is no event of default by the Company and the Company's stock is trading at or below \$.02 per share. An event of default includes the failure by the Company to pay the principal or interest on the notes when due or to timely file a registration statement as required by the Company or obtain effectiveness with the Securities and Exchange Commission of the registration statement. Prepayment of the notes is to be made in cash equal to either (a) 125% of the outstanding principal and accrued interest for prepayments occurring within 30 days following the issue date of the notes; (b) 130% of the outstanding principal and accrued interest for prepayments occurring between 31 and 60 days following the issue date of the notes; or (c) 145% of the outstanding principal and accrued interest for prepayments occurring after the 60<sup>th</sup> day following the issue date of the notes.

The warrants are exercisable until five years from the date of issuance at a purchase price of \$.10 per share. The investors may exercise the warrants on a cashless basis if the shares of common stock underlying the warrants are not registered pursuant to an effective registration statement. In the event the investors exercise the warrants on a cashless basis, the Company will not receive any proceeds therefrom. In addition, the exercise price of the warrants will be adjusted in the event the Company issues common stock at a price below market, with the exception of any securities issued as of the date of the warrants or issued in connection with the callable secured convertible notes issued pursuant to the securities purchase agreement.

The noteholders have agreed to restrict their ability to convert their convertible notes or exercise their warrants and receive shares of the Company's common stock such that the number of shares of common stock held by them in the aggregate and their affiliates after such conversion or exercise does not exceed 4.99% of the then issued and outstanding shares of common stock. However, the noteholders may repeatedly sell shares of common stock in order to reduce their ownership percentage, and subsequently convert additional convertible notes.

As of June 30, 2008, there was an outstanding balance of \$1,334,275 in principle remaining on the convertible notes. During the six months ended June 30, 2008 and 2007, the Company issued zero and 13,000,000 shares of common stock for the conversion of \$0.00 and \$64,900 of convertible notes, respectively.

June 11, 2007 Sale of \$500,000 in Callable Secured Convertible Notes: To obtain further funding for the Company's ongoing operations, the Company entered into a third securities purchase agreement on June 11, 2007 with the same four accredited investors for the sale of (i) \$500,000 in callable secured convertible notes and (ii) warrants to purchase 10,000,000 shares of its common stock. The investors disbursed \$500,000 to the Company on June 11, 2007.

Under the terms of the June 11, 2007 securities purchase agreement, the Company agreed that it would not, without the prior written consent of a majority-in-interest of the investors, negotiate or contract with any party to obtain additional equity financing (including debt financing with an equity component) that involves (i) the issuance of common stock at a discount to the market price of the common stock on the date of issuance (taking into account the value of any warrants or options to acquire common stock in connection therewith), (ii) the issuance of convertible securities that are convertible into an indeterminate number of shares of common stock, or (iii) the issuance of warrants during the lock-up period beginning June 11, 2007 and ending on the later of (a) 270 days from June 11, 2007, or (b) 180 days from the date the registration statement is declared effective.

In addition, the Company agreed not to conduct any equity financing (including debt financing with an equity component) during the period beginning June 11, 2007 and ending two years after the end of the above lock-up period unless it first provided each investor an option to purchase its pro-rata share (based on the ratio of each investor's purchase under the securities purchase agreement) of the securities being offered in any proposed equity financing. Each investor must be provided written notice describing any proposed equity financing at least 20 business days prior

to the closing of such proposed equity financing and the option must be extended to each investor during the 15-day period following delivery of such notice.

The \$500,000 in convertible notes bear interest at 8% per annum from the date of issuance. Interest is computed on the basis of a 365-day year and is payable quarterly in cash, with six months of interest payable up front. The interest rate resets to zero percent for any month in which the stock price is greater than 125% of the initial market price, or \$.0275, for each trading day during that month. Any amount of principal or interest on the callable secured convertible notes that is not paid when due will bear interest at the rate of 15% per annum from the date due thereof until such amount is paid. The convertible notes mature in three years from the date of issuance, and are convertible into the Company's common stock at the noteholders' option, at the lower of (i) \$.02 or (ii) 50% of the average of the three lowest intraday trading prices for the common stock on the OTC Bulletin Board for the 20 trading days before but not including the conversion date. Accordingly, there is no limit on the number of shares into which the notes may be converted. On June 16, 2008, the Company agreed to reduce the applicable percentage for calculating the conversion price from 60% to 45% of the average of the three lowest intraday trading prices of the Company's common stock. The Company agreed to this change as a condition to receiving further funding for its ongoing operations on June 16, 2008.

The \$500,000 in convertible notes are secured by the Company's assets, including the Company's inventory, accounts receivable and intellectual property. Moreover, the Company has a call option under the terms of the notes. The call option provides the Company with the right to prepay all of the outstanding convertible notes at any time, provided there is no event of default by the Company and its stock is trading at or below \$.10 per share. An event of default includes the failure by the Company to pay the principal or interest on the convertible notes when due or to timely file a registration statement as required by the Company or obtain effectiveness with the Securities and Exchange Commission of the registration statement. Prepayment of the convertible notes is to be made in cash equal to either (a) 125% of the outstanding principal and accrued interest for prepayments occurring within 30 days following the issue date of the notes; (b) 130% of the outstanding principal and accrued interest for prepayments occurring between 31 and 60 days following the issue date of the notes; or (c) 145% of the outstanding principal and accrued interest for prepayments occurring after the 60th day following the issue date of the notes.

The warrants are exercisable until seven years from the date of issuance at a purchase price of \$.005 per share. The investors may exercise the warrants on a cashless basis if the shares of common stock underlying the warrants are not then registered pursuant to an effective registration statement. In the event the investors exercise the warrants on a cashless basis, the Company will not receive any proceeds therefrom. In addition, the exercise price of the warrants will be adjusted in the event the Company issues common stock at a price below market, with the exception of any securities issued as of the date of the warrants or issued in connection with the convertible notes issued pursuant to the securities purchase agreement.

The noteholders have agreed to restrict their ability to convert their convertible notes or exercise their warrants and receive shares of the Company's common stock such that the number of shares of common stock held by them in the aggregate and their affiliates after such conversion or exercise does not exceed 4.99% of the then issued and outstanding shares of common stock. However, the noteholders may repeatedly sell shares of common stock in order to reduce their ownership percentage, and subsequently convert additional convertible notes, provided, however, that such conversions do not exceed \$75,000 per calendar month, or the average daily dollar volume calculated during the ten business days prior to conversion multiplied by the number of trading days of that calendar month, per calendar month.

The Company is required to register the shares of its common stock issuable upon the conversion of the convertible notes and the exercise of the warrants that were issued to the noteholders pursuant to the securities purchase agreement the Company entered in to on June 11, 2007. The registration statement must be filed with the Securities and Exchange Commission within 60 days of the June 11, 2007 closing date and the effectiveness of the registration is to be within 135 days of such closing date. Penalties of 2% of the outstanding principal balance of the convertible notes plus accrued interest are to be applied for each month the registration is not effective within the required time. The penalty may be paid in cash or stock at the Company's option.

As of June 30, 2008, there have been no conversions of these convertible notes. Upon conversion of the convertible notes, the Company extinguishes the convertible debt and related embedded derivatives and no gain or loss is recorded on the Company's statements of operations as a result of said conversion.

December 19, 2007 Issuance of \$389,010 in Callable Convertible Notes: On December 19, 2007, the Company was notified by the holders of the convertible notes that there was a past due interest owing on the outstanding convertible notes. The total amount of interest owed was \$389,010. To pay this interest, the noteholders were willing to accept \$389,010 in additional convertible notes due on December 31, 2010. Accordingly, on December 19, 2007, the Company issued \$389,010 in convertible notes to the noteholders as full payment of the past due interest.

The \$389,010 in convertible notes bear interest at 2% per annum from December 31, 2007. Interest is computed on the basis of a 365-day year and is payable quarterly in cash, with six months of interest payable up front. The interest

rate resets to zero percent for any month in which the stock price is greater than 125% of the initial market price, or \$.0275, for each trading day during that month. Any amount of principal or interest on the callable secured convertible notes that is not paid when due will bear interest at the rate of 15% per annum from the date due thereof until such amount is paid. The convertible notes mature on December 31, 2010, and are convertible into the Company's common stock at the noteholders' option, at the lower of (i) \$.02 or (ii) 50% of the average of the three lowest intraday trading prices for the common stock on the OTC Bulletin Board for the 20 trading days before but not including the conversion date. Accordingly, there is no limit on the number of shares into which the notes may be converted. On June 16, 2008, the Company agreed to reduce the applicable percentage for calculating the conversion price from 60% to 45% of the average of the three lowest intraday trading prices of the Company's common stock. The Company agreed to this change as a condition to receiving further funding for its ongoing operations on June 16, 2008.

The \$389,010 in convertible notes have a call option under the terms of the notes. The call option provides the Company with the right to prepay all of the outstanding convertible notes at any time, provided there is no event of default by the Company and its stock is trading at or below \$.04 per share. An event of default includes the failure by the Company to pay the principal or interest on the convertible notes when due. Prepayment of the convertible notes is to be made in cash equal to either (a) 135% of the outstanding principal and accrued interest for prepayments occurring within 30 days following the issue date of the notes; (b) 145% of the outstanding principal and accrued interest for prepayments occurring between 31 and 60 days following the issue date of the notes; or (c) 150% of the outstanding principal and accrued interest for prepayments occurring after the 60th day following the issue date of the notes.

The noteholders have agreed to restrict their ability to convert their convertible notes and receive shares of the Company's common stock such that the number of shares of common stock held by them in the aggregate and their affiliates after such conversion does not exceed 4.9% of the then issued and outstanding shares of common stock. However, the noteholders may repeatedly sell shares of common stock in order to reduce their ownership percentage, and subsequently convert additional convertible notes, provided, however, that such conversions do not exceed the average daily dollar volume calculated during the ten business days prior to conversion multiplied by the number of trading days of that calendar month, per calendar month.

As of June 30, 2008, there have been no conversions of these convertible notes. Upon conversion of the convertible notes, the Company extinguishes the convertible debt and related embedded derivatives and no gain or loss is recorded on the Company's statements of operations as a result of said conversion.

December 24, 2007 Sale of \$250,000 in Callable Secured Convertible Notes: To obtain further funding for the Company's ongoing operations, the Company entered into a fourth securities purchase agreement on December 24, 2007 with the same four accredited investors for the sale of (i) \$250,000 in callable secured convertible notes and (ii) warrants to purchase 15,000,000 shares of its common stock. The investors disbursed \$250,000 to the Company on December 24, 2007.

Under the terms of the December 24, 2007 securities purchase agreement, the Company agreed that it would not, without the prior written consent of a majority-in-interest of the investors, negotiate or contract with any party to obtain additional equity financing (including debt financing with an equity component) that involves (i) the issuance of common stock at a discount to the market price of the common stock on the date of issuance (taking into account the value of any warrants or options to acquire common stock in connection therewith), (ii) the issuance of convertible securities that are convertible into an indeterminate number of shares of common stock, or (iii) the issuance of warrants during the lock-up period beginning December 24, 2007 and ending on the later of (a) 270 days from December 24, 2007, or (b) 180 days from the date the registration statement is declared effective.

In addition, the Company agreed not to conduct any equity financing (including debt financing with an equity component) during the period beginning December 24, 2007 and ending two years after the end of the above lock-up period unless it first provided each investor an option to purchase its pro-rata share (based on the ratio of each investor's purchase under the securities purchase agreement) of the securities being offered in any proposed equity financing. Each investor must be provided written notice describing any proposed equity financing at least 20 business days prior to the closing of such proposed equity financing and the option must be extended to each investor during the 15-day period following delivery of such notice.

The \$250,000 in convertible notes bear interest at 8% per annum from the date of issuance. Interest is computed on the basis of a 365-day year and is payable quarterly in cash, with six months of interest payable up front. The interest rate resets to zero percent for any month in which the stock price is greater than 125% of the initial market price, or \$.0275, for each trading day during that month. Any amount of principal or interest on the callable secured convertible

notes that is not paid when due will bear interest at the rate of 15% per annum from the date due thereof until such amount is paid. The convertible notes mature in three years from the date of issuance, and are convertible into the Company's common stock at the noteholders' option, at the lower of (i) \$.02 or (ii) 50% of the average of the three lowest intraday trading prices for the common stock on the OTC Bulletin Board for the 20 trading days before but not including the conversion date. Accordingly, there is no limit on the number of shares into which the notes may be converted. On June 16, 2008, the Company agreed to reduce the applicable percentage for calculating the conversion price from 60% to 45% of the average of the three lowest intraday trading prices of the Company's common stock. The Company agreed to this change as a condition to receiving further funding for its ongoing operations on June 16, 2008.

The \$250,000 in convertible notes are secured by the Company's assets, including the Company's inventory, accounts receivable and intellectual property. Moreover, the Company has a call option under the terms of the notes. The call option provides the Company with the right to prepay all of the outstanding convertible notes at any time, provided there is no event of default by the Company and its stock is trading at or below \$.10 per share. An event of default includes the failure by the Company to pay the principal or interest on the convertible notes when due or to timely file a registration statement as required by the Company or obtain effectiveness with the Securities and Exchange Commission of the registration statement. Prepayment of the convertible notes is to be made in cash equal to either (a) 125% of the outstanding principal and accrued interest for prepayments occurring within 30 days following the issue date of the notes; (b) 130% of the outstanding principal and accrued interest for prepayments occurring between 31 and 60 days following the issue date of the notes; or (c) 145% of the outstanding principal and accrued interest for prepayments occurring after the 60th day following the issue date of the notes.

The warrants are exercisable until seven years from the date of issuance at a purchase price of \$.001 per share. The investors may exercise the warrants on a cashless basis if the shares of common stock underlying the warrants are not then registered pursuant to an effective registration statement. In the event the investors exercise the warrants on a cashless basis, the Company will not receive any proceeds therefrom. In addition, the exercise price of the warrants will be adjusted in the event the Company issues common stock at a price below market, with the exception of any securities issued as of the date of the warrants or issued in connection with the convertible notes issued pursuant to the securities purchase agreement.

The noteholders have agreed to restrict their ability to convert their convertible notes or exercise their warrants and receive shares of the Company's common stock such that the number of shares of common stock held by them in the aggregate and their affiliates after such conversion or exercise does not exceed 4.99% of the then issued and outstanding shares of common stock. However, the noteholders may repeatedly sell shares of common stock in order to reduce their ownership percentage, and subsequently convert additional convertible notes, provided, however, that such conversions do not exceed \$75,000 per calendar month, or the average daily dollar volume calculated during the ten business days prior to conversion multiplied by the number of trading days of that calendar month, per calendar month.

The Company is required to register the shares of its common stock issuable upon the conversion of the convertible notes and the exercise of the warrants that were issued to the noteholders pursuant to the securities purchase agreement the Company entered in to on December 24, 2007. The registration statement must be filed with the Securities and Exchange Commission within 60 days of the December 24, 2007 closing date and the effectiveness of the registration is to be within 135 days of such closing date. Penalties of 2% of the outstanding principal balance of the convertible notes plus accrued interest are to be applied for each month the registration is not effective within the required time. The penalty may be paid in cash or stock at the Company's option.

As of June 30, 2008, there have been no conversions of these convertible notes. Upon conversion of the convertible notes, the Company extinguishes the convertible debt and related embedded derivatives and no gain or loss is recorded on the Company's statements of operations as a result of said conversion.

June 16, 2008 Sale of \$310,000 in Callable Secured Convertible Notes: To obtain additional funding for the Company's ongoing operations, the Company entered into a fifth securities purchase agreement on June 16, 2008 with three accredited investors for the sale of (i) \$310,000 in convertible notes and (ii) warrants to purchase 10,000,000 shares of its common stock. The sale of the convertible notes and warrants is to occur in three tranches and the investors are obligated to provide the Company with an aggregate of \$310,000 as follows:

\$110,000 were disbursed on June 16, 2008;

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\$100,000 were disbursed on July 14, 2008 after the Company filed a Schedule 14A preliminary proxy statement for a reverse stock split with the Securities and Exchange Commission; and  
\$100,000 will be disbursed upon the effectiveness of the reverse stock split.

Under the terms of the June 16, 2008 securities purchase agreement, the Company agreed that it would not, without the prior written consent of a majority-in-interest of the investors, negotiate or contract with any party to obtain additional equity financing (including debt financing with an equity component) that involves (i) the issuance of common stock at a discount to the market price of the common stock on the date of issuance (taking into account the value of any warrants or options to acquire common stock in connection therewith), (ii) the issuance of convertible securities that are convertible into an indeterminate number of shares of common stock, or (iii) the issuance of warrants during the lock-up period beginning June 16, 2008 and ending on the later of (a) 270 days from June 16, 2008, or (b) 180 days from the date the registration statement is declared effective.

In addition, the Company agreed not to conduct any equity financing (including debt financing with an equity component) during the period beginning June 16, 2008 and ending two years after the end of the above lock-up period unless it first provided each investor an option to purchase its pro-rata share (based on the ratio of each investor's purchase under the securities purchase agreement) of the securities being offered in any proposed equity financing. Each investor must be provided written notice describing any proposed equity financing at least 20 business days prior to the closing of such proposed equity financing and the option must be extended to each investor during the 15-day period following delivery of such notice.

The \$310,000 in convertible notes bear interest at 8% per annum from the date of issuance. Interest is computed on the basis of a 365-day year and is payable quarterly in cash, with six months of interest payable up front. The interest rate resets to zero percent for any month in which the stock price is greater than 125% of the initial market price, or \$.0275, for each trading day during that month. Any amount of principal or interest on the callable secured convertible notes that is not paid when due will bear interest at the rate of 15% per annum from the date due thereof until such amount is paid. The convertible notes mature in three years from the date of issuance, and are convertible into the Company's common stock at the noteholders' option, at the lower of (i) \$.02 or (ii) 45% of the average of the three lowest intraday trading prices for the common stock on the OTC Bulletin Board for the 20 trading days before but not including the conversion date. Accordingly, there is no limit on the number of shares into which the notes may be converted.

The \$310,000 in convertible notes are secured by the Company's assets, including the Company's inventory, accounts receivable and intellectual property. Moreover, the Company has a call option under the terms of the notes. The call option provides the Company with the right to prepay all of the outstanding convertible notes at any time, provided there is no event of default by the Company and its stock is trading at or below \$.02 per share. An event of default includes the failure by the Company to pay the principal or interest on the convertible notes when due or to timely file a registration statement as required by the Company or obtain effectiveness with the Securities and Exchange Commission of the registration statement. Prepayment of the convertible notes is to be made in cash equal to either (a) 125% of the outstanding principal and accrued interest for prepayments occurring within 30 days following the issue date of the notes; (b) 130% of the outstanding principal and accrued interest for prepayments occurring between 31 and 60 days following the issue date of the notes; or (c) 145% of the outstanding principal and accrued interest for prepayments occurring after the 60th day following the issue date of the notes.

The warrants are exercisable until seven years from the date of issuance at a purchase price of \$.001 per share. The investors may exercise the warrants on a cashless basis if the shares of common stock underlying the warrants are not then registered pursuant to an effective registration statement. In the event the investors exercise the warrants on a cashless basis, the Company will not receive any proceeds therefrom. In addition, the exercise price of the warrants will be adjusted in the event the Company issues common stock at a price below market, with the exception of any securities issued as of the date of the warrants or issued in connection with the convertible notes issued pursuant to the securities purchase agreement.



The noteholders have agreed to restrict their ability to convert their convertible notes or exercise their warrants and receive shares of the Company's common stock such that the number of shares of common stock held by them in the aggregate and their affiliates after such conversion or exercise does not exceed 4.99% of the then issued and outstanding shares of common stock. However, the noteholders may repeatedly sell shares of common stock in order to reduce their ownership percentage, and subsequently convert additional convertible notes, provided, however, that such conversions do not exceed \$75,000 per calendar month, or the average daily dollar volume calculated during the ten business days prior to conversion multiplied by the number of trading days of that calendar month, per calendar month.

The Company is required to register the shares of its common stock issuable upon the conversion of the convertible notes and the exercise of the warrants that were issued to the noteholders pursuant to the securities purchase agreement the Company entered in to on June 16, 2008. The registration statement must be filed with the Securities and Exchange Commission within 60 days of the June 16, 2008 closing date and the effectiveness of the registration is to be within 135 days of such closing date. Penalties of 2% of the outstanding principal balance of the convertible notes plus accrued interest are to be applied for each month the registration is not effective within the required time. The penalty may be paid in cash or stock at the Company's option.

As of June 30, 2008, there have been no conversions of these convertible notes. Upon conversion of the convertible notes, the Company extinguishes the convertible debt and related embedded derivatives and no gain or loss is recorded on the Company's statements of operations as a result of said conversion.

The Notes include certain features that are considered embedded derivative financial instruments. These features are described as follows:

- The fixed conversion feature that allows the investor to convert the Notes at a fixed price per share;
- The variable conversion feature that allows the investor to convert the Notes at a specified percentage of the market price at the time of conversion;
- The variable interest rate provision that calls for no interest to be paid if the stock price exceeds a predetermined amount for a given number of months; and
- The value of the warrants issued in conjunction with each funding.

The initial fair value assigned to the embedded derivatives and warrants was \$4,169,000, which consisted of the fair value of the embedded derivatives of \$2,588,000 and the fair value of the warrants of \$1,582,000. The Company recorded the first \$2,500,000 of fair value of the derivatives and warrants to debt discount (equal to the total proceeds received as of June 30, 2005), which will be amortized to interest expense over the term of the Notes. The remaining balance of \$1,669,000 was recorded as loss of derivative valuation for the period ended June 30, 2005.

As of December 31, 2005, the carrying amount on the Notes was \$340,000, net of the unamortized debt discount of \$1,698,000. Interest expense on the Notes totaled \$739,000 for the period ended December 31, 2005, which consisted of \$369,000 of normal accretion of the Note discount and \$370,000 of accrued interest on the outstanding Note balance for the period. The fair value of the embedded derivatives and warrants decreased to \$195,000 during the year ended December 31, 2005, which consisted of a fair value of the embedded derivatives of \$137,000 and the fair value of the warrants of \$58,000. The corresponding decrease in derivative value was reflected as a gain on derivative valuation on the statements of operations in the amount of \$3,975,000.

During 2006, the Company entered into another securities purchase agreement in the amount \$1,000,000. The initial fair value assigned to the embedded derivatives and warrants was \$541,000 for this Note, which consisted of the fair value of the embedded derivatives of \$464,000 and the fair value of the warrants of \$77,000. The Company recorded the \$541,000 of fair value of the derivatives and warrants to debt discount, which will be amortized to interest expense over the term of the Notes.

As of December 31, 2006, the carrying amount on the Notes was \$1,421,000, net of the unamortized debt discount of \$1,235,000. Interest expense on the Notes totaled \$935,000 for the period ended December 31, 2006, which consisted of \$721,000 of normal accretion of the Note discount and \$214,000 of accrued interest on the outstanding Note balance for the period. The fair value of the embedded derivatives and warrants decreased by a total of \$536,000 during the year ended December 31, 2006, which consisted of a decrease in the fair value of the embedded derivatives of \$451,000 and the fair value of the warrants of \$85,000. Accordingly, the Company recorded a gain on derivative valuation to the statement of operations of \$536,000 for the year ended December 31, 2006.

During 2007, the Company entered into four securities purchase agreements in the aggregate amount of \$1,639,000. The initial fair value assigned to the embedded derivatives and warrants was \$466,000 for these Notes, which consisted of the fair value of the embedded derivatives of \$344,000 and the fair value of the warrants of \$122,000. The Company recorded \$466,000 of fair value of the derivatives and warrants to debt discount, which will be amortized to interest expense over the term of the Notes.

At December 31, 2007, the carrying amount on the Notes was \$3,100,000, net of the unamortized debt discount of \$828,000. Interest expense on the Notes totaled \$992,000 for the period ended December 31, 2007, which consisted of \$771,000 of normal accretion of the Note discount and \$221,000 of accrued interest on the outstanding Note balance for the period. The fair value of the embedded derivatives and warrants decreased by a total of \$413,000 during the year ended December 31, 2007, which consisted of a decrease in the fair value of the embedded derivatives of \$391,000 and the fair value of the warrants of \$22,000. Accordingly, the Company recorded a gain on derivative valuation to the statement of operations of \$413,000 for the year ended December 31, 2007.

At June 30, 2008, the carrying amount on the Notes was \$3,400,000, net of the unamortized debt discount of \$452,000. Interest expense on the Notes totaled \$515,000 for the period ended June 30, 2008, which consisted of \$361,000 of normal accretion of the Note discount and \$154,000 of accrued interest on the outstanding Note balance for the period. The fair value of the embedded derivatives and warrants decreased by a total of \$187,000 during the six months ended June 30, 2008, which consisted of a decrease in the fair value of the embedded derivatives of \$126,000 and the fair value of the warrants of \$61,000. Accordingly, the Company recorded a gain on derivative valuation to the statement of operations of \$187,000 for the six months ended June 30, 2008.

The market price of the Company's common stock significantly impacts the extent to which the Company may be required or may be permitted to convert the unrestricted and restricted portion of the Notes into shares of the Company's common stock. The lower the market price of the Company's common stock at the respective times of conversion, the more shares the Company will need to issue to convert the principal and interest payments then due on the Notes. If the market price of the Company's common stock falls below certain thresholds, the Company will be unable to convert any such repayments of principal and interest into equity, and the Company will be forced to make such repayments in cash. The Company's operations could be materially impacted, in an adverse way, if the Company is forced to make repeated cash payments on the Notes.

#### Simple Conversion Calculation

The number of shares of common stock issuable upon conversion of the convertible notes issued on April 27, 2005, February 28, 2006, June 11, 2007, December 19, 2007, December 23, 2007, and June 16, 2008 is determined by dividing that portion of the principal of the notes to be converted and interest, if any, by the conversion price. For example, assuming conversion of \$3,840,030 principal amount of the convertible notes on June 30, 2008 (consisting of \$5,139,010 in convertible notes that were sold to the four investors pursuant to securities purchase agreements dated April 27, 2005, February 28, 2006, June 11, 2007, December 24, 2007, and June 16, 2008, plus \$389,010 in convertible notes issued on December 19, 2007 in payment of past due interest on the notes, less \$1,408,980 in notes converted during the period from June 12, 2005 to June 30, 2008) and a conversion price of \$.001 per share with a

55% discount, the number of shares issuable upon conversion would be:

$$\$3,840,030 / \$0.000233 \times 45\% = 36,624,034,335 \text{ shares.}$$

The Company's obligation to issue shares upon conversion of the convertible notes issued on April 27, 2005, February 28, 2006, June 11, 2007, December 19, 2007, December 23, 2007, and June 16, 2008 is essentially limitless. The following is an example of the amount of shares of common stock that are issuable upon conversion of \$3,840,030 principal amount of the convertible notes (including accrued interest), based on market prices 25%, 50%, and 75% below the market price, as of July 2, 2008 of \$.0004 with a 55% discount:

% Below Market	Price Per Share	With 55% Discount	Number of Shares Issuable	% of Outstanding Shares*
25%	\$.0003	\$.000135	28,444,666,666	2,112%
50%	\$.0002	\$.00009	42,667,000,000	3,169%
75%	\$.0001	\$.000045	85,334,000,000	6,338%

\*Based on 1,346,390,590 shares outstanding.

As illustrated, the number of shares of common stock issuable upon conversion of the Company's callable secured convertible notes will increase if the market price of the Company's common stock declines, which will cause dilution to existing stockholders.

#### Adjustable Conversion Price of Convertible Notes

The convertible notes are convertible into shares of the Company's common stock at a 55% discount to the trading price of the common stock prior to the conversion. The significant downward pressure on the price of the common stock as the noteholders convert and sell material amounts of common stock could encourage short sales by investors. This could place further downward pressure on the price of the common stock. The noteholders could sell common stock into the market in anticipation of covering the short sale by converting their securities, which could cause further downward pressure on the stock price. In addition, not only the sale of shares issued upon conversion or exercise of notes, warrants and options, but also the mere perception that these sales could occur, may have a depressive effect on the market price of the common stock.

#### Possible Dilution to Stockholders

The issuance of shares upon conversion of convertible notes and exercise of warrants may result in substantial dilution to the interests of other stockholders since the holders of the convertible notes may ultimately convert and sell the full amount issuable upon conversion. Although the noteholders may not convert their convertible notes and/or exercise their warrants if such conversion or exercise price would cause them to own more than 4.99% of the Company's outstanding common stock, this restriction does not prevent the noteholders from converting and/or exercising some of their holdings and then converting the rest of their holdings. In this way, the noteholders could sell more than this limit while never holding more than this limit. There is no upper limit on the number of shares that may be issued, which will have the effect of further diluting the proportionate equity interest and voting power of holders of the Company's common stock.

#### Failure to Repay Convertible Notes May Require Company Operations to Cease

On April 27, 2005, the Company entered into a securities purchase agreement for the sale of an aggregate of \$2,500,000 principal amount of convertible notes. On February 28, 2006, the Company entered into another securities purchase agreement for the sale of an aggregate of \$1,500,000 principal amount of convertible notes. On June 11, 2007, and December 24, 2007, the Company entered into third and fourth securities purchase agreements for the sale of an aggregate of \$750,000 principal amount of convertible notes. On December 19, 2007, the Company issued an additional \$389,010 in convertible notes as payment of past due interest owing on the outstanding convertible notes. On June 16, 2008, the Company entered into a fifth securities purchase agreement for the sale of an aggregate of \$310,000 principal amount of convertible notes. These convertible notes are all due and payable, with 8% interest, three years from the date of issuance, unless sooner converted into shares of the Company's common stock. The Company currently has \$3,840,030 in convertible notes outstanding. Any event of default such as the Company's failure to repay the principal or interest when due on the notes, the Company's failure to issue shares of common stock upon conversion by the noteholders, the Company's breach of any covenant, representation or warranty in the securities purchase agreement or related convertible notes, the assignment or appointment of a receiver to control a substantial part of the Company's property or business, the filing of a money judgment, writ or similar process against the Company in excess of \$50,000, the commencement of a bankruptcy, insolvency, reorganization or liquidation proceeding against the Company, and the delisting of the Company's common stock could require the early repayment of the convertible notes, including a default interest rate of 15% on the outstanding principal balance of the notes if the default is not cured within the specified grace period.

The Company anticipates that the full amount of convertible notes will be converted into shares of its common stock, in accordance with the terms of the convertible notes. If the Company is required to repay the convertible notes, it would be required to use its limited working capital and raise additional funds. If the Company were unable to repay the notes when required, the noteholders could commence legal action against the Company and foreclose on all of its assets to recover the amounts due. Any such action would require the Company to curtail or cease operations.

### Preferred Stock Conversions

Under the Company's Certificate of Incorporation, holders of the Company's Class A and Class B preferred stock have the right to convert such stock into shares of the Company's common stock at the rate of 1.2 shares of common stock for each share of preferred stock. During the six months ended June 30, 2008 no shares of Series A preferred stock and no shares of Series B preferred stock were converted to the Company's common stock.

Holders of Series D preferred have the right to convert such stock into shares of the Company's common stock at the rate of one share of common stock for each share of preferred stock. During the six months ended June 30, 2008 no shares of Series D preferred stock were converted to the Company's common stock.

Holders of Series E preferred have the right to convert such stock into shares of the Company's common stock at the rate of 53.3 shares of common stock for each share of preferred stock. During the six months ended June 30, 2008 no shares of Series E preferred stock were converted to the Company's common stock.

Holders of Series F preferred have the right to convert such stock into shares of the Company's common stock at the rate of 53.3 shares of common stock for each share of preferred stock. During the six months ended June 30, 2008, no shares of Series F preferred stock were converted to the Company's common stock.

Holders of Series G preferred have the right to convert such stock into shares of the Company's common stock at the rate of one share of common stock for each share of preferred stock. During the six months ended June 30, 2008, no shares of Series G preferred stock were converted to shares of the Company's common stock.

### Warrants

The fair value of warrants granted as described herein is estimated at the date of grant using the Black-Scholes option pricing model. The exercise price per share is reflective of the then current market value of the stock. No grant exercise price was established at a discount to market. All warrants are fully vested, exercisable and nonforfeitable as of the grant date. As a result of the financing the Company completed on April 27, 2005 involving the sale of \$2,500,000 in convertible notes, the Company granted warrants to the noteholders to purchase 16,534,392 shares of its common stock. The warrants have an exercise price of \$.20 per share and expire on April 27, 2010. As a result of the financing the Company completed on February 28, 2006, involving the sale of \$1,500,000 in convertible notes, the Company granted that warrants to the noteholders to purchase 12,000,000 shares of its common stock. The warrants have an exercise price of \$.10 per share and expire on February 27, 2011. As a result of the financing the Company completed on June 11, 2007, involving the sale of \$500,000 in convertible notes, the Company granted warrants to the noteholders to purchase 10,000,000 shares of its common stock. The warrants have an exercise price of \$.005 per share and expire on June 11, 2014. As a result of the financing the Company completed on December 23, 2007, involving the sale of \$250,000 in convertible notes, the Company granted warrants to the noteholders to purchase 10,000,000 shares of its common stock. The warrants have an exercise price of \$.001 per share and expire on December 23, 2014. As a result of the financing that the Company completed on June 16, 2008, involving the sale of \$110,000 in convertible notes, the Company granted warrants to the noteholders to purchase 10,000,000 shares of its common stock. The warrants have an exercise price of \$.001 per share and expire on June 16, 2015.

## Related Party Transactions

Payments for legal services to the firm of which the Company's Chairman of the Board is a partner were \$45,000 and \$145,000 for the six months ended June 30, 2008 and 2007 respectively.

## Accrued Expenses

Accrued expenses consist of the following at June 30, 2008:

Litigation reserve	\$ 236,000
Interest expense on notes payable	153,000
Payroll and employee benefits	37,000
Sales tax payable	18,000
Customer deposits	62,000
Warranty and return allowance	224,000
Other accrued expenses	25,000
Total	\$ 755,000

## Restatement and reclassification

We have restated our quarterly financial statements for the quarter ended June 30, 2008. These restatements have been performed to reflect issues identified during a review of our financial statements. Management and the board of directors concluded these restatements were necessary to reflect the changes described below.

• We erroneously treated the conversion-related derivatives and warrants associated with the Company's Callable Secured Convertible Notes for the quarter ended June 30, 2008. The previous accounting treatment of the unamortized debt discount related to the converted shares during the period was not applicable and, accordingly, the unamortized debt discount associated with the portion of the debt discount should have been eliminated and offset to equity. In addition, the pro rata portion of the derivative liability should also be eliminated at the time of conversion, in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities."

• We have also expanded footnote disclosures and added disclosures to help clarify the amounts recorded in the financial statements of the Company.

A summary of the effects of these changes is as follows:

PARADIGM MEDICAL INDUSTRIES, INC.  
 CONDENSED CONSOLIDATED BALANCE SHEET  
 JUNE 30, 2008  
 (UNAUDITED)

Assets	As previously Reported	As Restated	Change
<b>Current assets</b>			
Cash	\$ 67,000	\$ 67,000	\$ --
Receivables, net	232,000	232,000	--
Inventories, net	911,000	911,000	--
Prepaid and other assets	52,000	52,000	--
<b>Total current assets</b>	<b>1,262,000</b>	<b>1,262,000</b>	<b>--</b>
Property and equipment, net	13,000	13,000	--
Goodwill	339,000	339,000	--
<b>Total assets</b>	<b>\$ 1,614,000</b>	<b>\$ 1,614,000</b>	<b>\$ --</b>
<b>Liabilities and Stockholders' (Deficit)</b>			
<b>Current liabilities:</b>			
Accounts payable	\$ 544,000	\$ 544,000	\$ --
Related party payable	--	--	--
Accrued liabilities	755,000	755,000	--
<b>Total current liabilities</b>	<b>1,299,000</b>	<b>1,299,000</b>	<b>--</b>
Convertible notes payable, net of debt discount			
of \$452,000 and \$828,000	3,400,000	3,400,000	--
Derivative liabilities	27,000	27,000	--
<b>Total long-term liabilities</b>	<b>3,427,000</b>	<b>3,427,000</b>	<b>--</b>
<b>Total liabilities</b>	<b>4,726,000</b>	<b>4,726,000</b>	<b>--</b>
Commitments and contingencies	--	--	--
<b>Stockholders' (Deficit):</b>			
Preferred stock, authorized:5,000,000 shares, \$001 par value,			
Series A			
Authorized: 500,000 shares; issued and outstanding: 5,627 shares at June 30, 2008	--	--	--
Series B			
Authorized: 500,000 shares; issued and outstanding: 8,986 shares at June 30, 2008	--	--	--
Series C			
Authorized: 30,000 shares; issued and outstanding: zero shares at June 30, 2008	--	--	--

Series D			
Authorized: 1,140,000 shares; issued and			
outstanding: 5,000 shares at June 30, 2008	--	--	--
Series E			
Authorized: 50,000 shares; issued and			
outstanding: 250 shares at June 30, 2008	--	--	--
Series F			
Authorized: 50,000 shares; issued and			
outstanding: 4,398.75 shares at June 30, 2008	--	--	--
Series G			
Authorized: 2,000,000 shares; issued and			
outstanding: 588,235 shares at June 30, 2008	1,000	1,000	--
Common Stock, Authorized:			
1,400,000,000 shares, \$.001 par value; issued and			
outstanding: 1,297,554,315 at June 30, 2008	1,297,000	1,297,000	--
Additional paid-in capital	57,043,000	57,088,000	45,000 a
Accumulated deficit	(61,453,000)	(61,498,000)	(45,000)b
Total stockholders' (Deficit)	(3,112,000)	(3,112,000)	--
Total liabilities and stockholders' (Deficit)	\$ 1,614,000	\$ 1,614,000	\$ --

a Reclassification of fully expensed beneficial conversion feature in 2005, 2006 and 2007

b Effective of properly accounting for embedded derivatives

PARADIGM MEDICAL INDUSTRIES, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
THREE MONTHS ENDED JUNE 30, 2008  
(UNAUDITED)

	As Previously Reported	As Restated	Change
Sales	\$ 213,000	\$ 213,000	\$ --
Cost of Sales	122,000	122,000	--
Gross Profit	91,000	91,000	--
Operating Expenses:			
General and administrative	(130,000)	(130,000)	--
Marketing and selling	(258,000)	(258,000)	--
Research and development	(62,000)	(62,000)	--
Total Operating Expenses	(450,000)	(450,000)	--
Operating loss	(359,000)	(359,000)	--
Other Income and (expense):			
Interest expense-accretion of debt discount	(177,000)	(177,000)	--
Gain and loss on derivative valuation	66,000	66,000	--
Interest expense	(78,000)	(78,000)	--
Interest income	--	--	--
Total other income (expense)	(189,000)	(189,000)	--
Income (loss) before provision for income taxes	(548,000)	(548,000)	--
Provision for income taxes	--	--	--
Net (loss)	\$ (548,000)	\$ (548,000)	\$ --
Earnings (loss) Per Common Share - Basic	\$ (0.00)	\$ (0.00)	\$ (0.00)
Earnings (loss) Per Common Share - Diluted	\$ (0.00)	\$ (0.00)	\$ (0.00)
Weighted Average Common Share - Basic	728,001,150	728,001,150	--
Weighted Average Common Share - Diluted	728,001,150	728,001,150	--

PARADIGM MEDICAL INDUSTRIES, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
SIX MONTHS ENDED JUNE 30, 2008  
(UNAUDITED)

	As Previously Reported	As Restated	Change
Sales	\$ 443,000	\$ 443,000	\$ --
Cost of Sales	264,000	264,000	--
Gross Profit	179,000	179,000	--
Operating Expenses:			
Marketing and selling	(311,000)	(311,000)	--
General and administrative	(484,000)	(484,000)	--
Research and development	(151,000)	(151,000)	--
Total Operating Expenses	(946,000)	(946,000)	--
Operating loss	(767,000)	(767,000)	--
Other Income and (expense):			
Interest expense-accetion of debt discount	(361,000)	(361,000)	--
Gain and loss on derivative valuation	192,000	187,000	(5,000) a
Interest expense	(154,000)	(154,000)	--
Interest income	2,000	2,000	--
Total other income (expense)	(321,000)	(326,000)	(5,000)
Income (loss) before provision for income taxes Provision			
for income taxes	(1,088,000)	(1,093,000)	--
Net (loss)	--	--	--
	\$ (1,088,000)	\$ (1,093,000)	\$ (5,000)
Earnings (loss) Per Common Share - Basic	\$ (0.00)	\$ (0.00)	\$ 0.00
Earnings (loss) Per Common Share - Diluted	\$ (0.00)	\$ (0.00)	\$ 0.00
Weighted Average Common Share - Basic	588,474,381	588,474,381	--
Weighted Average Common Share - Diluted	588,474,381	588,474,381	--

a Effect of valuation of embedded derivatives

PARADIGM MEDICAL INDUSTRIES, INC.  
 STATEMENTS OF CASH FLOWS  
 THREE MONTHS ENDED JUNE 30, 2008  
 (UNAUDITED)

	As Previously Reported	As Restated	Change
Cash flows from operating activities:			
Net income (loss)	(1,088,000)	(1,093,000)	(5,000) a
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Depreciation and amortization	3,000	3,000	--
Stock option valuation	14,000	14,000	--
Change in fair value of derivative liabilities	(193,000)	(188,000)	5,000 a
Beneficial conversion interest	361,000	361,000	--
Provision for losses on receivables	--	--	--
(Increase) decrease in:			
Accounts Receivables	392,000	392,000	--
Inventories	(66,000)	(66,000)	--
Prepaid and other assets	(25,000)	(25,000)	--
Increase (decrease) in:			
Accounts payable	128,000)	128,000	--
Accrued liabilities	120,000	110,000	--
Net cash used in operating activities:	(364,000)	(364,000)	--
Cash flows from investing activities:			
Net cash provided by (used in) investing activities	--	--	--
Cash flows from financing activities:			
Net cash (used in) provided by financing activities	110,000	110,000	--
Net change in cash	(254,000)	(254,000)	--
Cash, beginning of period	321,000	321,000	--
Cash, end of period	\$ 67,000	\$ 67,000	\$ --
Supplemental disclosure of cash flow information:			
Cash paid for interest	\$ 1,000	\$ 1,000	\$ --
Cash paid for income taxes	\$ --	\$ --	\$ --
Non-cash transactions:			
Notes converted into common stock	\$ 186,081	\$ 186,081	\$ --

a Effect of valuation of embedded derivatives

## Item 2: Management's Discussion and Analysis or Plan of Operation

This report contains forward-looking statements and information relating to the Company that is based on beliefs of management as well as assumptions made by, and information currently available to management. These statements reflect its current view respecting future events and are subject to risks, uncertainties and assumptions, including the risks and uncertainties noted throughout the document. Although the Company has attempted to identify important factors that could cause the actual results to differ materially, there may be other factors that cause the forward-looking statements not to come true as anticipated, believed, projected, expected or intended. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may differ materially from those described herein as anticipated, believed, projected, estimated, expected or intended.

### Critical Accounting Policies

**Revenue Recognition.** The Company recognizes revenue in compliance with Staff Accounting Bulletin 101, Revenue Recognition in Financial Statements (SAB 101), as revised by Staff Accounting Bulletin No. 104, Revenue Recognition (SAB 104). SAB 101 and SAB 104 detail four criteria that must exist before revenue is recognized:

1. Persuasive evidence of an arrangement exists. Prior to shipment of product, the Company required a signed purchase order and, depending upon the customer, a down payment toward the final invoiced price or full payment in advance with certain international product distributors.
2. Delivery and performance have occurred. Unless the purchase order requires specific installation or customer acceptance, the Company recognizes revenue when the product ships. If the purchase order requires specific installation or customer acceptance, the Company recognizes revenue when such installation or acceptance has occurred. Title to the product passes to its customer upon shipment. This revenue recognition policy does not differ among its various different product lines. The Company guarantees the functionality of its product. If its product does not function as marketed when received by the customer, the Company either makes the necessary repairs on site or has the product shipped to the Company for the repair work. Once the product has been repaired and retested for functionality, it is re-shipped to the customer. The Company provides warranties that generally extend for one year from the date of sale. Such warranties cover the necessary parts and labor to repair the product as well as any shipping costs that may be required. The Company maintains a reserve for estimated warranty costs based on its historical experience and management's current expectations.
3. The sales price is fixed or determinable. The purchase order received from the customer includes the agreed-upon sales price. The Company does not accept customer orders, and therefore does not recognize revenue, until the sales price is fixed.
4. Collectibility is reasonably assured. With limited exceptions, the Company requires down payments on product prior to shipment. In some cases the Company requires payment in full prior to shipment. The Company also performs credit checks on new customers and ongoing credit checks on existing customers. The Company maintains an allowance for doubtful accounts receivable based on historical experience and management's current expectations.
5. Revenues for sales of products that require specific installation and acceptance by the customer are recognized upon such installation and acceptance by the customer. Revenues for sales of other surgical systems, ultrasound diagnostic devices, and disposable products are recognized when the product is shipped. A signed purchase agreement and a depositor payment in full from customers are required before a product leaves the premises. Title passes at time of shipment (F.O.B. shipping point). The products of the Company contain both hardware and software components. The Company does not recognize revenue for the software components of the products separate from the product as a whole because the software is incidental to the product, as defined in paragraph 2 of SOP 97-2.

Recoverability of Inventory. Since its inception, the Company has purchased several complete lines of inventory. In some circumstances the Company has been able to utilize certain items acquired and others remain unused. On a quarterly basis, the Company attempts to identify inventory items that have shown relatively no movement or very slow movement. Generally, if an item has shown little or no movement for over a year, it is determined not to be recoverable and a reserve is established for that item. In addition, if the Company identifies products that have become obsolete due to product upgrades or enhancements, a reserve is established for such products. The Company intends to make efforts to sell these items at significantly discounted prices. If items are sold, the cash received would be recorded as revenue, but there would be no cost of sales on such items due to the reserve that has been recorded. At the time of sale, the inventory would be reduced for the item sold and the corresponding inventory reserve would also be reduced.

**Recoverability of Goodwill and Other Intangible Assets.** The Company's intangible assets consist of goodwill, product and technology rights, engineering and design costs, and patent costs. Intangibles with a determined life are amortized on a straight-line basis over their determined useful life and are also evaluated for potential impairment if events or circumstances indicate that the carrying amount may not be recoverable. Intangibles with an indefinite life, such as goodwill, are not amortized but are tested for impairment on an annual basis or when events and circumstances indicate that the asset may be impaired. Impairment tests include comparing the fair value of a reporting unit with its carrying net book value, including goodwill. To date, the Company's determination of the fair value of the reporting unit has been based on the estimated future cash flows of that reporting unit. Intangible assets other than goodwill have been fully amortized.

**Allowance for Doubtful Accounts.** The Company records an allowance for doubtful accounts to offset estimated uncollectible accounts receivable. Bad debt expense associated with the increases in the allowance for doubtful accounts is recorded as part of general and administrative expense. The Company's accounting policy generally is to record an allowance for receivables over 90 days past due unless there is significant evidence to support that the receivable is collectible.

#### General

The following Management's Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements, which involve risks and uncertainty. The Company's actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors discussed in this section. The Company's fiscal year is from January 1 through December 31.

The Company is engaged in the design, development, manufacture and sale of high technology diagnostic eye care products. Given the "going concern" status of the Company, management has focused efforts on those products and activities that will, in its opinion, achieve the most resource efficient short-term cash flow. As seen in the results for the three months ended June 30, 2008, diagnostic products have been the major focus and the Photon™ and other extensive research and development projects have been put on hold pending future evaluation when the Company's financial position improves. The Company does not focus on a specific diagnostic product or products but, instead, on the entire diagnostic group.

#### Results of Operations

##### Three Months Ended June 30, 2008, Compared to Three Months Ended June 30, 2007

Net sales for the three months ended June 30, 2008 decreased by \$47,000, or 18%, to \$213,000 as compared to \$260,000 for the same period of 2007. This reduction in sales was primarily due to decreased sales of the P40, P45 and P60 Ultrasound Biomicroscopes, the P37, P37II and P2700 Ocular Ultrasound Diagnostic A/B Scan, the P2000 A-Scan Biometric Ultrasound Analyzer, the P2200 and P2500 Pachymetric Analyzers, and the Blood Flow Analyzer™.

For the three months ended June 30, 2008, sales from the Company's diagnostic products totaled \$185,000, or 87% of total revenues, compared to \$198,000, or 76% of total revenues for the same period of 2007. The remaining 13% of sales, or \$28,000 during the three months ended June 30, 2008, was from parts, disposables, and service revenue.

Sales of the P60 UBM Ultrasound Biomicroscope decreased by \$5,000 to \$35,000, or 16% of total revenues, for the three months ended June 30, 2008, compared to \$40,000, or 15% of total revenues, for the same period last year. Sales of the Blood Flow Analyzer™ increased by \$11,000 to \$47,000, or 22% of total revenues, for the three months ended June 30, 2008, compared to net sales of \$36,000, or 14% of total revenues, during the same period in 2007. Sales from the P37 and P37-II A/B Scan Ocular Ultrasound Diagnostic devices decreased by \$27,000 to

\$21,000, or 10% of total revenues for the three months ended June 30, 2008, compared to \$48,000, or 18% of total revenues, during the same period in 2007. Sales of the P2200, and P2500 Pachymetric Analyzers, and the P2000 A-Scan Biometric Ultrasound Analyzer decreased by \$9,000 to \$4,000, or 2% of total revenues, for the three month period ended March 31, 2008, compared to \$13,000, or 5% of total revenues, for the same period of 2007. Combined sales of the LD 400 and TKS 5000 Autoperimetry Systems increased by \$17,000 to \$78,000, or 37% of the total revenues, for the three months ended June 30, 2008, compared to \$61,000, or 23% of total revenues, for the same period of 2007.

Sales have been lower during the three months ended June 30, 2008 for the Company due to a variety of reasons. Sales of the P60 UBM Ultrasound Biomicroscope were reduced primarily due to the delayed introduction of new software for the P60, which received FDA 510(k) premarket approval on May 26, 2005, allowing the device to be sold in the United States. The hardware problems have since been resolved and the Company continues to work on improving the software package for the P60.

The Company anticipates reversing the downward trend in sales through additional efforts by the Company to gain more widespread support for the P60 UBM Ultrasound Biomicroscope, the Blood Flow Analyzer™, the LD400 Antoperimetry System, the P37-II Ocular Ultrasound Diagnostic A/B Scan, the 2200 and 2500 Pachymetric Analyzers, the P2000 A-Scan Biometric Ultrasound Analyzer, and the Lace Perg through increased clinical awareness, ongoing product development, improved marketing plans and strategic product replacement, and ongoing development of the LD400 perimeter and the Lace Perg. The Blood Flow Analyzer™ is expected to have a new CPT reimbursement code for Medicare insurance providers issued in 2009, reversing the downward sales trend experienced by the Blood Flow Analyzer™.

Gross profit for the three months ended June 30, 2008 was 43% of total revenues. This gross profit was the same as the gross profit for the comparable period in 2007. There was no increase to cost of sales as a result of a charge to the reserve for obsolete inventory in 2007.

Marketing and selling expenses decreased by \$29,000, or 18%, to \$130,000, for the three months ended June 30, 2008, from \$159,000 for the comparable period in 2007. This decrease was due primarily to a reduction in overall marketing expenses, related travel expenses and a general reduction in staff.

General and administrative expenses decreased by \$51,000, or 17%, to \$258,000 for the three months ended June 30, 2008, from \$309,000 for the comparable period in 2007. This decrease was primarily due to a reduction in salaries as a result of a general reduction in staff.

Also, during the three months ended June 30, 2008, the Company has not been able to collect receivables that were previously allowed in the allowance for doubtful accounts. During the three months ended June 30, 2008, the Company has not increased the allowance for doubtful accounts.

Research, development and service expenses decreased by \$64,000, or 51%, to \$62,000 for the three months ended June 30, 2008, compared to \$126,000 in the same period of 2007. This decrease was mainly due to a reduction of funding available for the marketing of new products and a reduction in staff.

Six Months ended June 30, 2008, Compared to Six Months ended June 30, 2007.

Net sales for the six months ended June 30, 2008 decreased by \$213,000, or 33%, to \$443,000 as compared to \$656,000 for the same period of 2007. This reduction in sales was primarily due to decreased sales of the P40, P45 and P60 Ultrasound Biomicroscopes, the P37, P37II and P2700 Ocular Ultrasound Diagnostic A/B Scan, the P2000 A-Scan Biometric Ultrasound Analyzer, the P2200 and P2500 Pachymetric Analyzers, and the Blood Flow Analyzer™.

For the six months ended June 30, 2008, sales from the Company's diagnostic products totaled \$369,000, or 83% of total revenues, compared to \$568,000, or 87% of total revenues for the same period of 2007. The remaining 17% of sales, or \$74,000 during the six months ended June 30, 2008, was from parts, disposables, and service revenue.

Sales of the P60 UBM Ultrasound Biomicroscope decreased by \$155,000 to \$40,000 or 9% of total revenues, for the six months ended June 30, 2008, compared to \$195,000, or 30% of total revenues, for the same period last year. Sales of the Blood Flow Analyzer™ decreased by \$17,000 to \$49,000 or 11% of total revenues, for the six months ended June

30, 2008, compared to net sales of \$66,000, or 10% of total revenues, during the same period in 2007. Sales from the P37 and P37-II A/B Scan Ocular Ultrasound Diagnostic devices decreased by \$78,000 to \$61,000, or 14% of total revenues for the six months ended June 30, 2008, compared to \$139,000 or 21% of total revenues, during the same period in 2007. Sales of the P2200, and P2500 Pachymetric Analyzers, and the P2000 A-Scan Biometric Ultrasound Analyzer decreased by \$28,000 to \$11,000, or 2% of total revenues, for the three month period ended June 30, 2008, compared to \$39,000, or 6% of total revenues, for the same period of 2007. Combined sales of the LD 400 and TKS 5000 Autoperimetry Systems increased by \$78,000 to \$208,000, or 47% of the total revenues, for the six months ended June 30, 2008, compared to \$130,000 or 20% of total revenues, for the same period of 2007.

Sales have been lower during the six months ended June 30, 2008 for the Company due to a variety of reasons. Sales of the P60 UBM Ultrasound Biomicroscope were reduced primarily due to the delayed introduction of new software for the P60, which received FDA 510(k) premarket approval on May 26, 2005, allowing the device to be sold in the United States. The hardware problems have since been resolved and the Company continues to work on improving the software package for the P60.

The Company anticipates reversing the downward trend in sales through additional efforts by the Company to gain more widespread support for the P60 UBM Ultrasound Biomicroscope, the Blood Flow Analyzer™, the LD400 Antoperimetry System, the P37-II Ocular Ultrasound A/B Scan Diagnostics, the 2200 and 2500 Pachymetric Analyzers, the P2000 A-Scan Biometric Ultrasound Analyzer, and the Lace Perg through increased clinical awareness, ongoing product development, improved marketing plans and strategic product replacement, and ongoing development of the LD400 perimeter and the Lace Perg. The Blood Flow Analyzer™ is expected to have a new CPT reimbursement code for Medicare insurance providers issued in 2009, reversing the downward sales trend experienced by the Blood Flow Analyzer™.

Gross profit for the six months ended June 30, 2008 decreased by 2% to 40% of total revenues, compared to 43% of total revenues for the same period in 2007. This decrease in gross profit was mainly due to increased costs of parts and labor. There was no increase to cost of sales as a result of a charge to the reserve for obsolete inventory in 2007.

Marketing and selling expenses increased by \$38,000, or 14%, to \$311,000, for the six months ended June 30, 2008, from \$273,000 for the comparable period in 2007. This increase was due primarily to an increase in training expenses and related travel expenses associated with the introduction of the Lace Perg.

General and administrative expenses decreased by \$12,000, or 2%, to \$484,000 for the six months ended June 30, 2008, from \$496,000 for the comparable period in 2007. This decrease was primarily due to a reduction in salaries as a result of a general reduction in staff.

Also, during the six months ended June 30, 2008, the Company has not been able to collect receivables that were previously allowed in the allowance for doubtful accounts. During the six months ended June 30, 2008, the Company has not increased the allowance for doubtful accounts.

Research, development and service expenses decreased by \$39,000, or 21%, to \$151,000 for the six months ended June 30, 2008, compared to \$190,000 in the same period of 2007. This decrease was mainly due to the completion in the development of the P60 UBM software revision, a reduction of funding available for the marketing of new products, and a reduction of staff.

#### Liquidity and Capital Resources

The Company used \$364,000 in cash in operating activities for the six months ended June 30, 2008, compared to \$720,000 for the six months ended June 30, 2007. The decrease in cash used for operating activities for the six months ended June 30, 2008 was primarily attributable to the Company's net loss and increases in inventory, and a significant decrease of the change of the fair value of derivative liabilities. There was no cash used for investment activities for the six months ended June 30, 2008, compared to no cash used for investment activities for the same period in 2007. Net cash used in financing activities was \$110,000 for the six months ended June 30, 2008, compare to \$1,000,000 in the same period in 2007. The Company had a working capital deficit of \$37,000 as of June 30, 2008. In the past, the Company has relied heavily upon sales of the Company's common and preferred stock to fund operations. There can be no assurance that such equity funding will be available on terms acceptable to the Company in the future.

As of June 30, 2008, the Company had net operating loss carryforwards (NOLs) of approximately \$56 million. These loss carryforwards are available to offset future taxable income, if any, and have begun to expire in 2001 and extend for twenty years. The Company's ability to use net operating loss carryforwards (NOLs) to offset future income is dependent upon certain limitations as a result of the pooling transaction with Vismed and the tax laws in effect at the time of the NOLs being utilized. The Tax Reform Act of 1986 significantly limits the annual amount that can be utilized for certain of these carryforwards as a result of change of ownership.

As of June 30, 2008, the Company had accounts payable of \$544,000, a significant portion of which was over 90 days past due, compared to accounts payable of \$332,000 as of June 30, 2007. The Company has contacted many of the vendors or companies that have significant amounts of payables past due in an effort to delay payment, renegotiate a reduced settlement payment, or establish a longer term payment plan. While some companies have been willing to renegotiate the outstanding amounts, others have demanded payment in full. Under certain conditions, including but not limited to judgments rendered against the Company in a court of law, a group of creditors could force the Company into bankruptcy due to its inability to pay the liabilities arising out of such judgments at that time. In addition to the accounts payable noted above, the Company also has operating lease obligations that require the payment of approximately \$110,000 in 2008, and \$108,000 in 2007.

The Company has taken measures to reduce the amount of uncollectible accounts receivable such as more thorough and stringent credit approval, improved training and instruction by sales personnel, and frequent direct communication with the customer subsequent to delivery of the system. The allowance for doubtful accounts was 32% of total outstanding receivables as of June 30, 2008, compared to 15% of total outstanding receivables as of June 30, 2007.

The Company intends to continue its efforts to reduce the allowance for doubtful accounts as a percentage of accounts receivable. The Company has ongoing efforts to collect a significant portion of the sales price in advance of the sale or in a timely manner after delivery. The Company believes that by requiring a large portion of payment prior to shipment, it has greatly improved the collectibility of its receivables.

The Company carried an allowance for obsolete or estimated non-recoverable inventory of \$244,000 at June 30, 2008 and \$1,320,000 at June 30, 2007, or 21% and 57% of total inventory, respectively. The Company's means of expansion and development of product has been largely from acquisition of businesses, product lines, existing inventory, and the rights to specific products. Through such acquisitions, the Company has acquired substantial inventory, some of which the eventual use and recoverability was uncertain. In addition, the Company has a significant amount of inventory relating to the Photon™ laser system, which does not yet have FDA approval in order to sell the product domestically. Therefore, the allowance for inventory was established to reserve for these potential eventualities.

On a quarterly basis, the Company attempts to identify inventory items that have shown relatively no movement or very slow movement. Generally, if an item has shown little or no movement for over a year, it is determined not to be recoverable and a reserve is established for that item. In addition, if the Company identifies products that have become obsolete due to product upgrades or enhancements, a reserve is established for such products. The Company intends to make efforts to sell these items at significantly discounted prices. If items are sold, the cash received would be recorded as revenue, but there would be no cost of sales on such items due to the reserve that has been recorded. At the time of sale, the inventory would be reduced for the item sold and the corresponding inventory reserve would also be reduced.

At this time, the Company's Photon™ Laser Ocular Surgery Workstation requires regulatory FDA approval in order to be sold in the United States. Any possible future efforts to complete the clinical trials on the Photon™ in order to file for FDA approval would depend on the Company obtaining adequate funding. The Company estimates that the funds needed to complete the clinical trials in order to obtain the necessary regulatory approval on the Photon™ to be approximately \$2,500,000.

#### Effect of Inflation and Foreign Currency Exchange

The Company has not realized a reduction in the selling price of its products as a result of domestic inflation. Nor has it experienced unfavorable profit reductions due to currency exchange fluctuations or inflation with its foreign customers. All sales transactions to date have been denominated in U.S. dollars. The Company has experienced an increase in products being manufactured in England and Italy, and in parts being acquired from the European

Community due to the fluctuations of the dollar compared to the Euro and the Pound Sterling. This has increased the cost of several products. There may be an impact on profits as a result of this decrease in the value of the dollar because the profit margins will decrease if higher product pricing has a negative impact on sales.

#### New Accounting Pronouncements

In February 2007, the Financial Accounting Standards Board ("FASB") issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of Statement No. 115 ("SFAS 159"). SFAS 159 permits companies to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value, and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 is effective on January 1, 2008, and is not expected to have a material effect on the Company's consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations ("SFAS 141R"). SFAS 141R establishes the principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree, and the goodwill acquired. SFAS 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS 141R is effective on January 1, 2009, and is not expected to have a material effect on the Company's consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51 ("SFAS 160"). SFAS 160 will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity. This new consolidation method will significantly change the accounting for transactions with minority interest holders. SFAS 160 is effective on January 1, 2009, and is not expected to have a material effect on the Company's consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities ("SFAS 161"). SFAS 161 amends SFAS 133, Accounting for Derivative Instruments and Hedging Activities to require enhanced disclosures concerning the manner in which an entity uses derivatives (and the reasons it uses them), the manner in which derivatives and related hedged items are accounted for under SFAS 133 and interpretations thereof, and the effects that derivatives and related hedged items have on an entity's financial position, financial performance, and cash flows. SFAS 161 is effective for financial statements of fiscal years and interim periods beginning after November 15, 2008. The Company has not yet determined the effects on its consolidated financial statements, if any, that may result upon the adoption of SFAS 161.

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles ("SFAS 162"). FAS 162 is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board Auditing amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. The statement is intended to improve financial reporting by identifying a consistent hierarchy for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. generally accepted accounting principles (GAAP). The Company has not completed its evaluation of the effects, if any, that SFAS 162 may have on its consolidated financial position, results of operations and cash flows.

### Item 3. Controls and Procedures

#### Disclosures Controls and Procedures

As of the end of the period covered by the quarterly report for the period ended June 30, 2008 the Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the Company's disclosure controls and procedures pursuant to rule 13a-15(b) promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by such report, the Company's disclosure controls and procedures were not effective and adequate because of errors related to the Company not correctly following the requirements of SFAS No. 133 when accounting for the convertible notes and related embedded derivatives in the financial statements and related disclosures of its quarterly report for the period ended June 30, 2008.

#### Management's Annual Report on Internal Control over Financial Reporting

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief financial Officer, the Company conducted an evaluation of the effectiveness of its internal control over financial reporting. Based on the Company's evaluation, the Company's management concluded that the Company's internal control over financial reporting was not effective as June 30, 2008. In particular, the Company's management was not effective in identifying and following new accounting rules and new rules promulgated by the SEC. The remedial plan to correct this material weakness includes management training and the engagement of outside counsel to assist the Company's management in identifying and following such new accounting and SEC rules.

Another material weakness in the Company's internal control over financial reporting was that the Company did not account for the convertible notes and related embedded derivatives in the financial statements and related disclosures in accordance with SFAS No. 133. To correct this material weakness the Company has developed procedures to value these convertible notes and related embedded derivatives in the financial statements and related disclosures and will continue to apply these valuation principles in the future.

#### Inherent Limitations on Effectiveness of Controls

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 risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

## PART II Other Information

### Item 1. Legal Proceedings

An action was brought against the Company on September 11, 2000 by PhotoMed International, Inc. and Daniel M. Eichenbaum, M.D. in the Third District Court of Salt Lake County, State of Utah. The action involves an amount of royalties that are allegedly due and owing to PhotoMed International, Inc. and Dr. Eichenbaum under a license agreement dated July 7, 1993, with respect to the sale of certain equipment, plus costs and attorneys' fees. Certain discovery has taken place and the Company has paid royalties of \$15,717, which the Company believes brings all payments current as of the date of last payment on January 7, 2005. The Company has been working with PhotoMed and Dr. Eichenbaum to ensure that the calculations have been correctly made on the royalties paid as well as the proper method of calculation for the future.

It is anticipated that once the parties can agree on the correct calculations on the royalties, the legal action will be dismissed. An issue in dispute concerning the method of calculating royalties is whether royalties should be paid on returned equipment. Since July 1, 2001, only one Photon™ laser system has been sold and no systems returned. Thus, the amount of royalties due, according to the Company's calculations, is \$981. The Company made payment of this amount to Photomed and Dr. Eichenbaum on January 5, 2005 and, as a result, seeks to have the legal action dismissed. However, if the parties are unable to agree on a method for calculating royalties, there is a risk that PhotoMed and Dr. Eichenbaum might amend their complaint to request termination of the license agreement and, if successful, the Company would lose its right to manufacture and sell the Photon™ laser system.

An action was filed on June 20, 2003, in the Third Judicial District Court, Salt Lake County, State of Utah (Civil No. 030914195) by CitiCorp Vendor Finance, Inc., formerly known as Copelco Capital, Inc. The complaint claims that \$49,626 plus interest is due for the leasing of three copy machines that were delivered to the Company's Salt Lake City facilities on or about April of 2000. The action also seeks an award of attorney's fees and costs incurred in the collection. The Company filed an answer to the complaint disputing the amounts allegedly owed due to machine problems and a claimed understanding with the vendor. The Company returned two of the machines. Due to an assignment, CIT Technology Financing Services I, LLC is the substitute plaintiff. Formal discovery has been in progress. On June 26, 2008, the Company filed a third party complaint against certain entities. A new schedule for the case is being prepared for presentation to the court. Settlement discussions are also in process. The Company believes the claims are without merit and intends to vigorously defend against such action.

The Company is not a party to any other material legal proceedings outside the ordinary course of its business or to any other legal proceedings, which, if adversely determined, would have a material adverse effect on its financial condition or results of operations.

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

Callable Secured Convertible Notes and Warrants

December 19, 2007 Issuance of \$389,010 in Callable Convertible Notes: On December 19, 2007, the Company was notified by the holders of the convertible notes that there was a past due interest owing on the outstanding convertible notes. The total amount of interest owed was \$389,010. To pay this interest, the noteholders were willing to accept \$389,010 in additional convertible notes due on December 31, 2010. Accordingly, on December 19, 2007, the Company issued \$389,010 in convertible notes to the noteholders as full payment of the past due interest.

The \$389,010 in convertible notes bear interest at 2% per annum from December 31, 2007. Interest is computed on the basis of a 365-day year and is payable quarterly in cash, with six months of interest payable up front. The interest rate resets to zero percent for any month in which the stock price is greater than 125% of the initial market price, or \$.0275, for each trading day during that month. Any amount of principal or interest on the callable secured convertible notes that is not paid when due will bear interest at the rate of 15% per annum from the date due thereof until such amount is paid. The convertible notes mature on December 31, 2010, and are convertible into the Company's common stock at the noteholders' option, at the lower of (i) \$.02 or (ii) 50% of the average of the three lowest intraday trading prices for the common stock on the OTC Bulletin Board for the 20 trading days before but not including the conversion date. Accordingly, there is no limit on the number of shares into which the notes may be converted. On June 16, 2008, the Company agreed to reduce the applicable percentage for calculating the conversion price from 60% to 45% of the average of the three lowest intraday trading prices of the Company's common stock. The Company agreed to this change as a condition to receiving further funding for its ongoing operations on June 16, 2008.

The \$389,010 in convertible notes have a call option under the terms of the notes. The call option provides the Company with the right to prepay all of the outstanding convertible notes at any time, provided there is no event of default by the Company and its stock is trading at or below \$.04 per share. An event of default includes the failure by the Company to pay the principal or interest on the convertible notes when due. Prepayment of the convertible notes is to be made in cash equal to either (a) 135% of the outstanding principal and accrued interest for prepayments occurring within 30 days following the issue date of the notes; (b) 145% of the outstanding principal and accrued interest for prepayments occurring between 31 and 60 days following the issue date of the notes; or (c) 150% of the outstanding principal and accrued interest for prepayments occurring after the 60th day following the issue date of the notes.

The noteholders have agreed to restrict their ability to convert their convertible notes and receive shares of the Company's common stock such that the number of shares of common stock held by them in the aggregate and their affiliates after such conversion does not exceed 4.9% of the then issued and outstanding shares of common stock. However, the noteholders may repeatedly sell shares of common stock in order to reduce their ownership percentage, and subsequently convert additional convertible notes, provided, however, that such conversions do not exceed the average daily dollar volume calculated during the ten business days prior to conversion multiplied by the number of trading days of that calendar month, per calendar month.

December 24, 2007 Sale of \$250,000 in Callable Secured Convertible Notes: To obtain further funding for the Company's ongoing operations, the Company entered into a fourth securities purchase agreement on December 24, 2007 with the same four accredited investors for the sale of (i) \$250,000 in callable secured convertible notes and (ii) warrants to purchase 15,000,000 shares of its common stock. The investors disbursed \$250,000 to the Company on December 24, 2007.

Under the terms of the December 24, 2007 securities purchase agreement, the Company agreed that it would not, without the prior written consent of a majority-in-interest of the investors, negotiate or contract with any party to obtain additional equity financing (including debt financing with an equity component) that involves (i) the issuance of common stock at a discount to the market price of the common stock on the date of issuance (taking into account the value of any warrants or options to acquire common stock in connection therewith), (ii) the issuance of convertible securities that are convertible into an indeterminate number of shares of common stock, or (iii) the issuance of warrants during the lock-up period beginning December 24, 2007 and ending on the later of (a) 270 days from December 24, 2007, or (b) 180 days from the date the registration statement is declared effective.

In addition, the Company agreed not to conduct any equity financing (including debt financing with an equity component) during the period beginning December 24, 2007 and ending two years after the end of the above lock-up period unless it first provided each investor an option to purchase its pro-rata share (based on the ratio of each

investor's purchase under the securities purchase agreement) of the securities being offered in any proposed equity financing. Each investor must be provided written notice describing any proposed equity financing at least 20 business days prior to the closing of such proposed equity financing and the option must be extended to each investor during the 15-day period following delivery of such notice.

The \$250,000 in convertible notes bear interest at 8% per annum from the date of issuance. Interest is computed on the basis of a 365-day year and is payable quarterly in cash, with six months of interest payable up front. The interest rate resets to zero percent for any month in which the stock price is greater than 125% of the initial market price, or \$.0275, for each trading day during that month. Any amount of principal or interest on the callable secured convertible notes that is not paid when due will bear interest at the rate of 15% per annum from the date due thereof until such amount is paid. The convertible notes mature in three years from the date of issuance, and are convertible into the Company's common stock at the noteholders' option, at the lower of (i) \$.02 or (ii) 50% of the average of the three lowest intraday trading prices for the common stock on the OTC Bulletin Board for the 20 trading days before but not including the conversion date. Accordingly, there is no limit on the number of shares into which the notes may be converted. On June 16, 2008, the Company agreed to reduce the applicable percentage for calculating the conversion price from 60%, to 45% of the average of the three lowest intraday trading prices of the Company's common stock. The Company agreed to this change as a condition to receiving further funding for its ongoing operations on June 16, 2008.

The \$250,000 in convertible notes are secured by the Company's assets, including the Company's inventory, accounts receivable and intellectual property. Moreover, the Company has a call option under the terms of the notes. The call option provides the Company with the right to prepay all of the outstanding convertible notes at any time, provided there is no event of default by the Company and its stock is trading at or below \$.10 per share. An event of default includes the failure by the Company to pay the principal or interest on the convertible notes when due or to timely file a registration statement as required by the Company or obtain effectiveness with the Securities and Exchange Commission of the registration statement. Prepayment of the convertible notes is to be made in cash equal to either (a) 125% of the outstanding principal and accrued interest for prepayments occurring within 30 days following the issue date of the notes; (b) 130% of the outstanding principal and accrued interest for prepayments occurring between 31 and 60 days following the issue date of the notes; or (c) 145% of the outstanding principal and accrued interest for prepayments occurring after the 60th day following the issue date of the notes.

The warrants are exercisable until seven years from the date of issuance at a purchase price of \$.001 per share. The investors may exercise the warrants on a cashless basis if the shares of common stock underlying the warrants are not then registered pursuant to an effective registration statement. In the event the investors exercise the warrants on a cashless basis, the Company will not receive any proceeds therefrom. In addition, the exercise price of the warrants will be adjusted in the event the Company issues common stock at a price below market, with the exception of any securities issued as of the date of the warrants or issued in connection with the convertible notes issued pursuant to the securities purchase agreement.

The noteholders have agreed to restrict their ability to convert their convertible notes or exercise their warrants and receive shares of the Company's common stock such that the number of shares of common stock held by them in the aggregate and their affiliates after such conversion or exercise does not exceed 4.99% of the then issued and outstanding shares of common stock. However, the noteholders may repeatedly sell shares of common stock in order to reduce their ownership percentage, and subsequently convert additional convertible notes, provided, however, that such conversions do not exceed \$75,000 per calendar month, or the average daily dollar volume calculated during the ten business days prior to conversion multiplied by the number of trading days of that calendar month, per calendar month.

The Company is required to register the shares of its common stock issuable upon the conversion of the convertible notes and the exercise of the warrants that were issued to the noteholders pursuant to the securities purchase agreement the Company entered in to on December 24, 2007. The registration statement must be filed with the Securities and Exchange Commission within 60 days of the December 24, 2007 closing date and the effectiveness of the registration is to be within 135 days of such closing date. Penalties of 2% of the outstanding principal balance of the convertible notes plus accrued interest are to be applied for each month the registration is not effective within the

required time. The penalty may be paid in cash or stock at the Company's option.

June 16, 2008 Sale of \$310,000 in Callable Secured Convertible Notes: To obtain additional funding for the Company's ongoing operations, the Company entered into a fifth securities purchase agreement on June 16, 2008 with three accredited investors for the sale of (i) \$310,000 in convertible notes and (ii) warrants to purchase 10,000,000 shares of its common stock. The sale of the convertible notes and warrants is to occur in three tranches and the investors are obligated to provide the Company with an aggregate of \$310,000 as follows:

\$110,000 were disbursed on June 16, 2008;

\$100,000 were disbursed on July 14, 2008 after the Company filed a Schedule 14A preliminary proxy statement for a reverse stock split with the Securities and Exchange Commission; and

\$100,000 will be disbursed upon the effectiveness of the reverse stock split.

Under the terms of the June 16, 2008 securities purchase agreement, the Company agreed that it would not, without the prior written consent of a majority-in-interest of the investors, negotiate or contract with any party to obtain additional equity financing (including debt financing with an equity component) that involves (i) the issuance of common stock at a discount to the market price of the common stock on the date of issuance (taking into account the value of any warrants or options to acquire common stock in connection therewith), (ii) the issuance of convertible securities that are convertible into an indeterminate number of shares of common stock, or (iii) the issuance of warrants during the lock-up period beginning June 16, 2008 and ending on the later of (a) 270 days from June 16, 2008, or (b) 180 days from the date the registration statement is declared effective.

In addition, the Company agreed not to conduct any equity financing (including debt financing with an equity component) during the period beginning June 16, 2008 and ending two years after the end of the above lock-up period unless it first provided each investor an option to purchase its pro-rata share (based on the ratio of each investor's purchase under the securities purchase agreement) of the securities being offered in any proposed equity financing. Each investor must be provided written notice describing any proposed equity financing at least 20 business days prior to the closing of such proposed equity financing and the option must be extended to each investor during the 15-day period following delivery of such notice.

The \$310,000 in convertible notes bear interest at 8% per annum from the date of issuance. Interest is computed on the basis of a 365-day year and is payable quarterly in cash, with six months of interest payable up front. The interest rate resets to zero percent for any month in which the stock price is greater than 125% of the initial market price, or \$.0275, for each trading day during that month. Any amount of principal or interest on the callable secured convertible notes that is not paid when due will bear interest at the rate of 15% per annum from the date due thereof until such amount is paid. The convertible notes mature in three years from the date of issuance, and are convertible into the Company's common stock at the noteholders' option, at the lower of (i) \$.02 or (ii) 45% of the average of the three lowest intraday trading prices for the common stock on the OTC Bulletin Board for the 20 trading days before but not including the conversion date. Accordingly, there is no limit on the number of shares into which the notes may be converted.

The \$310,000 in convertible notes are secured by the Company's assets, including the Company's inventory, accounts receivable and intellectual property. Moreover, the Company has a call option under the terms of the notes. The call option provides the Company with the right to prepay all of the outstanding convertible notes at any time, provided there is no event of default by the Company and its stock is trading at or below \$.02 per share. An event of default includes the failure by the Company to pay the principal or interest on the convertible notes when due or to timely file a registration statement as required by the Company or obtain effectiveness with the Securities and Exchange Commission of the registration statement. Prepayment of the convertible notes is to be made in cash equal to either (a) 125% of the outstanding principal and accrued interest for prepayments occurring within 30 days following the issue date of the notes; (b) 130% of the outstanding principal and accrued interest for prepayments occurring between 31 and 60 days following the issue date of the notes; or (c) 145% of the outstanding principal and accrued interest for prepayments occurring after the 60th day following the issue date of the notes.

The warrants are exercisable until seven years from the date of issuance at a purchase price of \$.001 per share. The investors may exercise the warrants on a cashless basis if the shares of common stock underlying the warrants are not then registered pursuant to an effective registration statement. In the event the investors exercise the warrants on a cashless basis, the Company will not receive any proceeds therefrom. In addition, the exercise price of the warrants will be adjusted in the event the Company issues common stock at a price below market, with the exception of any securities issued as of the date of the warrants or issued in connection with the convertible notes issued pursuant to the securities purchase agreement.

The noteholders have agreed to restrict their ability to convert their convertible notes or exercise their warrants and receive shares of the Company's common stock such that the number of shares of common stock held by them in the aggregate and their affiliates after such conversion or exercise does not exceed 4.99% of the then issued and outstanding shares of common stock. However, the noteholders may repeatedly sell shares of common stock in order to reduce their ownership percentage, and subsequently convert additional convertible notes, provided, however, that such conversions do not exceed \$75,000 per calendar month, or the average daily dollar volume calculated during the ten business days prior to conversion multiplied by the number of trading days of that calendar month, per calendar month.

The Company is required to register the shares of its common stock issuable upon the conversion of the convertible notes and the exercise of the warrants that were issued to the noteholders pursuant to the securities purchase agreement the Company entered in to on June 16, 2008. The registration statement must be filed with the Securities and Exchange Commission within 60 days of the June 16, 2008 closing date and the effectiveness of the registration is to be within 135 days of such closing date. Penalties of 2% of the outstanding principal balance of the convertible notes plus accrued interest are to be applied for each month the registration is not effective within the required time. The penalty may be paid in cash or stock at the Company's option.

#### Adjustable Conversion Price of Convertible Notes

The callable secured convertible notes are convertible into shares of the Company's common stock at a 55% discount to the trading price of the common stock prior to the conversion. The significant downward pressure on the price of the common stock as the noteholders convert and sell material amounts of common stock could encourage short sales by investors. This could place further downward pressure on the price of the common stock. The noteholders could sell common stock into the market in anticipation of covering the short sale by converting their securities, which could cause further downward pressure on the stock price. In addition, not only the sale of shares issued upon conversion or exercise of notes, warrants and options, but also the mere perception that these sales could occur, may have a depressive effect on the market price of the common stock.

#### Possible Dilution to Stockholders

The issuance of shares upon conversion of convertible notes and exercise of warrants may result in substantial dissolution to the interests of other stockholders since the holders of the convertible notes may ultimately convert and sell the full amount issuable upon conversion. Although the noteholders may not convert their callable secured convertible notes and/or exercise their warrants if such conversion or exercise price would cause them to own more than 4.99% of the Company's outstanding common stock, this restriction does not prevent the noteholders from converting and/or exercising some of their holdings and then converting the rest of their holdings. In this way, the noteholders could sell more than this limit while never holding more than this limit. There is no upper limit on the number of shares that may be issued, which will have the effect of further diluting the proportionate equity interest and voting power of holders of the Company's common stock.

#### Item 3. Defaults Upon Senior Securities

None

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

At the Special Meeting of Shareholders held on April 14, 2008, the proposed amendment to the Company's Certificate of Incorporation to increase the authorized shares of the Company's common stock from 800,000,000 shares to 1,400,000,000 shares was approved (with 421,231,530 shares voting for and 155,802,572 shares voting against the proposed amendment and 288,586 abstaining, out of 765,984,307 shares outstanding as of the record date on March 4, 2008).

#### Item 5. Other Information

None

#### Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

The following Exhibits are filed herewith pursuant to Rule 601 of Regulation S-B or are incorporated by reference to previous filings.

31

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## Exhibit

No.	Document Description
2.1	Amended Agreement and Plan of Merger between Paradigm Medical Industries, Inc., a California corporation and Paradigm Medical Industries, Inc., a Delaware corporation(1)
3.1	Certificate of Incorporation(1)
3.2	Amended Certificate of Incorporation
3.3	Bylaws(1)
4.1	Specimen Common Stock Certificate (2)
4.2	Specimen Series C Convertible Preferred Stock Certificate(3)
4.3	Certificate of the Designations, Powers, Preferences and Rights of the Series C Convertible Preferred Stock(3)
4.4	Specimen Series D Convertible Preferred Stock Certificate (4)
4.5	Certificate of the Designations, Powers, Preferences and Rights of the Series D Convertible Preferred Stock(5)
4.6	Certificate of Designations, Powers, Preferences and Rights of the Series G Convertible Preferred Stock (6)
10.1	Exclusive Patent License Agreement with PhotoMed(1)
10.2	1995 Stock Option Plan (1)
10.3	April 2005 Securities Purchase Agreement with AJW Partners, LLC, AJW Offshore, Ltd., AJW Qualified Partners, LLC, and New Millennium Capital Partners II, LLP (the "Purchasers")(7)
10.4	Form of Convertible Note with each Purchaser(7)
10.5	Form of Stock Purchase Warrant with each Purchaser(7)
10.6	Security Agreement with Purchasers(7)
10.7	Intellectual Property Security Agreement with Purchasers(7)
10.8	Registration Rights Agreement with Purchasers(7)
10.9	Employment Agreement with Raymond P.L. Cannefax(8)
10.10	February 2006 Securities Purchase Agreement with AJW Partners, LLC, AJW Offshore, Ltd., AJW Qualified Partners, LLC, and New Millennium Capital Partners II, LLP(9)
10.11	Form of Callable Secured Convertible Note with each Purchaser(9)
10.12	Form of Stock Purchase Warrant with each Purchaser(9)
10.13	Security Agreement with Purchasers(9)
10.14	Intellectual Property Security Agreement with Purchasers(9)
10.15	Registration Rights Agreement with Purchasers(9)
10.16	Settlement Agreement with Dr. Joseph W. Spadafora (10)
10.17	Worldwide OEM Agreement with MEDA Co., Ltd. (11)
10.18	Second Amendment to the Registration Rights Agreement dated April 27, 2005 (12)
10.19	Second Amendment to the Registration Rights Agreement dated February 28, 2006 (12)
10.20	June 2007 Securities Purchase Agreement with AJW Partners, LLC, AJW Offshore, Ltd., AJW Qualified Partners, LLC, and New Millennium Capital Partners L1, LLP (13)
10.21	Form of Convertible Note with each Purchaser (13)
10.22	Form of Stock Purchase Warrant with each Purchaser (13)
10.23	Security Agreement with Purchasers (13)
10.24	Intellectual Property Agreement with Purchasers (13)
10.25	Registration Rights Agreement with Purchasers (13)
10.26	December 2007 Securities Purchase Agreement with AJW Partners, LLC, AJW Offshore, Ltd., AJW Qualified Partners, LLC, and New Millennium Capital Partners II, LLP (14)
10.27	Form of Convertible Note with each Purchaser (14)
10.28	Form of Stock Purchase Warrant with each Purchaser (14)
10.29	Security Agreement with Purchasers (14)
10.30	Intellectual Property Agreement with Purchasers (14)
10.31	Registration Rights Agreement with Purchasers (14)

- 10.32 Agreement with Equity Source Partners, LLC
- 10.33 Distribution Agreement with LACE Elettronica srl
- 31.1 Certification pursuant to 18 U.S.C. Section 1350, as enacted by Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification pursuant to 18 U.S.C. Section 1350, as enacted by Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbane's-Oxley Act of 2002
- 32.2 Certification 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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- (1) Incorporated by reference from Registration Statement on Form SB-2, as filed on March 19, 1996.
  - (2) Incorporated by reference from Amendment No. 1 to Registration Statement on Form SB-2, as filed on May 14, 1996.
  - (3) Incorporated by reference from Annual Report on Form 10-KSB, as filed on April 16, 1998.
  - (4) Incorporated by reference from Registration Statement on Form SB-2, as filed on April 29, 1999.
  - (5) Incorporated by reference from Report on Form 10-QSB, as filed on August 16, 2000.
  - (6) Incorporated by reference from Report on Form 10-QSB, as filed on November 14, 2003.
  - (7) Incorporated by reference from Current Report on Form 8-K, as filed on May 18, 2005.
  - (8) Incorporated by reference from Current Report on Form 8-K, as filed on January 18, 2006.
  - (9) Incorporated by reference from Current Report on Form 8-K, as filed on March 1, 2006.
  - (10) Incorporated by reference from Registration Statement on Form SB-2, as filed on June 15, 2006.
  - (11) Incorporated by reference from Current Report on Form 8-K, as filed on June 19, 2006.
  - (12) Incorporated by reference from Registration Statement on Form SB-2, as filed on April 16, 2007.
  - (13) Incorporated by reference from Report on Form 10-QSB, as filed on August 17, 2007.
  - (14) Incorporated by reference from Current Report on Form 8-K, as filed on January 7, 2008.

(b) Reports on Form 8-K

Current report on Form 8-K, as filed on May 16, 2008.

Current report on Form 8-K, as filed on June 2, 2008.

SIGNATURES

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.

PARADIGM MEDICAL INDUSTRIES, INC.

October 14, 2008

/s/ Raymond P.L. Cannefax  
Raymond P.L. Cannefax  
President and Chief Executive Officer

October 14, 2008

/s/ Luis A. Mostacero  
Luis A. Mostacero  
Chief Financial Officer, Treasurer and Secretary