

NEW MEXICO SOFTWARE, INC
Form 10KSB/A
June 15, 2006

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-KSB/A

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

SECURITIES EXCHANGE ACT OF 1934

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

EXCHANGE ACT OF 1934

FOR FISCAL YEAR ENDED

DECEMBER 31, 2005

COMMISSION FILE #333-30176

NEW MEXICO SOFTWARE, INC.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

NEVADA

(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)

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91-1287406

(IRS EMPLOYER IDENTIFICATION NUMBER)

5021 Indian School Road, Suite 100

Albuquerque, New Mexico 87110

(505) 255-1999

(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)(ZIP CODE)

(505) 255-1999

(REGISTRANT S TELEPHONE NO., INCLUDING AREA CODE)

NMXS.COM, INC.

(FORMER NAME, FORMER ADDRESS AND FORMER FISCAL YEAR,

IF CHANGED SINCE LAST REPORT)

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

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

CHECK WHETHER THE ISSUER IS NOT REQUIRED TO FILE REPORTS PURSUANT TO SECTION 13 OR 15 (d) OF THE EXCHANGE ACT. ()

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

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

INDICATE BY CHECK MARK WHETHER THE REGISTRANT IS A SHELL COMPANY (AS DEFINED IN RULE 12b-2 OF THE EXCHANGE ACT).

YES NO

REVENUES FOR YEAR ENDED DECEMBER 31, 2005: \$1,399,000

AGGREGATE MARKET VALUE OF THE VOTING COMMON STOCK HELD BY NON-AFFILIATES OF THE REGISTRANT AS OF MARCH 28, 2006, WAS: \$ 7,975,497

NUMBER OF SHARES OF THE REGISTRANT'S COMMON STOCK OUTSTANDING AS OF MARCH 28, 2006 IS: 56,263,421

DOCUMENTS INCORPORATED BY REFERENCE

Proxy statement pursuant to the annual shareholder meeting of September 30, 2005.

Transitional Small Business Disclosure Format YES NO

PART I

ITEM 1. DESCRIPTION OF BUSINESS

BUSINESS - OUR COMPANY

Our History and Background

New Mexico Software, Inc., was originally incorporated under the laws of the state of New Mexico in April 1996. The privately held company was involved in a reverse merger with Raddatz Exploration, Inc. on August 3, 1999, and the corporate name was changed to NMXS.com, Inc., with New Mexico Software, Inc. becoming a wholly-owned subsidiary. NMXS.com, Inc. went public at that time. NMXS was quoted on the OTC Bulletin Board under the symbol NMXS and on the Berlin Stock Exchange with the symbol NM9. In 2004 we filed an alternate name registration in the state of Delaware to use the name New Mexico Software. On January 1, 2006, NMXS.com, Inc merged into its newly incorporated, wholly-owned subsidiary, New Mexico Software, Inc., a Nevada corporation, for the purpose of changing its state of incorporation and its name. The new stock symbol on the OTC Bulletin Board is NMXC .

In April 2000, we acquired Working Knowledge, Inc., a Kansas corporation. Working Knowledge became our wholly-owned subsidiary which provided services necessary to prepare, enter, and maintain the customer's data in our software.

New Mexico Software, Inc. develops and markets a range of proprietary Internet-based software products for digital asset management. Our software can assist the customer in the conversion of documents or images into digital media, and the storage, organization, retrieval and search of documents, high-resolution graphic images, video clips and audio recordings. In addition, we provide related services such as software hosting and maintenance, database management and consulting. At this time, Working Knowledge, Inc. includes the healthcare division, which is centered around the product XR-EXpress. XR-EXpress is software that allows medical providers to store, organize and access a variety of patient medical images.

Our Products

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

Every industry shares the need to track, organize and distribute information efficiently and accurately. Our products bridge the gap between the paper and digital worlds and reduce dependence on paper files. Working with paper files takes time and money, and going digital cuts costs and eliminates wasted effort.

In addition to organizing and archiving, our products allow a company to control access to and dissemination of its digital files. They also have the security controls necessary to protect information and meet legal obligations. Because they are intuitive and web-based, they require no special software or training.

Our core technology is called the Roswell Information Chain Management System (Roswell ICM). Roswell ICM optimizes the movement of information throughout an enterprise, its clients, its suppliers and its partners. As a core product, it is sold only as a highly customized enterprise-level system. Roswell ICM offers extensive file management capabilities which allow information to be intelligently organized so that any particular item can be instantly located. In addition, it allows the customer to track and control the entire flow of information.

Our second product is called XR-EXpress. It is a secure, web-based software that allows medical providers to store, organize and access patient medical images such as x-rays, EKG s, MRI s, CT s, and ultrasounds. It instantly delivers images to radiologists over the Internet; the radiologist then diagnoses the case and returns the results, cutting the time

it takes for a patient to receive a diagnosis. XR-EXpress is structured and delivered as a hosted model, reducing the customer's need for technology and capital investment.

DFC3 (Digital Filing Cabinet) is our third enterprise-level product. DFC3 allows the customer to find the right document at the right time, whether it's an invoice, contract, legal brief, logo or other image. It easily converts paper documents to digital format, and every word of every document is searchable with Optical Character Recognition and DFC3's advanced search engine. Security is tailored to the customer—the customer determines who has access to what information. We market DFC3 with several plans ranging from a hosted application to enterprise servers to accommodate a variety of customers. In all plans the main user interface for DFC3 is a web browser, which makes it accessible and more intuitive to a greater number of users. It can be used on Windows, Macintosh or Linux operating systems.

During 2006 New Mexico Software will offer two new products: TORC and Rodeo. TORC is a backup server that provides a backup and disaster recovery solution for every notebook or desktop on a company's network. It allows users to create an exact image of a hard disk, which is then uploaded to the TORC server. Subsequent backups are incremental, backing up only changed files. Backups are scheduled automatically, providing security for the customer. TORC will be offered as a stand-alone or hosted model.

In 2006 New Mexico Software will be introducing a new content management system that is going to be called Rodeo. Rodeo will round up content from a hard drive and build a dynamically controlled web site similar to the website of New Mexico Software. Rodeo Content Management will interface with the Digital Filing Cabinet (DFC3) to maintain and categorize the assets for a web site.

During the fall of 2004 we launched three new desktop products. The three products, Santa Fe, White Sands, and Taos, further extend our document and image management capabilities, as well as the potential for market penetration. During the fourth quarter of 2005 we discontinued the sales of White Sands because its technology was included in the DFC3 software.

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

Taos is a digital photo database application. It provides a low-cost image database solution for organizing, cataloging, and searching for images based on their color or shape. The Taos software provides enhanced photo editing, and it allows images to be tagged with "hot words" and exported to other popular database and image formats.

Our Technology

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

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Our technology is based on Open Source. Open Source is source code from independent programmers who build applications and release their source code in the public interest. By integrating Open Source programs into our technology, we are able to reduce development time and costs, thereby providing well-built, low-cost products for the digital management market. In addition, the code that we deliver to customers is compiled. When software code is compiled it is difficult to use the code to create a similar program, even though the code we create originates from Open Source. This provides better protection and security of our products.

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

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

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

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

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

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

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

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

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

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

We are continuing to develop our core products using a mix of readily available Open Source software development tools. Knowledgeable competitors may be able to deduce how we have assembled our code base and be able to develop competing products. The principal advantage in utilizing Open Source tools is the extremely high degree of portability they ensure. Migrating our products from one operating system or hardware base to another is more easily accomplished by avoiding proprietary development tools. The risk factor inherent in the use of such freely available tools is the fact that a sophisticated competitor might be able to imitate our work and produce similar functionality. Any such imitation, should it occur, could have material adverse effects on our business, operations, and financial condition.

Business Strategy

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

One competitive strategy we are using is offering our enterprise-level products as hosted applications. By hosting our applications, we are able to provide the customer with a customized product that is maintained by us, which eliminates the customer's need for an information technology staff. We provide the hardware, connectivity, maintenance, technical support, and automatic backups of the customer's data. In addition, now that our core product has been completed, our cycle time (the time required to get a new customer up and running) is greatly reduced. We are often

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able to accommodate new customers, even those with complex databases, in a matter of weeks. We believe that our strategy to provide hosted applications coupled with our custom system design capabilities provide us with a diversity of competitive market penetration opportunities.

Our main business strategy for the coming year is to take advantage of the current accelerated growth of the digital asset management aspect of the information technology industry. In order to accomplish this strategy, we will emphasize direct marketing of our products and building our reseller channels in order to effect broader market penetration and to increase revenues.

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

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

Marketing and Customers

Our marketing focus to date has been in three principal fields. Approximately 70% of our clients have been in the entertainment industry, approximately 10% have been in the medical field, and approximately 10% have been government agencies. In the fourth quarter 2004, we began marketing our desktop software products to a wide retail market, which, along with several customers in various other industries, encompasses the other 10%. In 2005 we began marketing our XR-EXpress software to medical clients; currently that customer base is expanding at the rate of several new customers per month. In the second half of 2005 we began marketing DFC3 to customers in the small to mid-level revenue range. These customers are in several different industrial segments, and we anticipate that this product will continue to have broad applications across a variety of industries.

With the marketing of these new products our customer base for recurring revenues at the end of 2005 has increased by approximately 50% over the number of recurring customers at the end of 2004. Although a high percentage of our revenue still comes from a few customers, we believe that as we retain current clients and gain new clients, our reliance on a small number of customers will continue to decrease. In addition, while our enterprise-level products will continue to depend on a relatively small number of customers, we expect an expanded customer base for our XR-Express and DFC3 products, and a wider retail base for our desktop products. Overall, we anticipate that our customer base will continue to broaden in the next year with the marketing of our medical and consulting practice, giving more stability and predictability to our revenues.

Our Intellectual Properties

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

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

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

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

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

Copyrights and Trademarks

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

Government Regulation

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

There are currently few laws and regulations directly applicable to the Internet. It is possible that a number of laws and regulations may be adopted with respect to the Internet covering issues such as user privacy, pricing, content, copyrights, distribution, antitrust and characteristics and quality of products and services. The growth of the market for online commerce may prompt calls for more stringent consumer protection laws that may impose additional burdens on

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companies conducting business online. Tax authorities in a number of states are currently reviewing the appropriate tax treatment of companies engaged in online commerce, and new state tax regulations may subject us to additional state sales and income taxes.

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

Employees

As of March 30, 2006, we had 17 full-time staff, including 7 in systems engineering and quality assurance; 6 in sales and marketing; and 4 in administration.

ITEM 2. DESCRIPTION OF PROPERTY

We currently lease a 3,000 square foot facility in Albuquerque, New Mexico, at a cost of approximately \$4,000 per month. The lease expires on April 30, 2009. The facility houses our administrative, marketing and engineering offices, and provides adequate room for expansion. It also contains an advanced telephone system which will provide the capability needed to provide adequate customer telephone support. Our servers are located in a separate facility downstairs from ours, and the two locations are networked together by fiber optics. In this facility we have access to a large power generator, which enables our servers to continue operating during power outages.

In March 2005, we leased approximately 400 square feet of office space in Santa Monica, California, to house the scanning and site development operations. Monthly lease payments were \$1,400. The lease expired on February 28, 2006, and at that time we discontinued the California site and absorbed those activities into the Albuquerque site.

ITEM 3. LEGAL PROCEEDINGS

Internal Revenue Service Payments: In October 2003 we entered into an interim agreement with the Internal Revenue Service concerning the repayment of federal tax deposits which we failed to pay for the six operating quarters ended September 30, 2003. We agreed to pay and did pay \$5,000 per month toward the past due tax obligation beginning November 1, 2003. On September 1, 2005 we negotiated a final settlement with the IRS. We agreed to pay \$25,000 per month until the total balance of \$358,000 has been paid. The balance owed at December 31, 2005 including penalties and interest is \$262,000.

On March 28, 2006 Avodah Publishing, Inc. filed a complaint in District Court in New Mexico for Breach of Contract. They are requesting \$20,000 plus interest, attorney's fees and court costs pursuant to an advertising contract.

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

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

No matters were submitted to a vote of the security holders during the fourth quarter ended December 31, 2005.

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PART II**ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS****Market Information**

Our stock has historically been quoted on the OTC Bulletin Board under the symbol NMXS. When we merged NMXS.com, Inc. with New Mexico Software on January 1, 2006 our new symbol became NMXC. The table below sets forth, for the periods indicated below, our high and low sales prices. These quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not necessarily represent actual transactions.

	<u>Quarter</u>	<u>High</u>	<u>Low</u>
FISCAL YEAR ENDED	First	\$1.07	\$0.41
DECEMBER 31, 2004	Second	\$0.78	\$0.22
	Third	\$0.46	\$0.22
	Fourth	\$0.28	\$0.13
FISCAL YEAR ENDED	First	\$0.505	\$0.135
DECEMBER 31, 2005	Second	\$0.25	\$0.134
	Third	\$0.16	\$0.098
	Fourth	\$0.13	\$0.098

Shareholders

As of March 28, 2006, there were 341 holders of record of our common shares.

Dividends

We did not declare any cash dividends on our common stock during the year ended December 31, 2005. We have no plans to pay any dividends to the holders of our common stock in 2006.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS**OVERVIEW**

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All three industries that affect New Mexico Software (digital asset management, open-source software and the Internet) have been in existence for approximately a decade or less. As relatively new industries, they are characterized by high growth, but also with intense competition and rapid changes. These characteristics cause uncertainties as well as inconsistent results for the individual companies operating within those industries.

The qualitative analysis recommended by Standard & Poors in their Industry Survey *Computers: Consumer Services & the Internet* is useful in determining the value of our enterprise beyond the current results of operations. We believe that our competitive positioning as a solution provider for a wide variety of industries, our entrepreneurial structure, and our ability to quickly convert new ideas into marketable products provide value beyond what can be seen in the financial statements.

One of the challenges of operating in these industries is being able to create a balance between sustaining a consistent vision and business strategy and yet maintaining the flexibility required to adapt to the rapidly changing market conditions. We believe that our product structure allows us to do that. Since our core technology is useful to literally any company that manages digital assets and has access to Internet browser functions, it is the backbone of our product framework. As such, it provides the consistency and stability aspect of the business strategy. The next generation of our products primarily consists of derivative products, new technological combinations, and enhancements to the core product. These have the advantage of taking an extraordinarily short time to develop into a marketable product

(sometimes in as little as a few months). This aspect of our product structure provides the flexibility necessary to be able to respond quickly to new market opportunities.

Our goals for the coming year are to build our reseller channels in order to effect broader market penetration, as well as to educate potential customers about the benefits of digital asset management. We believe that the current accelerated growth of the information technology industry in the area of digital asset management provides us with an excellent opportunity for revenue growth.

We presently realize revenues from three primary sources: (i) software sales and license fees; (ii) software hosting and maintenance services; and (iii) custom programming. We also occasionally realize revenues from scanning services, hardware sales when the hardware is sold together with the software, and occasionally from other services. To date, license fees and software sales have been directly related. With each sale of our enterprise-level products, the end user enters into a license agreement for which an initial license fee is paid. The license agreement also provides that in order to continue the license, the licensee must pay an annual software maintenance fee for which the party receives access to product upgrades and bug fixes or product patches. Software maintenance consists primarily of hosting and managing our customers' data on our servers, as well as technical support programs for our products. This hosting and licensing structure will continue with both our Roswell, XR-EXpress, and DFC3 products; therefore, we anticipate a positive impact on software sales and licenses, software maintenance, and custom programming revenues from sales of these products.

Scanning services to date have been performed principally at our site in Santa Monica, California. In February 2006 that site was shut down and those functions were absorbed into the Albuquerque site. Management has determined that scanning services will be reserved in the future primarily for existing customers and customers of our core products. We don't anticipate that scanning services will be a significant part of our future revenues.

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

Revenue Recognition

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The Company derives revenues from three main activities: the sale of software licenses to end users, software hosting and maintenance contracts, and software licenses that require us to provide significant production, customization or modification to our core software product. The Company also derives revenue from scanning services, hardware sales, XR-EXpress customer usage fees, and from services such as installation, training and consulting.

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

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

Should the sale of its software involve an arrangement with multiple elements (for example, the sale of a software license along with the sale of maintenance and support to be delivered over the contract period), the Company allocates revenue to each component of the arrangement using the residual value method based on the fair value of the undelivered elements. The Company defers revenue from the arrangement equivalent to the fair value of the undelivered elements and recognizes the remaining amount at the time of the delivery of the product or when all other revenue recognition criteria have been met. Fair values for the ongoing maintenance and support obligations are based upon separate sales of renewals of maintenance contracts. Fair value of services, such as training or consulting, is based upon separate sales of these services to other customers.

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

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

Maintenance contract revenue and tech support revenue also are recognized on a straight-line basis over the life of the respective contracts, as this format best approximates the timing of the services rendered per paragraph 57 of SOP 97-2. If a maintenance or support contract is sold as part of a contract with multiple elements, the amount allocated to the maintenance portion is based on VSOE of fair value, which is the price charged for the services when they are sold separately. The Company typically charges 17% to 21% of the software purchase price for a 12-month maintenance contract with discounts available for longer-term agreements. The complexity of the software determines the percentage that is charged to any individual customer, and that percentage remains consistent upon renewal unless there is a change in the software or the terms of the agreement.

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

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

We follow the guidance in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* for custom software development arrangements that require us to provide significant production, customization or modification to our core software. Revenue is generally recognized for such arrangements under the percentage of completion method. Under percentage of completion accounting, both the product license and custom software development revenue are recognized as work progresses based on specific milestones in accordance with

paragraphs 85 through 91 of SOP 97-2. We believe that project milestones based on completion of specific tasks provide the best approximation of progress toward the completion of the contract. If custom programming services are sold as part of a contract with multiple elements, a portion of the contract revenue is allocated to the custom programming services based on VSOE of fair value. VSOE for custom programming services is determined based on the price charged for these services when they are sold separately. At December 31, 2003 and December 31, 2004, there were no custom software development arrangements in progress.

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

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

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

Income Taxes

Management evaluates the probability of the utilization of the deferred income tax assets. The Company has estimated a \$10,699,000 deferred income tax asset at December 31, 2005, related primarily to net operating loss carryforwards at December 31, 2005. Management determined that because the Company has not yet generated taxable income it was not appropriate to recognize a deferred income tax asset related to the net operating loss carryforward. Therefore, the fully deferred income tax asset is offset by an equal valuation allowance. If the Company begins to generate taxable income, we may determine that some, if not all of the deferred income tax asset may be recognized. Recognition of the asset could increase after tax income in the future. Management is required to make judgments and estimates related to the timing and utilization of net operating loss carryforwards, utilization of other deferred income tax assets, applicable tax rates and feasible tax planning strategies.

Goodwill

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

Stock Based Compensation

The Company grants stock awards and stock options to employees and non-employees as consideration for services. Management believes that the best indicator of value for stock awards is the trading value of the shares of stock on the date the Company enters into the agreements. For non-employees, that date is generally the date on which the company is committed to such an agreement. At times the Company may grant stock

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as payment for accrued but unpaid payroll. In these cases, the Company values the shares at the trading price on the date they are granted and reduces the payroll accrual by the same amount. We have elected to apply the intrinsic value method prescribed in APB No. 25 for stock options granted to employees. For options granted to non-employees, we estimate the value of those awards using the Black-Scholes option pricing model.

Contingencies

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

The Company is paying past due federal payroll taxes of approximately \$262,000 (including estimated penalties and interest) at a rate of \$25,000 per month based on a final agreement with the IRS. The Company has accrued interest and penalties on this past due amount pursuant to notices from the IRS.

Software Development Costs

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

RESULTS OF OPERATIONS

A summary of operating results for the twelve months ended December 31, 2005 and 2004 is as follows:

	2005		2004		
	Amount	% of Revenue	Amount	% of Revenue	
Revenues	\$ 1,399,000	100.0	% \$ 1,018,000	100.0	%
Cost of service	583,000	41.7	% 374,000	36.7	%
Gross profit	816,000	58.3	% 644,000	63.3	%
General & administrative	1,348,000	96.4	% 992,000	97.4	%
Research & development	215,000	15.4	% 207,000	20.3	%
Bad Debt Expense	61,000	4.3	% 0	0.0	%
Net operating (loss)	(808,000)	) (63.6	)% (555,000)	) (61.8)%
Other income (expense)	(240,000)	) (11.3	)% (148,000)	) (7.2)%
Net income (loss)	(1,048,000)	) (74.9	)% (703,000)	) (69.0)%
Earnings (loss) per share	\$(0.03)	)	\$(0.02))	

Revenues: Total revenues increased 37.4%, or \$381,000, for the year ended December 31, 2005, as compared to the same period in the prior year (the comparable prior year period). These revenues were primarily generated from the following three revenue streams:

1. Revenues generated by software sales and licenses increased 38%, or \$148,000, for the year ended December 31, 2005, as compared to the comparable prior year period. This increase was mostly attributable to several large software sales during 2005 as compared with one large sale in 2004. We anticipate that sales of software based on our Roswell technology will increase slightly over the next two years; however, since it is a highly customized enterprise-level system, its sales are characterized by a small number of contracts with much higher revenues than our other products.

As a result, its sales growth will most likely be inconsistent from one quarter to the next. Sales of Roswell, however, will be balanced by sales of our XR-EXpress and DFC3 products, which are easily adaptable to small and medium-sized companies. Revenues from these products will be driven more by volume, providing balance for the more expensive enterprise products which provide only a few contracts per year. We are not currently emphasizing sales of our desktop products, although we will continue to sell and support Santa Fe and Taos as customers request them.

2. Revenues from software hosting and maintenance increased 27% or \$87,000 for the year 2005 as compared to the comparable prior year period. This increase is due to the addition of several new hosting agreements during 2005. Software hosting and maintenance averaged approximately \$34,000 per month during 2005 as compared with \$27,000 per month during 2004. Software maintenance consists mainly of hosting and managing our customers' data on our systems, and to a lesser extent includes technical support programs associated with our products. We will continue hosting for various existing clients and for our Roswell, XR-EXpress and DFC3 customers. Based on the response to our new products during 2005, management anticipates that revenues from software hosting and maintenance will increase in the coming year, although it is not possible to predict the rate of increase until we have been actively marketing the products for some time.

3. Custom programming revenue increased 340%, or \$214,000, for the year ended December 31, 2005, as compared to the comparable prior year period. This increase was primarily due to the fact that we recognized revenue on two custom programming contracts during 2005, and we had no major custom programming contracts during 2004. Our Roswell technology is only available as a highly customized enterprise-level product. In addition, approximately 10% of the customers that purchase our other products will require customization, and we continue to offer this service. Based on this history, we anticipate that custom programming projects associated with new product purchases will continue to provide revenues in this category, although there is no assurance they will remain at this level. We also continue to offer programming services for customer database integration, and for other projects for our existing customers. Therefore, we anticipate that this revenue source will remain steady in the coming year.

We also generated revenue from scanning services, hardware sales, XR-EXpress customer usage fees and other services. Our long-term scanning project with a major movie studio was completed near the end of 2005, and we had no additional scanning projects during the year. Although we still offer scanning, we are not emphasizing this service, and we have no active projects at this time. As a result, we anticipate that scanning services will not be a significant source of revenue for us in the coming year. All hardware sales were associated with sales of our XR-EXpress and DFC3 software. We provide options for these products that include hardware for customers who need the complete system, but we do not emphasize hardware sales, therefore it is a less significant element in our revenue stream.

Cost of Services. Cost of services increased 55.9%, or \$209,000, for the year ended December 31, 2005, as compared to the comparable prior year period. Approximately \$178,000 (85%) of this increase is attributable to additional personnel costs and contract services for our engineering staff. The remainder of the increase is related to the cost of additional engineering supplies and the cost of additional bandwidth for our internet connections. During the current year, approximately 85% of our cost of sales consists of salaries, contract services and other personnel-related expenses for our engineering staff. We consider these expenses to be directly associated with our ability to generate revenues, however, they do not vary with revenues in that much of those costs are fixed. As a result, the gross margin percent will vary as sales vary.

For the year ended December 31, 2005, cost of services as a percentage of revenues was 41.7%, as compared with 36.7% for the comparable prior year period. Although revenues in 2005 increased 37% from 2004, cost of services increased almost 56% over the prior year, which results in a lower gross margin increase for the same period. Management anticipates that as revenues increase in the coming year, the cost of goods and services required to support those revenues will continue to increase, and engineering salaries will also increase as we hire additional staff to support a greater number of products and customers. However, we expect that revenues will increase at a greater rate than cost of services, since most of our costs are relatively fixed. Cost of services for the last two years has averaged approximately 40% of revenues. We believe this range of percentages over the last two years is more indicative of the percentage of costs associated with future revenues, but until we have been in the active marketing phase for a longer period, management is unable to yet determine to what extent this percentage may change in the future.

General and Administrative. General and administrative expenses increased 36.0%, or \$356,000, for the year ended December 31, 2005, as compared to the comparable prior year period. Although we have streamlined our administrative expenses appreciably during the last two years, our marketing goals for 2005 and 2006 require that we increase spending in several areas. As a result there were two significant items that made up this increase in 2005. The first is staffing costs (56% of the increase) due to the hiring of additional sales and marketing staff, plus increased compensation-related costs such as health insurance. The other significant increase is advertising (44% of the increase). Both of these increases directly relate to our goals to develop our reseller channels and broaden our market penetration for our products.

For the year ended December 31, 2005, general and administrative expenses as a percentage of revenues was 96.4%, as compared with 97.4% for the comparable prior year period. We believe that this high ratio is more indicative of the fact that revenues are not yet where we would like them to be than it is of administrative expenses being too high. We anticipate that the ratio of general and administrative costs to revenues will decrease in the future because revenues will increase at a greater rate than general and administrative costs, but until we have been in the active marketing phase for a longer period, management is unable to yet determine to what extent this percentage may change in the future.

Research and Development. Research and development expenses increased 3.9%, or \$8,000, for the year ended December 31, 2005, as compared to the comparable prior year period. Taking into account a one-time \$30,000 write-off of deposits in the fourth quarter of 2004, the actual increase is approximately \$38,000 for 2005. This increase is entirely related to staffing costs.

During 2005, over 90% of our research and development costs are directly associated with staffing. In the software industry it is common for research and development costs to be ongoing, since development of the next version of the software begins as soon as the current version is completed. In addition, we are constantly developing new applications for our existing software which require modification. Management anticipates that research and development costs in the future will focus both on the upgrading of our existing products and the continued development of new products using our core technology; therefore they will remain relatively steady or increase slightly in the coming year.

Other Income. Interest expense increased 116.4%, or \$85,000 for the year ended December 31, 2005, as compared to the comparable prior year period. This increase was due to the accrual of an additional \$120,000 in penalties and interest on the outstanding payroll tax obligation pursuant to a statement from the IRS after the final settlement with them. Interest on other long-term obligations has decreased from approximately \$2,000 per month at the beginning of 2005 to approximately \$600 per month at the end of the year as a result of payment plans that reduced the balances owed on these obligations.

Other expense also increased \$7,000, which was a combination of two factors. The first factor is an increase of \$82,000 due to the settlement of the Manhattan Scientifics and Grossman legal issues in the first quarter of 2006. This \$82,000 represents the conclusion of these issues. The second factor is a decrease of \$75,000 due to the write-off of goodwill during 2004. There was no loss on disposal of fixed assets during the year 2005.

In general, our key indicator of operating progress is still gross revenue. For the years ending December 2005 and 2004, personnel-related expenses have accounted for approximately 55% of our total operating expenses, with fixed costs such as building and equipment rent, utilities, insurance, communications and depreciation accounting for an additional 10%. The only personnel-related costs that are directly variable with sales are those associated with custom programming, because they are directly billable. This means that over 65% of our expenses are relatively fixed. All of the remaining expenses vary, but less than 5% varies directly with sales. Until we have been marketing our products consistently for a certain period of time, gross revenue will remain the best gauge of our progress.

REPORTABLE SEGMENTS

On January 1, 2005, we reorganized our company's segments to more clearly reflect the company's direction and growth. In addition to having a variety of products and services available, we have formulated a business strategy for the next two years that will take advantage of opportunities to market these products. Our current business strategy is to

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form up to twenty joint venture projects over the next two to three years. These joint venture projects would be formed to develop, market and distribute various digital lifecycle management applications built around our core Roswell technology.

In the past, Working Knowledge, Inc. provided data maintenance services related to the NMS digital asset management system. We have absorbed the data maintenance services into New Mexico Software, and redefined Working Knowledge, Inc. to include those product divisions for which we are forming the joint venture projects. Therefore, at this time, Working Knowledge, Inc. includes the healthcare division, which is centered around the product XR-EXpress. Information related to the Company's reportable segments for the nine months ended December 31, 2005 is as follows:

	2005 NMS	WKI
Revenue	\$ 1,302,000	\$97,000
Cost of services	533,000	50,000
General and administrative	1,340,000	8,000
Research and development	213,000	2,000
Bad Debt	61,000	
Operating income (loss)	(845,000)	37,000
Total assets	\$ 1,002,000	\$47,000

In the year ended 2004, XR-EXpress and the healthcare division did not exist. Therefore, only 2005 data is reflected in the table, since no comparison is available.

Liquidity and Capital Resources

As of December 31, 2005, cash and cash equivalents totaled \$157,000, representing a \$157,000 increase from the beginning of the period. The increase in available cash was due to a combination of several factors during the year.

Operating activities used \$343,000 of cash for the year ended December 31, 2005, as compared to \$107,000 for the comparable prior year period, an increase of \$236,000. This increase in operating funds used was mainly due to our operating loss for 2005, partially offset by the issuance of common stock for salaries and outside services. The barter transactions effected in 2005 caused in a net decrease in operating cash flow of \$448,000, but will result in positive net cash flow in 2006 as we use the available advertising credits without impacting cash.

Although we continued to reduce our notes and taxes payable during 2005, this activity was offset by additional interest accrued on the tax obligation and additional attorney fees owed due to the settlement of the two lawsuits, resulting in only a slight decrease in current liabilities during 2005.

The following table shows current balances and payment details of our obligations as of December 31, 2005:

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	<u>Dec 31 Balance</u>	<u>Negotiated Payment</u>	<u>Payment Frequency</u>
<u>Notes Payable:</u>			
Los Alamos National Bank note + interest	89,000	25,000	semiannually
Demand notes	13,000		
<u>Past due payroll taxes:</u>			
New Mexico payroll taxes	9,000	1,000	monthly
IRS + estimated penalties & interest	262,000	25,000	monthly
Legal Settlements	150,000	25,000	monthly
Other payables and accrued expenses	180,000		
Subscriptions payable	117,000		
Accrued payroll and deferred revenue	<u>214,000</u>		
Total Liabilities per Balance Sheet	1,034,000		

Based on our payment plans and our progress over the last six months, we anticipate that our liabilities will be reduced by approximately 40% by the end of 2006.

Investing activities used \$26,000 for the year ended December 31, 2005, as compared to \$16,000 for the comparable prior year period. The increase in the cash used for investing activities for the current period was due to the purchase of equipment to provide additional data facilities and security for our customers.

Financing activities provided \$526,000 in cash for the year ended December 31, 2005, as compared to \$112,000 for the comparable prior year period. This increase was due to an increase in issuance of common stock for cash during the year ended 2005. During the year we issued over six million shares of common stock for gross proceeds of approximately \$600,000.

During the year ended December 31, 2005, we have had two barter transactions totaling \$600,000 for the sale of software to Forbes.com in return for advertising credits. These transactions are in addition to \$135,000 of advertising remaining from a prior barter transaction, which was used during the fourth quarter of 2005. Although no schedule has been determined (nor is one required by the agreement), we anticipate using the remaining advertising credits during 2006. Since the advertising agreements were barter transactions, the sale of the software will not directly generate cash. This results in a short-term negative impact on cash flow since we won't be collecting cash for that transaction. However, it will allow us to advertise our new products in the coming year without expending cash, which will result in a long-term positive impact on cash flow as it will contribute to revenue generation.

In these barter transactions we transferred customized software to the customer in return for print advertising. Paragraph 2 of the Minutes of the 11/18/93 Meeting on EITF Issue 93-11 specifically refers to the transfer of non-monetary assets such as inventory in return for barter credits used to purchase goods and services such as advertising. Paragraph 7 of those Minutes states that it should be presumed that the fair value of the non-monetary asset exchanged is more clearly evident than the fair value of the barter credits received and that the barter credits should be reported at the fair value of the non-monetary asset exchanged. The software and customization was valued at the same price it would have been valued if it had been sold for cash, so no impairment was recorded before the asset was transferred. The revenue was recognized when the software was transferred to the customer in accordance with paragraph 8 of SOP 97-2, and a corresponding receivable for the barter credits was recorded at that time. During the third quarter of 2005, the receivable was reclassified as prepaid advertising. The advertising expense will be recognized as the ads are placed. The value of any remaining barter credits will be reviewed at the end of each fiscal year for possible impairment, and any such impairment loss will be recorded at that time.

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At December 31, 2005, we had an outstanding balance on a line of credit with Los Alamos National Bank (LANB) which was originally due on July 24, 2002. The outstanding principal amount due at that date was \$300,000, plus interest of \$10,545. We negotiated a three month extension on the repayment of the outstanding balance of the line of credit by reducing the principal amount of the debt with the payment of \$50,000 and the payment of the interest due on July 24, 2002. The note was extended until April 24, 2003 by paying \$25,000 of the principal amount due and \$4,555

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in interest due on October 24, 2002. On April 24, 2003, we paid \$12,224 of principal and \$12,768 of interest, and we negotiated another six-month extension to October 20, 2003. On October 20, 2003 we negotiated an extension of the amount due until April 23, 2004 by paying \$25,000 in principal and \$7,500 in interest. On March 27, 2004 the note was extended until October 15, 2004 upon payment of \$25,000 of principal and approximately \$6,000 of interest. On October 4, 2004 the note was extended until April 15, 2005 upon payment of \$25,000 of principal and approximately \$6,000 of interest. In May 2005, we paid \$25,000 of principal and approximately \$5,000 of interest, and the remaining balance was extended until October 15, 2005. In October 2005, we paid \$25,000 of principal and approximately \$5,000 of interest, and the remaining balance was extended until April 15, 2006. The outstanding principal balance was \$88,035 at December 31, 2005. The company has the necessary cash to continue to reduce the note under these circumstances. Our inability to retire this debt, negotiate an extension of the payment amount and/or date, or obtain an alternative loan would likely have a material negative impact on our business, and could impair our ability to continue operations if the bank foreclosed on the note. However, the bank has continued to extend the note six months at a time, providing we pay an agreed-upon amount of principal and interest at the time of the extension. We believe that LANB will continue to work with us in this manner.

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

At December 31, 2005 we had working capital of \$15,000 as opposed to a working capital deficit of \$500,000 at the end of 2004. This increase is primarily due to a reduction in notes payable as well as the barter transactions which generated advertising credits during 2005. We have incurred operating losses and negative cash flows for the past two fiscal years that have been funded through the issuance of additional equity securities. Approximately 35% of our cash flow for 2005 was funded by the sale of equity securities during the year. We expect our focus on direct sales and the establishment of reseller channels to have a significant positive impact on revenues during 2006. As a result, we believe that we will be generating positive cash flow from operations by the end of 2006. We may also continue to sell equity securities and incur debt as needed to meet our operating needs, especially in the first half of 2006. In addition, we may continue to issue equity compensation to employees and outside consultants to meet payroll and pay for needed legal and other services.

We anticipate that our primary uses of cash in the next year will be allocated to continue to satisfy delinquent obligations and for general operating purposes. Based on cash flow projections, our working capital requirements for the next twelve months will be approximately \$1,000,000 - \$1,500,000. We are currently generating working capital from recurring revenues of approximately \$55,000 per month, and our goal is to be funding our operating requirements entirely from revenues by the end of 2006.

We have received a non-binding letter of intent from a fiduciary trust, In God We Trust, to invest up to \$500,000 in the company through December 31, 2006. These funds, if made available, would provide additional working capital necessary for operations over the next twelve months and to retire long-term debt and past-due payroll taxes if needed. The letter of intent does not require the investor to fund. If we are not able to raise funds through sales of products and services, sales of stock or debt, and the funds from this investor are also not obtainable, the company may have to drastically reduce its size and operations, and could possibly have to cease operations. To date, we have not received any financing from this investor, because we have been able to raise any needed financing through other means. However, we have had a long-term relationship with this investor and believe that the investor has the willingness and wherewithal to provide funds should our cash requirements exceed our abilities to generate cash elsewhere.

ITEM 7. FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and Board

of New Mexico Software, Inc.:

We have audited the accompanying consolidated balance sheets of New Mexico Software, Inc. and subsidiaries as of December 31, 2005 and 2004 and the related statements of operations, stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of New Mexico Software, Inc. and subsidiaries as of December 31, 2005 and 2004, and the consolidated results of its operations and cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ Epstein, Weber & Conover, PLC

Scottsdale, Arizona

March 27, 2006

New Mexico Software, Inc. and Subsidiaries

Consolidated Balance Sheets

(Rounded to the nearest thousand)

	For the years ended December 31,	
	2005	2004
Assets		
Current assets:		
Cash and equivalents	\$ 157,000	\$
Accounts receivable, net	151,000	298,000
Inventory	50,000	7,000
Prepaid expenses and other assets	607,000	161,000
Total current assets	965,000	466,000
Furniture, equipment and improvements, net	71,000	85,000
Security deposits	13,000	11,000
	\$ 1,049,000	\$ 562,000
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	\$ 152,000	\$ 111,000
Legal settlements payable	150,000	
Accrued expenses	437,000	459,000
Deferred revenue	77,000	86,000
Subscriptions payable	105,000	130,000
Notes payable	101,000	276,000
Total current liabilities	1,022,000	1,062,000
Stockholders equity/(deficit):		
Preferred stock, \$0.001 par value, 500,000 shares authorized, 75 and 135 shares issued and outstanding as of 12/31/05 and 12/31/04, respectively		
Common stock, \$0.001 par value, 200,000,000 shares authorized, 50,916,041 and 32,834,458 shares issued and outstanding as of 12/31/05 and 12/31/04, respectively	51,000	33,000
Additional paid-in capital	10,994,000	9,279,000
Deferred compensation	(319,000)	(161,000)
Accumulated (deficit)	(10,699,000)	(9,651,000)
Total stockholders equity/(deficit)	27,000	(500,000)
	\$ 1,049,000	\$ 562,000

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

New Mexico Software, Inc. and Subsidiaries

Consolidated Statements of Operations

(Rounded to the nearest thousand)

	For the years ended December 31,	
	2005	2004
Revenue		
Software sales and licenses	\$ 539,000	\$ 391,000
Software hosting and maintenance	410,000	323,000
Custom programming	277,000	63,000
Scanning services	114,000	181,000
Hardware sales	48,000	58,000
XR-EXpress report fees	8,000	
Other	3,000	2,000
	1,399,000	1,018,000
Operating costs and expenses:		
Cost of services	583,000	374,000
General and administrative	1,348,000	992,000
Research and development	215,000	207,000
Bad debt	61,000	
Total operating costs and expenses	2,207,000	1,573,000
Net operating income/(loss)	(808,000)	(555,000)
Other income (expense):		
Interest (expense)	(158,000)	(73,000)
Impairment of goodwill		(75,000)
Legal settlement	(82,000)	
Total other income (expense)	(240,000)	(148,000)
Net income(loss)	\$(1,048,000)	\$(703,000)
Earnings (loss) per share - basic and fully diluted	\$(0.03)	\$(0.02)
Weighted average number of common shares outstanding - basic and fully diluted	40,539,127	30,744,304

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

New Mexico Software, Inc. and Subsidiaries

Consolidated Statements of Stockholders' Equity

(Rounded to the nearest thousand)

	Preferred Stock		Common Stock		Additional	Deferred	Accumulated	Total
	Shares	Amount	Shares	Amount	Paid-in Capital	Compensation	(Deficit)	Stockholders' Equity
Balance, December 31, 2003	135	\$	29,392,256	\$29,000	\$8,861,000	\$(135,000)	\$(8,948,000)	\$(193,000)
Issuance of common stock for services			90,000		22,000			22,000
Issuance of common stock for services to be rendered			1,425,000	1,000	85,000	(86,000)		
Cash received for exercise of warrants								
Compensation earned						60,000		60,000
Cancellation of common stock for bonus correction			(22,500)		(9,000)			(9,000)
Issuance of common stock for cash			243,000	1,000	60,000			61,000
Issuance of common stock for exercise of warrants/options			345,000	1,000	50,000			51,000
Issuance of common stock for cashless exercise of warrants			309,000					