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UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

**Form 10-K**

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

For the fiscal year ended December 31, 2006

Or

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

Commission file number: 1-31949

**INX Inc.**

*(Exact name of Registrant as specified in its charter)*

**Delaware**  
*(State of Incorporation)*

**76-0515249**  
*(I.R.S. Employer  
Identification No.)*

**6401 Southwest Freeway**  
**Houston, TX**  
*(Address of principal executive offices)*

**77074**  
*(Zip code)*

**Registrant's telephone number: (713) 795-2000**

**Securities registered pursuant to section 12(b) of the Act:**

| <u>Title of Each Class</u>        | <u>Name of Each Exchange on Which Registered</u> |
|-----------------------------------|--|
| Common stock, par value \$0.01    | Nasdaq Capital Market                            |
| Warrants to purchase common stock | Nasdaq Capital Market                            |

**Securities registered pursuant to Section 12(g) of the Act:**

**None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

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

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, and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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. (Check one):

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

The aggregate market value of the voting stock held by non-affiliates of the registrant, based upon the closing price of the common stock on June 30, 2006 as reported on the Nasdaq Capital Market was approximately \$26,342,388.

The number of shares of common stock, \$0.01 par value, outstanding as of February 28, 2007 was 6,671,444.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the definitive Proxy Statement for the registrant's 2007 Annual Meeting of Shareholders have been incorporated by reference into Part III of this Annual Report on Form 10-K.

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**INX Inc.**  
**FORM 10-K**  
**For the Year Ended December 31, 2006**

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NOTE: Amounts are presented in thousands except per share and par value in all parts of this Form 10-K except in the Exhibits, unless otherwise stated.

## PART I

### Item 1. *Business*

#### Special Notice Regarding Forward-Looking Statements

This report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 relating to future events or our future financial performance including, but not limited to, statements contained in “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations.” Readers are cautioned that any statement that is not a statement of historical fact, including but not limited to, statements which may be identified by words including, but not limited to, “anticipate”, “appear”, “believe”, “could”, “estimate”, “expect”, “hope”, “indicate”, “intend”, “likely”, “may”, “might”, “plan”, “potential”, “seek”, “should”, “will”, “would”, and other variations or negative expressions thereof, are predictions or estimations and are subject to known and unknown risks and uncertainties. Numerous factors, including factors that we have little or no control over, and factors that we may not be able to anticipate, may affect our actual results and may cause actual results to differ materially from those expressed in the forward-looking statements contained herein. In evaluating such statements, readers should consider the various matters identified in “Item 1. Risk Factors”, which are some of the factors that could cause actual events, performance or results to differ materially from those indicated by such statements.

#### General

We are a provider of IP communications solutions for enterprise-class organizations such as corporations, schools and federal, state and local governmental agencies. We provide solutions based primarily on Cisco Systems, Inc. (“Cisco”) technology and provide our customers with implementation and support services. We believe that our focus and expertise enables us to better compete in the markets that we serve. Because we have significant experience implementing and supporting the critical technology building blocks of Internet Protocol (“IP”) telephony systems for enterprises, we believe we are well positioned to deliver superior solutions and services to our customers.

The convergence of data, voice, and video into a single seamless IP communications infrastructure is increasingly responsible for driving business benefits through improved business operations. The foundation of a converged communication platform is a robust, secure, high-performance, high-availability IP network infrastructure. As part of our commitment to full life-cycle solutions for our customers, we are dedicated to excellence not only in IP telephony voice communications but also in the underlying network infrastructure components upon which IP telephony depends.

The IP communications solutions we offer are “Cisco-centric,” meaning they are based primarily on the products and technology of Cisco. These solutions include design, implementation and support of LAN/WAN routing and switching, IP telephony, voice over IP (“VoIP”), network security, network storage and wireless networks. We offer a full suite of advanced technology solutions that support the entire life-cycle of IP communications. Our solutions are designed with the complete life-cycle of our customer’s IP communications infrastructure in mind. Within a finite set of practice areas, we have standardized our design, implementation, and post-implementation support processes to drive a reliable and scalable solution that can be tailored to meet the business objectives of our clients. Because of our substantial experience and technical expertise in the design, implementation and support of IP communications solutions, we believe we are well-positioned to take advantage of what we believe to be a growing trend of implementation by enterprise organizations of IP telephony and VoIP technology, and the use by enterprise organizations of the IP network as the platform for all forms of communications.

The market for IP communications solutions is extremely competitive. We compete with larger and better financed entities. We currently have thirteen physical offices, which are located in Texas, California, Idaho, Louisiana, New Mexico, Oregon, Washington and Washington DC. We primarily market to enterprise-class organizations headquartered in or making purchasing decisions from markets that we serve with branch offices. We plan to continue to expand to additional markets throughout the U.S. by establishing additional branch offices in other markets, either by opening additional new offices or through acquisition.

We derive revenue from sales of both products and services. Our product sales consist primarily of sales of Cisco brand products. Our services revenues are derived from two principal types of services: professional services that include design and implementation engineering services, and post-sale support services, which consist of remote monitoring and managed services for enterprise network infrastructure, which we offer through our NetSurant branded service offering. In 2006, 2005 and 2004, sales of products made up 86.7%, 88.1% and 91.2% of total revenue and services revenues made up 13.3%, 11.9% and 8.8% of total revenue.

## **Industry**

### ***IP Telephony and Convergence***

IP telephony is a general term for an existing and rapidly expanding technology that uses an IP network to perform voice communications that have traditionally been conducted by conventional private branch exchange (“PBX”) telephone systems used by enterprises and by the public switched telephone network (the “PSTN”). IP telephony uses IP network infrastructure, such as a local area network (“LAN”) or a wide area network (“WAN”) to replace the telephony functions performed by an organization’s PBX telephone system. “Convergence” is a term generally used to describe the manner in which voice and video communications technology is converging with data communications onto the IP network. “IP communications” is a term generally used to describe data, voice and video communications using an IP network. In addition to offering potential long-term cost savings, implementation of IP telephony allows enterprises to reap other benefits of participating in the growing trend of convergence.

In the traditional enterprise communications model, different types of communication have been conducted by different means:

- data communication has been performed using LAN/WAN IP network infrastructure, including the Internet;
- telephone/voice communication has been conducted using traditional circuit-switched PBX systems and the PSTN; and
- video communications have often been accomplished using stand-alone video conferencing systems using either multiple circuit-switched telephone lines over the PSTN or using data network communications.

In contrast, the converged communications model enables data, voice and video to be carried by a single IP network infrastructure. Converged IP telephony and data communication over IP network infrastructures is already being used by many enterprises, and the trend is building rapidly.

Today, implementation of converged IP telephony and data communications networks can offer both significant long-term cost savings and increased productivity to enterprises. Among the potential long-term savings that an enterprise might experience are:

- elimination of redundant traditional telephone line circuits and cabling systems as internal voice communications move to the enterprise’s IP-based network cabling system;
- reduced cost resulting from consolidation of PSTN circuits to a central location so that all external communications to and from the enterprise occur through fewer or only one point of interface to the PSTN;
- more efficient support of telephone and data functions by a single support organization rather than multiple service providers and in-house support departments;
- simplified administration and lower costs for moves, adds and changes of the telephone system because an IP telephony handset can be moved or changed within an enterprise without rewiring the PBX or re-programming the telephone number as is required in a conventional PBX system; and
- elimination or reduction of long distance toll charges as enterprises operating a converged solution move their internal voice communications to the fixed-cost data network that often already exists between the enterprise’s remote facilities.

IP telephony as implemented by most enterprises often requires upgraded or new IP network infrastructure. Older networks designed solely for data communications are inadequate to accommodate IP telephony functions featuring the quality of telephony service demanded by most customers. To meet the demands of voice communications

delivered across an IP network, the network infrastructure must be able to distinguish between data communication packets and voice communication packets. It must also be capable of prioritizing and allocating the use of system resources between voice and data to achieve the quality of service required for voice and video communications.

As the use of IP telephony has become more prevalent over the past few years, the IP network technology environment has evolved, and we believe it will continue to evolve. Enterprise-class organizations today demand more from their IP network than ever before. Traditionally, network infrastructure was focused on achieving connectivity as its initial goal of networking. Now that reliable, quality connectivity has been achieved, business requirements have surpassed the desire for mere connectivity. IP-based voice, wireless communications, and network security represent a new breed of network-based applications that will position the IP network infrastructure to perform higher level, more complex problems and positively impact business productivity.

Until recently, the networking industry has treated network operations as “a sum of individual parts” that have not operated holistically. The approach has been to create point product solutions through the creation of individual products, uniquely designed to solve single problems, one at a time. These products, each with their unique design, have demanded individual administration, management, maintenance, sparing, and optimization that has created a challenging and expensive infrastructure.

We believe that over the coming years IP network infrastructure will move toward a technology environment in which there is a dependency between the component parts of the network that maintain relationships through time and change; a fully cooperating system that is flexible, stable, and predictable and more easily managed.

As a result of recently adding deterministic technologies to the IP network, the networking industry has begun to take its first unified steps toward building a system of products that more fully cooperate in their mission of moving payloads across an arrangement of networks. This has required that the IP network infrastructure evolve from route-specific performance to endpoint-to-endpoint performance, from route-level resiliency to service-level resiliency and from box-level management to system-wide management.

We believe that as the network evolves to perform higher-level functions the complexity of the IP network infrastructure, by necessity, will increase. As the network becomes more complex, the role of network architecture design, business process-mapping, policy decision making, implementation and ongoing service and support play increasingly important roles.

### ***The Evolution to the “Business Ready Network”***

We believe the IP network is evolving into what we refer to as a “business ready network” environment. By evolving from network architectures comprised solely of interacting devices to architectures that provide pervasive services and then to fully application-aware infrastructures, the corresponding business value grows from simply offering essential services to a network that enables and ultimately optimizes the organization.

The initial stage of the evolution towards the business ready network involves providing business essential functionality through a network of converged infrastructure “synergistic devices.” The network architecture during this current phase contains synergistic devices that must be fully interoperable and based on open standards and protocols in order to build a foundation upon which further phases of the business ready network can be built. During this phase of network evolution the network of devices must be fully functional, bringing to bear the full range of capabilities necessary for the business’ communications needs. As the network becomes the focal point of mission-critical communications and applications it must be fully available, with minimal downtime.

The network must also be converged. It is no longer feasible or practical to operate and maintain separate infrastructures for data, voice and video communications. A converged network not only brings these services onto a common IP-based network, but also opens the door for the next phases of the evolution by providing network characteristics such as quality of services to all applications riding on the network.

In a second phase of the evolution towards the business ready network, which we believe is beginning now, the network infrastructure begins to incorporate what we call “pervasive services” that truly become “business enabling” rather than simply providing business essential services. By our definition, a “business ready network” is integrated, accessible, flexible, transparent and highly secure. Network technologies such as security, storage,

voice and wireless are what we refer to as pervasively available network services. They are services that are available to, and needed by, many other resources on the network.

In a future phase of network evolution, we believe the IP network will become the application delivery platform of choice. In this phase, in which the network infrastructure is characterized by being aware, collaborative, and borderless, applications take full advantage of the network to provide business optimizing solutions. The power of pervasive services is further enhanced as applications become fully aware of their availability and can thereby inherently take advantage of these services to optimize the way business gets done. By breaking applications out of their individual silos of data and functionality and enabling them to be collaborative, business workflows and processes become much more meaningful and efficient. In this future phase of network evolution, the IP network enables applications to become “borderless” in a number of ways, including the virtualization of resources such as storage, CPU and computer memory residing anywhere on the network as well as the breaking down of borders between business process and their dependant information

### ***Converged Infrastructure***

The Business Ready Network is built on a foundation of devices that are specifically built to move and deliver payloads across a system of networks in a predictable manner. Deterministic payloads such as voice and video are being combined with data over IP network infrastructure to consolidate network costs and overlaps. As the network becomes more of an integrated and robust machine and less merely a number of components joined together, infrastructure design is evolving from one that is based on “point” solutions to one that operates at a “system” level. Previous specialized components, such as routers and switches, are no longer adequate to perform at a route-level resiliency but must evolve to operate at a service-level resiliency. Device-level management, therefore, must be system-wide. The integration of the traditional data network infrastructure and the call-flow layer required to enable voice on the network has enabled a system that is more aware, more capable and more empowered to cooperate with itself and the resources attached to it.

Once an organization’s voice communications is placed on the IP network its data network becomes its voice communications network. The “IP telephony” systems, including management systems, voice gateways, and messaging systems, are not only easier to set up than traditional PBX telephone system features, they save time and boost productivity. VoIP is commonly an enterprise organization’s first move toward a converged solution.

Unified messaging solutions allow a user to decide how and when they will receive messages. Unified messaging allows for retrieval of any communication form by any method, such as accessing voice messages from a computer or text e-mail, converted to speech, over the phone. This provides a greater level of control over communications, improving organizational productivity. Unified messaging is typically an enterprise organization’s second move toward a more completely converged solution.

Video communications that are seamlessly integrated into voice communications recently became available and are becoming more feasible, but are not yet popular, in part because video communications require more expensive endpoints (telephone handsets) and uses substantial network bandwidth. Over time, as network bandwidth improves and as high quality touch screen video endpoints become less expensive, we believe that integrated voice and video communications will become more popular.

### ***Pervasively Available Network Services***

Network technologies such as security, storage, voice and wireless are what we refer to as pervasively available network services. They are services that are available to, and needed by, many other resources on the network. A network that provides more efficient and flexible use of the resources attached to it is one that is more closely tied to, aware of, and responsive to the needs of its applications and devices. Today, service-level innovation baselines include: IPv6, quality-of-service (“QOS”), multicasting, network security and network management. Each of these services exists to provide an extension throughout the network that globally supports an organization’s storage, wireless and IP communications initiatives.

## Security

Network security is progressively moving from a tertiary issue to a central component of information and communications technology architecture. Traditionally, much of the focus has been on securing the network edge through firewalls on Internet and Extranet connections. But business and technology drivers are dictating that security, like other services, be applied pervasively throughout the entire network infrastructure. Among the issues facing enterprise organizations today are the following:

- The ease with which attacks can be initiated through freely available tools. These attacks are as likely to come from inside the network as they are from the Internet.
- The increased number of users utilizing laptops and other mobile devices that may become infected while outside the controls of the network further complicates security issues once mobile users reconnect within the network, behind the firewall.
- In order to support mobile users, organizations are deploying more and more wireless solutions that create another network access point easily compromised by malicious users if not secured properly.
- While more difficult to exploit than wireless networks, unused network ports that are not properly secured are another potential network access point available to zealous hackers that are able to physically connect to such ports.
- Many organizations want to grant limited access to guests, consultants, and others while protecting their critical infrastructure from these “less trusted” users.
- There is an increasing trend towards criminal activity via network attacks; it is no longer an issue of only “industrial espionage” or vandalism.
- As security needs increase, the complexity of security solutions increases, requiring well designed solutions.
- Many organizations have policies driven by regulatory and compliance requirements (such as HIPPA and Sarbanes-Oxley) that dictate enhanced security stances.

Pervasive security solutions address these needs by weaving security throughout the information and communications technology infrastructure that go beyond the network edge in a number of ways. By making “policy enforcement points” ubiquitous and managing them centrally the security architecture can be designed to meet far wider threat characteristics than traditional designs. As users and systems are authenticated at the edge of the network their access can be appropriately designed for their requirements. Pervasive security systems allow the proper individuals to access the proper resources while guarding those same resources against accidental or deliberate compromise, and the consequent loss of access, and do so in an efficiently managed manner. As security becomes pervasive throughout the IP network architecture it is no longer a separate requirement but rather something that every device performs to some greater or lesser degree.

## Storage

Pervasive storage solutions are an essential component of a business ready network. Business continuance embodies the necessity and ability to efficiently consolidate data and manage, replicate, and mirror information in order to eliminate points of failure that occur during downtime or loss of information. To meet this challenge, technology is evolving from storage that is directly attached to and incorporated within a server and other forms of isolated storage networks to converged and intelligent network storage solutions delivering substantial performance and cost benefits. The need for improved productivity as well as regulatory requirements have accelerated the need for enterprise organizations to protect data, rapidly recover applications, and maintain uninterrupted access to information. This has caused storage requirements to grow at a dramatic pace as business process continues to depend on its applications.

Information, or data, can be classified by criticality, age, and the level of accessibility required. Such a lifecycle-oriented management approach allows an organization to prioritize and make intelligent decisions about the logistics and economics of how to manage different data types. This architecture enables operational

efficiencies of data and applications by providing intelligence embedded in the network infrastructure, and provides flexibility of data access integrated into the network.

### Voice

To the extent that voice is integrated into every part of the network, the role of voice also extends across that network. Already part of video conference and telephone conversations, voice will become part of e-mail, documents, and Web URLs distributed inside and outside of an organization. This means creating a new standard for business applications. Voice communications will no longer sit on top of the network as a separate application but will be woven into the fabric of the network. Just as a word processing or e-mail application is aware of the qualities of a URL and can enable such URL to open a web browser that will redirect the user to specific information, so will voice become embedded into applications as a level of business logic. The result is a network that enhances efficiency of communication by allowing all of the communication devices within it to become easily available.

### Wireless

Wireless connectivity to the IP network, as it continues to proliferate within offices, Wi-Fi hotspots in airports, coffee shops, and even on public transportation, is now becoming a mainstream service. This fact is demonstrative of Internet connectivity transpiring to a pervasive service. Although wireless solutions are becoming as readily available as electrical power and phone service, deployment of these pervasive wireless networks through the enterprise still presents a myriad of challenges.

The ease of access to a wireless network, while beneficial for public hotspots, becomes a challenge in securing against unauthorized usage while still providing appropriate levels of access for legitimate users. Likewise, the low-cost and low-complexity of consumer wireless products increases the likelihood that user's will create unsecured wireless networks by simply connecting an access point to an open port on an enterprise organization's network. Within the complexity of an organization, different classes of security must be established to differentiate between internal systems for authorized uses and basic Internet access to guests.

Increased availability of advanced IP network services that demand QOS, such as VoIP and IP telephony on Wi-Fi capable devices, demand QOS on wireless networks. Roaming throughout a building or campus must not only be secure, but seamless. Management of large scale wireless deployments can quickly become unwieldy, especially if access points are deployed as individually configured devices and not as an integrated, centrally managed system. Many organizations have policies driven by regulatory and compliance requirements (such as HIPPA, FIPS compliance and Sarbanes-Oxley) that dictate advanced security requirements for wireless networks. Pervasive wireless solutions meet the needs of the enterprise in providing secure, ubiquitous network access by making the wireless network a seamless extension of the entire network infrastructure.

## **Our Business**

We serve enterprise-class organizations to intelligently deploy advanced networking technologies in a way that maximizes their investments. We are a top provider of Cisco's advanced technology solutions, both in terms of the volume of these technologies deployed and in terms of positive customer experiences as evidenced by Cisco's customer satisfaction surveys. We design, implement and support, for our enterprise-class organization customers, IP network routing and switching, VoIP, network security, network storage, wireless and other advanced network technologies.

As one of the earliest entrants to VoIP integration and support, we have successfully deployed and supported IP telephony solutions for a large and diverse customer base. We offer a complete range of products and services for Cisco-centric IP telephony solutions. Until approximately two years ago, most IP telephony solutions work we performed for customers involved our customer testing the technology rather than full-scale implementation of IP telephony. As the market for IP telephony solutions for enterprises continues to mature from testing to full scale deployment, we believe that offering a comprehensive range of products and services to our customers will be critical in differentiating us from our competitors.

## ***Products***

We generate revenue from the sale of products. The products we sell consist principally of network infrastructure components manufactured by Cisco, including routing and switching equipment, and related Cisco software, including Cisco Call Manager IP telephony software. We also offer other manufacturer's products to augment Cisco technology, including storage solution products from Network Appliance and EMC and software applications from various third party providers.

Recently we began developing, manufacturing and offering our own "custom IP products" based on Cisco technology, which we are marketing under the trade name Routestep™ Communications, but we have not yet generated any material revenue from these new products. These custom IP products are specialized products made to address highly specialized requirements of specific market segments. We believe we will be able to generate higher gross margins on sales of our custom IP products, as compared to the gross margin resulting from our reselling other manufacturer's products, if and when we begin generating revenue from sales of these products. There can be no assurance that we will be successful marketing these new products.

Gross margin on product sales was 18.6%, 15.7% and 16.6% for 2006, 2005 and 2004, respectively. Product sales revenue grew 43.1%, 45.0% and 65.6%, and made up 86.7%, 88.1% and 91.2% of total revenue in 2006, 2005 and 2004, respectively.

## ***Services***

We generate services revenue by providing services to our customers. We provide two basic categories of service, implementation services and post-sale support services. Gross margin on services revenue was 25.9%, 29.2% and 33.4% for 2006, 2005 and 2004, respectively. Services revenue grew 62.3%, 103.0% and 48.6%, and made up 13.3%, 11.9% and 8.8% of total revenue in 2006, 2005 and 2004, respectively.

### *Design and Implementation Services*

We design and implement Cisco-centric IP communications solutions. These solutions include design, implementation and support of VoIP, LAN/WAN routing and switching, network security, and wireless networks, as well as support services other than our NetSurant® long-term support services discussed separately below. To provide these services, we employ highly trained network engineering staff, who are trained and experienced in both large, complex network infrastructure technology as well as Cisco IP telephony technology. We have developed not only expertise in the area of enterprise IP telephony solutions and converged communications, but also methodologies for designing and implementing large, complex, converged communications infrastructures for enterprise-class organizations.

During 2001 and 2002, as the move towards IP telephony technology by enterprises began to develop, the majority of our customer engagements were limited to the installation of pilot projects in which our customers tested the technology. These types of projects required long selling cycles, substantial pre-sale involvement by skilled engineers and significant IP network design and upgrade services. Our IP telephony implementation services were a comparatively small component of the total services we provided in these pilot projects because our customers were implementing only relatively small "test" sites. These projects were characterized by sporadic services revenue and generally depressed gross margin for our services because significant amounts of our engineering staff time was utilized in "pre-sales" support activities showing the customer that the technology worked. Additionally, our engineering staff was often not fully utilized between projects during this period. During 2003 and 2004 customers began to adopt IP telephony technology and we began to perform full implementations of the technology, which has resulted in our ability to more fully employ our engineering staff. During 2005 we saw what we believe to be the beginnings of the movement towards what we call "mass adoption" or "full adoption" of IP telephony technology, with fewer customers "testing" the product and more of our customer engagements involving moving customers towards actual implementation of IP telephony. Gross margin on our implementation services revenue was 25.5%, 29.1% and 38.4% for 2006, 2005 and 2004, respectively. Implementation services revenue grew 54.1%, 96.6% and 42.9%, and made up 88.2%, 92.9% and 95.9% of total services revenue in 2006, 2005 and 2004, respectively.

### Post-Implementation Support Services

In our view, there are essentially two primary support models offered by competitors for IP telephony: the current model used to support traditional PBX systems and the model used to support data networks. We believe that neither the traditional PBX telephone support model nor the existing computer data network support model best suits the needs of customers operating a converged communications infrastructure. We have created a specialized support model for supporting Cisco-centric IP-based converged communications systems, which we have branded under the NetSurant® name. These services include remote monitoring and management of the customer's IP telephony and network infrastructure equipment and related applications. These NetSurant® services are performed using specialized toolsets and a network support center with technical staff that are specifically trained and experienced in the area of Cisco IP telephony and complex, state-of-the-art IP network infrastructure. Customers are notified of system problems and we solve the problems detected either remotely or onsite.

Several years ago, when most customers were only testing IP telephony technology, rather than utilizing IP telephony enterprise-wide for their primary voice communication system, post-implementation support services were not a high priority for those customers. But as customers transition to the full implementation of IP telephony, we believe that post-implementation support of their converged IP communications infrastructure will become essential for them. Additionally, we believe that the quality of support services is likely to become among the more significant factors for enterprise-class customers when they are choosing a service provider. Through our branded NetSurant® service offering we believe we are positioned to provide support services that enterprise-class organizations desire and require.

In order to provide our NetSurant® post-sale support services we were required to make an investment in certain technology products and infrastructure, and in building and staffing a network support center, which we did in 2003. These direct costs of providing the NetSurant® services initially resulted in negative gross profit margin on NetSurant® support services, but as NetSurant® support services have grown, gross margins became positive. There is a relatively high fixed cost associated with offering NetSurant® services, but such costs do not increase in proportion with increases in NetSurant® support services revenues. Therefore, we expect that as NetSurant® revenue continues to grow that gross margin on NetSurant® revenue will continue to improve and that NetSurant® will provide operating profits. The improvement in NetSurant® gross margin, and the relatively higher growth of NetSurant® support services revenue, relative to implementation and support services revenue, has resulted in our gross margins on services revenue improving. Gross margin on our NetSurant® support services revenue was negative in 2004, when we were first beginning to offer NetSurant® support services, but improved to 29.1% for 2006 and 29.9% for 2005. NetSurant® support services revenue made up an immaterial portion of our total services revenue in 2003 but grew 169.8%, 255.3% and 2,450.0%, to make up 11.8%, 7.1% and 4.1% of total services revenue in 2006, 2005, and 2004, respectively.

### ***Why We Offer Cisco-Centric IP Telephony Solutions Exclusively***

Although we sell products that are complementary with Cisco products, we offer only Cisco-centric network infrastructure solutions and Cisco-centric IP telephony solutions. We choose to do this because we believe it enables us to compete more effectively for large Cisco-centric IP telephony projects. Our sales force works closely with Cisco's sales organization to identify and close IP telephony projects. By deliberately refraining from selling products that are competitive with Cisco's products, we believe our relationship with Cisco is enhanced, and our sales staff and sales management, as well as our engineering staff, are more focused and knowledgeable about the products we sell.

We believe that most sales of Cisco IP telephony systems are market share gains by Cisco. This is because Cisco only entered the voice communications market in 1998, and does not have a large traditional PBX telephone systems customer base to protect against encroachment by competitors. Because sales of IP telephony systems to enterprises will be largely systems replacing existing traditional PBX telephone systems, the traditional PBX manufacturers will be seeking to retain their existing customers while each system sold by Cisco will be a new customer for Cisco at the expense of a competitor, resulting in market shares gains by Cisco.

The majority of the enterprise organization IP-based routing and switching equipment installed today is manufactured by Cisco. For that reason, we believe Cisco has a competitive advantage with respect to implementing IP telephony solutions, which are essentially an extension of the IP network, and has the potential to gain market share against its competitors as the move towards full adoption of IP telephony technology by enterprises continues. If we are able to grow to become a national leader in providing Cisco-centric network infrastructure, and if, as we expect, Cisco gains market share against its competitors, we believe that we will be able to substantially increase our revenues.

Because the IP telephony and network infrastructure solutions we offer are based on the IP telephony products and technology of Cisco, it is critical to our business that we maintain a good working relationship with Cisco. We believe that because of our focus on Cisco's products, and our commitment to their strategy, our relationship with Cisco is excellent. We are an authorized reseller of Cisco products and have been awarded their "Gold" level status, which enables us to obtain the best published pricing discounts on the Cisco products that we sell, which in turn enables us to be competitive with larger competitors.

### **Competition**

Our competition for IP communications solutions is highly fragmented, and we compete with numerous large and small competitors. In our efforts to market Cisco-centric IP telephony solutions we compete with manufacturers of IP telephony equipment such as Avaya, Inc. and Nortel Networks Corporation as well as with such manufacturers' integrators and solution providers. For network infrastructure solutions, as well as Cisco-centric IP telephony solutions, we compete with large, well established systems integrators and solution providers, including most of the major national and international systems integrators, such as AT&T, EDS, IBM and others.

We believe that the principal competitive factor when marketing IP communications solutions is price. Other important factors include technical competence, the quality of our support services, the perception of the customer regarding our financial and operational ability to manage a project and to provide high quality service, and the quality of our relationship with Cisco.

The market for IP communications solutions is evolving rapidly, is highly competitive and is subject to rapid technological change. Many of our competitors are larger than we are and have greater financial, sales, marketing, technical and other resources. We expect to face increasing competitive pressures from both current and future competitors in the markets we serve.

### **The Geographic Markets We Currently Serve**

A majority of our customers are located in, or make significant decisions concerning their IP communications infrastructure in the markets in which we maintain branch offices. We believe it is important to have local management, sales and engineering staff in a metropolitan market in order to be a leading competitor in the market. Our administrative offices are located in Houston, Texas and our operations headquarters offices are located in Dallas, Texas. As of February 28, 2007 we maintained branch offices in the following thirteen markets:

- Los Angeles, California
- Boise, Idaho
- Metairie, Louisiana
- Albuquerque, New Mexico
- Eugene, Oregon
- Portland Oregon
- Austin, Texas
- Dallas, Texas
- El Paso, Texas
- Houston, Texas
- San Antonio, Texas
- Seattle, Washington
- Washington, DC

Our Washington, DC branch office markets primarily to the federal government. Eight of our thirteen branch offices have been opened or acquired during approximately the past twenty-four months.

## **Our Plans for Geographic Expansion**

By early 2005 we had grown to what we believe was the leading regional focused Cisco-centric IP telephony solutions provider for Texas, with offices in Austin, Dallas, Houston and San Antonio, Texas. Over approximately the past twenty months we made three acquisitions that added six additional branch offices and opened three new branch offices as new startup operations in new markets. We intend to continue opening new offices and making additional acquisitions to further expand our geographic coverage throughout the United States.

When we open a new branch office we expect that the new branch office will produce operating losses for a period of approximately six months to one year until revenue has ramped up to a level sufficient that gross profit exceeds normalized levels of operating expenses, and because during such start-up period sales and marketing expenses are higher than normal levels, relative to revenue, as we market our company in the new market. We believe it is sometimes advantageous to enter a new market by acquiring the assets and operations of an existing Cisco partner in the market. This is because acquiring an existing organization in a new market allows us to enter the market with an existing set of sales and engineering staff, existing customers, a relationship with the local Cisco branch office, and allows us to enter the market without the need to compete with the acquired organization. Our ability to acquire organizations in a new market is dependent upon an acceptable acquisition candidate organization existing in such new market and our ability to structure a transaction that is acceptable to both the seller and us.

With full adoption of IP telephony technology by enterprises at what we believe is an early stage, we intend to expand nationally, establishing offices in other major U.S. markets in order to create a national presence, with the goal of eventually becoming the leading focused, national provider of Cisco-based IP communications solutions to our target customers, enterprise-class organizations.

We believe that expanding to new markets creates a two-fold opportunity for us. First, adding new geographic markets provides us with new customer opportunities in those new markets. Second, we believe that becoming a recognized leading “national” provider of Cisco-based IP communications solutions will allow us to pursue larger customer opportunities in all of our markets, including our existing markets.

## **Customers**

Today our customers are typically medium- to larger-sized corporate organizations, schools and governmental agencies with approximately 300 to 20,000 users of telephone and/or networked computer technology, although as we continue to expand to new markets throughout the United States we hope to be able to begin winning contracts with larger customers. A majority of our customers are located in, or make significant decisions concerning their network infrastructure and voice communications systems in, the markets in which we maintain branch offices. Our customers include private enterprises in numerous industries including healthcare, legal, banking, energy and utilities, hospitality, transportation, manufacturing and entertainment, as well as federal, state and local governmental agencies and private and public educational organizations. We typically refer to this type of organization as an “enterprise organization” or an “enterprise.” In addition to our direct sales model to enterprise customers, we also provide technical consulting and project management services as a sub-contractor for other large, national or international systems integrators. Although the majority of our customers are based in the United States, we have performed work at their locations internationally, and we have performed consulting and project management services as a subcontractor internationally.

During 2004 and early 2005, we performed an increased amount of business with educational and governmental customers, including schools that receive funding for network infrastructure under a federal program commonly referred to as the “E-Rate” program. These customers typically pay more slowly than our commercial customers, and to the extent a greater portion of our revenue is derived from these customers, our business cycle and collections cycle is extended and our working capital requirements are increased as a percent of our revenue.

No single customer represented 10% or more of our revenue for the year ended December 31, 2006. We had one customer that represented 10% or more of our revenue for each of the years ended December 31, 2005 and 2004. This customer, Micro System Enterprise, Inc./Acclaim Professional Services (“MSE”), an agent related to the Dallas Independent School District E-Rate funded program, represented approximately 12.8% and 20.9% of our

consolidated revenue for the years ended December 31, 2005 and 2004 respectively, and represented approximately 11.2% of our consolidated net accounts receivable at December 31, 2005.

### **Sales and Marketing**

We market our products and services primarily through our sales personnel, including account managers and customer service representatives. These sales personnel are compensated in part based on productivity, specifically the profitability of sales that they participate in developing. We also promote our services through general and trade advertising, and participation in trade shows. Our sales organization works closely with the Cisco sales organization to identify opportunities.

### **Supply and Distribution**

We purchase products for the network infrastructure and/or IP telephony solutions we provide to our customers. The majority of our product purchases are Cisco products, and the majority of our Cisco product purchases are made directly from Cisco. We also purchase some of our products through various distribution channels when a product is not available directly from Cisco. We attempt to keep minimal inventory on hand and attempt to purchase inventory only as needed to fulfill orders. We attempt to ship products directly from our supplier to our customer when possible in order to shorten the business cycle and avoid handling the product in our facility, and the substantial majority of the product that we purchase is shipped directly from Cisco to our customer.

### **Management Information Systems**

We use an internally developed, highly customized management information system (“MIS”) to manage most aspects of our business. We use our MIS to manage accounts payable, accounts receivable and collections, general ledger, sales order processing, purchasing, service contracts, service calls and work orders, engineer and technician scheduling and time tracking, service parts acquisition and manufacturer warranties. Reporting can be generated for project profitability, contract and customer analysis, parts and inventory tracking, employee time tracking, etc.

### **Employees**

At February 28, 2007 we employed approximately 287 people. Of these, approximately 89 were employed in sales, marketing and customer service, 126 were employed in engineering and technical positions and 72 were employed in administration, finance and MIS. We believe our ability to recruit and retain highly skilled and experienced technical, sales and management personnel has been, and will continue to be, critical to our ability to execute our business plans. None of our employees are represented by a labor union nor are any subject to a collective bargaining agreement. We believe our relations with our employees are good.

### **Seasonality**

Historically, our second and third quarters have been stronger quarters than our first and fourth quarters, but we believe this seasonality was primarily the result of increased activity with educational customers during those periods, and our business with education type customers has been deemphasized over the past year. We therefore expect less of an impact from educational customers and therefore, past seasonal strength in the second and third quarters may not continue in the future.

### **Certain Milestones in Our Corporate Development**

We started business as a technology systems integrator, computer reseller and information technology service provider in 1983. We added a traditional PBX telephone systems dealer business unit in 1994, and founded Stratasoft, Inc., a computer-telephony software company, in 1995. We conducted an initial public offering and became a public company in 1997. By 1999, we had grown to over \$200 million in revenue, operating from five offices in Texas, with over 500 employees.

In 1999, we decided to sell both our computer products reselling business and our traditional PBX telephone systems business, which together accounted for approximately 90% of our total revenue at the time, and reposition

our company to take advantage of what we believed would become a significant opportunity in the area of converged communications using IP network infrastructure. We closed the sale of these two business units by mid-2000 and started the process of building our current Cisco-centric IP communications solutions organization, which we incorporated in July 2000 as InterNetwork Experts, Inc., a wholly-owned subsidiary.

When we sold our computer products and traditional PBX telephone systems business in 2000 we retained a small information technology services business. After mid-2000 we operated this IT services business through Valerent, Inc., a wholly-owned subsidiary. We also retained Stratasoft, Inc., the computer-telephony software company we had established in 1995. Thus, from mid-2000 until the end of 2005 we operated as a “holding company” with three subsidiaries, Valerent, Inc., Stratasoft, Inc. and InterNetwork Experts, Inc.

By 2005 our InterNetwork Experts subsidiary had grown to be over 90% of our total revenue and in late 2005 we decided to sell both Valerent and Stratasoft, eliminate our “holding company” structure, and concentrate all of our efforts and resources on our IP communications solutions business. Effective December 31, 2005 we merged our InterNetwork Experts, Inc. subsidiary, which we, Cisco and our customers commonly referred to as “INX,” into the parent publicly-traded company and changed the name of the parent publicly traded company from I-Sector Corporation to INX Inc. We sold Stratasoft in January 2006 and Valerent in October 2006.

## **General Information**

Our corporate administrative headquarters are located at 6401 Southwest Freeway, Houston, Texas 77074, and our telephone number is (713) 795-2000. Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports are available without charge from us on our website at <http://www.INXI.com>, as reasonably practicable following the time they are filed with or furnished to the SEC.

### **Item 1A. Risk Factors**

#### **We have a history of losses and may continue to incur losses.**

We incurred a net loss from continuing operations in each fiscal year since 1999, except fiscal 2006, 2005, and 2003. During 2005 our income from continuing operations was \$812 excluding the noncash charge for remeasurement of stock options discussed in Note 11 to consolidated financial statements in Part II, Item 8. We cannot assure you that profitability will be achieved or continue in upcoming quarters or years. In order to continue profitability, we will have to maintain or increase our operating margin. We cannot assure you that we will be able to continue to achieve improved operating margins, or that operating margin will not decrease in the future. If we were unable to increase revenue, if our gross margin decreases, or if we are unable to control our operating expenses, our business could produce losses. We have only recently become profitable and are in a rapidly changing industry. In addition, our business depends upon winning new contracts with new customers, the size of which may vary from contract to contract. When we open new branch offices to expand our geographic presence, we expect the newly opened branch offices to produce operating losses for a period of six months to over one year. We plan to open multiple new branch offices in the near future. Whether we are able to remain profitable in the future will depend on many factors, but primarily upon the commercial acceptance of IP telephony products and services, specifically those developed and marketed by Cisco.

#### **Our success is dependent upon maintaining our relationship with Cisco.**

Substantially all of our revenue for the years ended December 31, 2006, 2005, and 2004 was derived from the sale of Cisco products and related services. We anticipate that these products and related services will account for the majority of our revenue for the foreseeable future. We have a contract with Cisco to purchase the products that we resell, and we purchase substantially all of our Cisco products directly from Cisco. Cisco can terminate this agreement on relatively short notice. Cisco has designated us an authorized reseller and we receive certain benefits from this designation, including special pricing and payment terms. We have in the past, and may in the future, purchase Cisco-centric products from other sources. When we purchase Cisco-centric products from sources other than Cisco, the prices are typically higher and the payment terms are not as favorable. Accordingly, if we are unable to purchase directly from Cisco and maintain our status as an authorized reseller of Cisco network products, our business could be significantly harmed. If we are unable to purchase Cisco products from other sources on terms

that are comparable to the terms we currently receive, our business would be harmed and our operating results and financial condition would be materially and adversely affected.

**Our success depends upon broad market acceptance of IP telephony.**

The market for IP telephony products and services is relatively new and is characterized by rapid technological change, evolving industry standards and strong customer demand for new products, applications and services. As is typical of a new and rapidly evolving industry, the demand for, and market acceptance of, recently introduced IP telephony products and services are highly uncertain. We cannot assure you that the use of IP telephony will become widespread. The commercial acceptance of IP telephony products, including Cisco-centric products, may be affected by a number of factors including:

- quality of infrastructure;
- security concerns;
- equipment, software or other technology failures;
- government regulation;
- inconsistent quality of service;
- poor voice quality over IP networks; and
- lack of availability of cost-effective, high-speed network capacity.

If the market for IP telephony fails to develop, develops more slowly than we anticipate, or if IP telephony products fail to achieve market acceptance, our business will be adversely affected.

**Although our success is generally dependent upon the market acceptance of IP telephony, our success also depends upon a broad market acceptance of Cisco-centric IP telephony.**

We cannot assure you that the Cisco-centric IP telephony products we offer will obtain broad market acceptance. Competition, technological advances and other factors could reduce demand for, or market acceptance of, the Cisco-centric IP telephony products and services we offer. In addition, new products, applications or services may be developed that are better adapted to changing technology or customer demands and that could render our Cisco-centric products and services unmarketable or obsolete. To compete successfully, the Cisco-centric IP telephony products we offer must achieve broad market acceptance and we must continually enhance our related software and customer services in a timely and cost-effective manner. If the Cisco-centric IP telephony products we offer fail to achieve broad market acceptance, or if we do not adapt our existing services to customer demands or evolving industry standards, our business, financial condition and results of operation could be significantly harmed.

**Our business depends on the level of capital spending by enterprises for communications products and services.**

As a supplier of IP telephony products, applications and services for enterprises, our business depends on the level of capital spending for communications products and services by enterprises in our markets. We believe that an enterprise's investment in communications systems and related products and services depends largely on general economic conditions that can vary significantly as a result of changing conditions in the economy as a whole. The market for communications products and services may continue to grow at a modest rate or not at all. If our customers decrease their level of spending on communications systems and the related products and services, our revenue and operating results may be adversely affected.

**Our profitability depends on Cisco product pricing and incentive programs.**

Our annual and quarterly gross profits and gross margins on product sales are materially affected by Cisco product pricing and incentive programs. These incentive programs currently enable us to qualify for cash rebates or product pricing discounts and are generally earned based on sales volumes of particular Cisco products and customer satisfaction levels. We recognized vendor incentives as a reduction of a cost of sales amounting to \$6,303, \$2,876

and \$3,480 in 2006, 2005 and 2004, respectively, representing 4.0%, 2.7%, and 4.9% of total revenues. From time to time Cisco changes the criteria upon which qualification for these incentives are based and there is no assurance that we will continue to meet the program qualifications. Cisco is under no obligation to continue these incentive programs.

**A substantial portion of our customers are based in Texas.**

We have only recently expanded outside of Texas. Because a majority of the customers we offer our IP telephony products to are geographically concentrated in Texas, our customers' level of spending on communication products may be affected by economic condition in Texas, in addition to general economic conditions in the United States. If demand for IP telephony products by enterprises in Texas decreases, our business, financial condition and results of operations could be significantly harmed.

**Our strategy contemplates rapid geographic expansion, which we may be unable to achieve, and which is subject to numerous uncertainties.**

A component of our strategy is to become one of the leading national providers of Cisco-centric IP telephony products. To achieve this objective, we must either acquire existing businesses or hire qualified personnel in various locations throughout the country, fund a rapid increase in operations and implement corporate governance and management systems that will enable us to function efficiently on a national basis. Identifying and acquiring existing businesses is a time-consuming process and is subject to numerous risks. Qualified personnel are in demand, and we expect the demand to increase as the market for IP telephony grows. We will also likely face competition from our existing competitors and from local and regional competitors in the markets we attempt to enter. A rapid expansion in the size and geographical scope of our business is likely to introduce management challenges that may be difficult to overcome. We cannot assure you that we will be successful in expanding our operations beyond Texas or achieving our goal of becoming a national provider. An unsuccessful expansion effort would consume capital and human resources without achieving the desired benefit and would have an adverse effect on our business.

**We may require additional financing to achieve expansion of our business operations, and failure to obtain financing may prevent us from carrying out our business plan.**

We may need additional capital to grow our business. Our business plan calls for the expansion of sales of our IP telephony products to enterprises in geographical markets where we currently do not operate, including expansion through acquisitions. If we do not have adequate capital or are not able to raise the capital to fund our business objectives, we may have to delay the implementation of our business plan. We can provide no assurance that we will be able to obtain financing if required, or if financing is available, there is no assurance that the terms would be favorable to existing stockholders. Our ability to obtain additional financing is subject to a number of factors, including general market conditions, investor acceptance of our business plan, our operating performance and financial condition, and investor sentiment. These factors may affect the timing, amount, terms or conditions of additional financing available to us.

**We require access to significant working capital and vendor credit to fund our day-to-day operations. Our failure to comply with the financial and other covenants under our working capital facility could lead to a termination of the agreement and an acceleration of our outstanding debt.**

We require access to significant working capital and vendor credit to fund our day-to-day operations. Our credit facility with Castle Pines Capital ("CPC") contain a number of financial and other covenants. A breach of these financial or other covenants, unless waived, would be a default under the credit facility. Upon an event of default, CPC may terminate the facility and/or declare all amounts outstanding under such facility immediately due and payable. The acceleration of our debt could have a material adverse effect on our financial condition and liquidity. Additionally, the amount of working capital available to us under the credit facility is dependent upon the amount and quality of our accounts receivable. A significant default or payment delays of our accounts receivable could materially adversely affect our borrowing base and our access to sufficient working capital.

**We may be unable to manage our growth effectively, which may harm our business.**

The ability to operate our business in a rapidly evolving market requires effective planning and management. Our efforts to grow have placed, and are expected to continue to place, a significant strain on our personnel, management systems, infrastructure and other resources. Our ability to manage future growth effectively will require us to successfully attract, train, motivate and manage new employees, to integrate new employees into our operations and to continue to improve our operational, financial and management controls and procedures. If we are unable to implement adequate controls or integrate new employees into our business in an efficient and timely manner, our operations could be adversely affected and our growth could be impaired.

**Our operating results have historically been volatile, and may continue to be volatile, particularly from quarter to quarter.**

Our quarter-to-quarter revenue, gross profit and operating profitability have fluctuated significantly. During quarterly periods in which we realize lower levels of revenue our profitability is negatively impacted. Our quarterly operating results have historically depended on, and may fluctuate in the future as a result of, many factors including:

- volume and timing of orders received during the quarter;
- amount and timing of supplier incentives received in any particular quarter, which can vary substantially;
- gross margin fluctuations associated with the mix of products sold;
- general economic conditions;
- patterns of capital spending by enterprises for communications products;
- the timing of new product announcements and releases;
- pricing pressures;
- the cost and effect of acquisitions;
- the amount and timing of sales incentives we may receive from our suppliers, particularly Cisco; and
- the availability and cost of products and components from our suppliers.

As a result of these and other factors, we have historically experienced, and may continue to experience, fluctuations in sales and operating results. In addition, it is possible that in the future our operating results may fall below the expectations of analysts and investors, and as a result, the price of our securities may fall.

**We have many competitors and expect new competitors to enter our market, which could increase price competition and may affect the amount of business available to us and the prices that we can charge for our products and services.**

The markets for our all of products and services, and especially our IP telephony products and services, are extremely competitive and subject to rapid change. Substantial growth in demand for IP telephony solutions has been predicted, and we expect competition to increase as existing competitors enhance and expand their products and services and as new participants enter the IP telephony market. IP telephony involves the application of traditional computer-based technology to voice communication, and the hardware component of the solution is readily available. Accordingly, there are relatively few barriers to entry to companies with computer and network experience. A rapid increase in competition could negatively affect the amount of business that we get and the prices that we can charge.

Additionally, many of our competitors and potential competitors have substantially greater financial resources, customer support, technical and marketing resources, larger customer bases, longer operating histories, greater

name recognition and more established relationships than we do. We cannot be sure that we will have the resources or expertise to compete successfully. Compared to us, our competitors may be able to:

- develop and expand their products and services more quickly;
- adapt faster to new or emerging technologies and changing customer needs;
- take advantage of acquisitions and other opportunities more readily;
- negotiate more favorable agreements with vendors;
- devote greater resources to marketing and selling their products; and
- address customer service issues more effectively.

Some of our competitors may also be able to increase their market share by providing customers with additional benefits or by reducing their prices. We cannot be sure that we will be able to match price reductions by our competitors. In addition, our competitors may form strategic relationships with each other to better compete with us. These relationships may take the form of strategic investments, joint-marketing agreements, licenses or other contractual arrangements that could increase our competitors' ability to serve customers.

**Business acquisitions, dispositions or joint ventures entail numerous risks and may disrupt our business, dilute stockholder value or distract management attention.**

As part of our business strategy, we plan to consider acquisitions of, or significant investments in, businesses that offer products, services and technologies complementary to ours. Any acquisition could materially adversely affect our operating results and/or the price of our securities. Acquisitions involve numerous risks, some of which we have experienced and may continue to experience, including:

- unanticipated costs and liabilities;
- difficulty of integrating the operations, products and personnel of the acquired business;
- difficulty retaining key personnel of the acquired business;
- difficulty retaining customers of the acquired businesses;
- difficulties in managing the financial and strategic position of acquired or developed products, services and technologies;
- difficulties in maintaining customer relationships, in particular where a substantial portion of the target's sales were derived from products that compete with products that we currently offer;
- the diversion of management's attention from the core business;
- inability to maintain uniform standards, controls, policies and procedures; and
- damage to relationships with acquired employees and customers as a result of integration of the acquired business.

Finally, to the extent that shares of our common stock or rights to purchase common stock are issued in connection with any future acquisitions, dilution to our existing stockholders will result and our earnings per share may suffer. Any future acquisitions may not generate the anticipated level of revenue and earnings or provide any benefit to our business, and we may not achieve a satisfactory return on our investment in any acquired businesses.

**Our international operations, which we plan to expand, will subject us to additional risks that may adversely affect our operating results due to increased costs.**

Revenue generated by products delivered and services provided outside the United States, as a percentage of consolidated revenue, was approximately 4.9%, 3.5% and 2.7% for 2006, 2005 and 2004, respectively. Substantially all of our international revenue represents products delivered or services provided in foreign countries for companies based in the United States or for United States Armed Forces under contracts entered into, administered

and paid in the United States. We intend to continue to pursue international opportunities. Pursuit of international opportunities may require us to make significant investments for an extended period before returns on such investments, if any, are realized. International operations are subject to a number of risks and potential costs, including:

- unexpected changes in regulatory requirements and telecommunication standards;
- tariffs and other trade barriers;
- risk of loss in currency exchange transactions;
- exchange controls or other currency restrictions;
- difficulty in collecting receivables;
- difficulty in staffing and managing foreign operations;
- the need to customize marketing and products;
- inadequate protection of intellectual property in countries outside the United States;
- adverse tax consequences; and
- political and economic instability.

Any of these factors could prevent us from increasing our revenue and otherwise adversely affect our operating results. We may not be able to overcome some of these barriers and may incur significant costs in addressing others.

**If we lose key personnel we may not be able to achieve our objectives.**

We are dependent on the continued efforts of our senior management team, including our Chairman and Chief Executive Officer, James Long, and our President and Chief Operating Officer, Mark Hilz. If for any reason, these or other senior executives or other key members of management do not continue to be active in management, our business, financial condition or results of operations could be adversely affected. We cannot assure you that we will be able to continue to retain our senior executives or other personnel necessary for the development of our business.

**We may not be able to hire and retain highly skilled technical employees, which could affect our ability to compete effectively and could adversely affect our operating results.**

We depend on highly skilled technical personnel to research and develop and to market and service our products. To succeed, we must hire and retain employees who are highly skilled in rapidly changing communications technologies. In particular, as we implement our strategy of focusing on IP telephony, we will need to:

- hire more employees with experience developing and providing advanced communications products and services;
- retrain our current personnel to sell IP telephony products and services; and
- retain personnel to service our products.

Individuals who can perform the services we need to provide our products and services are scarce. Because the competition for qualified employees in our industry is intense, hiring and retaining qualified employees is both time-consuming and expensive. We may not be able to hire enough qualified personnel to meet our needs as our business grows or to retain the employees we currently have. Our inability to hire and retain the individuals we need could hinder our ability to sell our existing products, systems, software or services or to develop and sell new ones. If we are not able to attract and retain qualified employees, we will not be able to successfully implement our business plan and our business will be harmed.

**If we are unable to protect our intellectual property rights, our business may be harmed.**

Although we attempt to protect our intellectual property through patents, trademarks, trade secrets, copyrights, confidentiality and non-disclosure agreements and other measures, intellectual property is difficult to protect and

these measures may not provide adequate protection. Patent filings by third parties, whether made before or after the date of our patent filings, could render our intellectual property less valuable. Competitors may misappropriate our intellectual property, disputes as to ownership of intellectual property may arise and our intellectual property may otherwise become known or independently developed by competitors. The failure to protect our intellectual property could seriously harm our business because we believe that developing new products and technology that are unique to us is important to our success. If we do not obtain sufficient international protection for our intellectual property, our competitiveness in international markets could be significantly impaired, which would limit our growth and future revenue.

**We may be found to infringe on third-party intellectual property rights.**

Third parties may in the future assert claims or initiate litigation related to their patent, copyright, trademark and other intellectual property rights in technology that is important to us. The asserted claims and/or litigation could include claims against us or our suppliers alleging infringement of intellectual property rights with respect to our products or components of those products. Regardless of the merit of the claims, they could be time consuming, result in costly litigation and diversion of technical and management personnel, or require us to develop a non-infringing technology or enter into license agreements. There can be no assurance that licenses will be available on acceptable terms, if at all. Furthermore, because of the potential for high court awards, which are not necessarily predictable, it is not unusual to find even arguably unmeritorious claims resulting in large settlements. If any infringement or other intellectual property claim made against us by any third party is successful, or if we fail to develop non-infringing technology or license the proprietary rights on commercially reasonable terms and conditions, our business, operating results and financial condition could be materially adversely affected.

**Costs of compliance with the Sarbanes-Oxley Act of 2002 and the related SEC regulations may harm our results of operations.**

The Sarbanes-Oxley Act of 2002 requires heightened financial disclosure and corporate governance for all publicly traded companies. Although costs of compliance with the Sarbanes-Oxley Act are uncertain due to several factors, we expect that our general and administrative expenses will increase. Failure to comply with the Sarbanes-Oxley Act, Securities and Exchange Commission (“SEC”) regulations or NASDAQ listing requirements may result in penalties, fines or delisting of our securities from the NASDAQ, which could limit our ability to access the capital markets, having a negative impact on our financial condition and results of operations.

**Item 1B. *Unresolved Staff Comments***

None.

**Item 2. *Properties***

We conduct operations at the following leased sites:

- Los Angeles, California
- Boise, Idaho
- Metairie, Louisiana
- Albuquerque, New Mexico
- Eugene, Oregon
- Portland Oregon
- Austin, Texas
- Dallas, Texas
- El Paso, Texas
- Houston, Texas
- San Antonio, Texas
- Seattle, Washington
- Washington, DC

Through January 31, 2007, we leased a freestanding 48,000 square foot building for our operations, accounting, MIS, and corporate offices in Houston, Texas from a corporation owned by our Chairman and Chief Executive Officer. Approximately 16,773 square feet were subleased to Stratasoft, Inc. and Valerent, Inc., which were both sold during 2006. Effective February 1, 2007, the lease was reduced to 16,488 square feet as discussed further in

Note 13 to the consolidated financial statements in Part II, Item 8. The Dallas facility consists of 28,479 square feet. The remainder of the locations range in size from 800 to 7,800 square feet. We believe our existing leased properties are in good condition and suitable for the conduct of our business.

**Item 3. Legal Proceedings**

See discussion of legal proceedings in Note 14 to the consolidated financial statements included in Part II, Item 8 of this Report.

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

No matters were submitted to a vote of security holders during the fourth quarter of 2006.

**Executive Officers of the Registrant**

The executive officers of the Company are as follows:

| <u>Name</u>             | <u>Age</u> | <u>Position</u>                                   |
|-------------------------|------------|---|
| James H. Long . . . . . | 48         | Chairman of the Board and Chief Executive Officer |
| Mark T. Hilz . . . . .  | 48         | President and Chief Operating Officer             |
| Brian Fontana . . . . . | 49         | Vice President and Chief Financial Officer        |
| Larry Lawhorn . . . . . | 54         | Controller and Chief Accounting Officer           |
| Paul Klotz . . . . .    | 45         | Vice President of Operations                      |

*James H. Long* is our founder and has served as our Chairman of the Board and Chief Executive Officer since our inception in 1983. Mr. Long also served as our president through December of 2003. Prior to founding our company, Mr. Long served with the United States Navy in a technical position and was then employed by IBM in a technical position.

*Mark T. Hilz* was appointed as our President and Chief Operating Officer in December 2003. Mr. Hilz’ responsibilities include management of our operations. Mr. Hilz has also served as the President of InterNetwork Experts, Inc. since its founding in July 2000 until it was merged into I-Sector Corporation in December 2005. Mr. Hilz served as a director of our company from April 1999 until June 2001. From January 1999 to June 2000, Mr. Hilz was Vice President of Project Development at Mathews Southwest, LLC, Inc., a real estate investment and development firm headquartered in Dallas. From 1998 to July 2000, Mr. Hilz was one of our directors and the Chief Executive Officer of Nichecast, Inc., a privately held internet services company. From July 1990 to July 1998 Mr. Hilz was the founder, President and Chief Executive Officer of PC Service Source, Inc., a publicly held distributor of personal computer hardware for the repair industry. Before that, Mr. Hilz was founder, President and Chief Executive Officer of Hilz Computer Products, Inc., a privately held wholesale computer products distributor.

*Brian Fontana* has served as the Chief Financial Officer since January 2005. Mr. Fontana has an extensive financial management background that includes the management of the accounting, finance, investor relations, internal information systems and legal functions for large, complex organizations, including organizations that were executing strategies for rapid expansion through acquisitions. As CFO, he has managed multiple initial public offerings, follow-on equity offerings, private equity offerings, public debt placements and syndicated bank financings. He previously held the position of CFO at three NYSE listed public companies, one NASDAQ listed company and two privately held companies. His prior experience includes serving as Chief Financial Officer of Talent Tree, Inc., a privately-held workforce outsourcing organization; PerformanceRetail, Inc., an early-stage venture-capital funded software company; Drypers Corporation, a NASDAQ listed multinational diaper manufacturing company; Pentacon, Inc., a NYSE listed fastener distribution company; Prime Service, Inc., a NYSE listed equipment rental company; and National Convenience Stores, Inc., a NYSE listed operator of convenience stores. Mr. Fontana is a 1981 graduate of the University of Texas, where he earned a BBA in Finance.

*Larry Lawhorn* was appointed as our Controller and Chief Accounting Officer in April 2005 and is responsible for our accounting and reporting functions. From August 2002 to April 2005, Mr. Lawhorn was the Vice President — Corporate Controller for Talent Tree, Inc., a privately-held workforce outsourcing organization headquartered in

Houston, Texas. From March 1987 to July 2001, Mr. Lawhorn served with Corporate Express, Inc. headquartered in Broomfield, Colorado as regional controller and division president in Houston, Texas and Baton Rouge, Louisiana, respectively. Previously, Mr. Lawhorn served with Coopers & Lybrand (now PriceWaterhouseCoopers) for eleven years. Mr. Lawhorn is a Certified Public Accountant and he is a member of the American Institute of Certified Public Accountants and the Texas Society of Certified Public Accountants.

*Paul Klotz* was appointed as the Vice President of Operations effective December 31, 2005 and held a similar position with InterNetwork Experts, Inc. since August 2000. Mr. Klotz' responsibilities include the operations management of the IP communications business. From 1997 to July 2000, Mr. Klotz was the Vice President of Marketing of PC Service Source. Before that, Mr. Klotz served as the Vice President of Acme Keystone, a privately held consumer products manufacturing company.

**Family Relationships**

There are no family relationships among any of our directors and executive officers.

**PART II**

**Item 5. *Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

**Market Information**

Beginning April 24, 2006, our common stock and warrants began trading on the Nasdaq Capital Market under the symbols "INXI" and "INXIW", respectively. From December 29, 2003 until April 24, 2006, our common stock has traded on the American Stock Exchange under the ticker symbol "ISR". From June 8, 2004 until April 24, 2006, our warrants traded on the American Stock Exchange under the symbol "ISR.WS".

**Common Stock**

The following table sets forth the price range of our common stock.

|                          | <u>High</u> | <u>Low</u> |
|--------------------------|-------------|------------|
| <b>2005</b>              |             |            |
| First Quarter . . . . .  | \$7.73      | \$4.94     |
| Second Quarter . . . . . | \$8.14      | \$5.20     |
| Third Quarter . . . . .  | \$8.40      | \$4.45     |
| Fourth Quarter . . . . . | \$5.80      | \$4.04     |
| <b>2006</b>              |             |            |
| First Quarter . . . . .  | \$7.48      | \$5.55     |
| Second Quarter . . . . . | \$7.15      | \$5.40     |
| Third Quarter . . . . .  | \$6.89      | \$5.77     |
| Fourth Quarter . . . . . | \$7.99      | \$6.40     |

## Warrants

The following table sets forth the price range of our warrants.

|                          | <u>High</u> | <u>Low</u> |
|--------------------------|-------------|------------|
| <b>2005</b>              |             |            |
| First Quarter . . . . .  | \$1.70      | \$0.80     |
| Second Quarter . . . . . | \$1.53      | \$0.80     |
| Third Quarter . . . . .  | \$1.50      | \$0.75     |
| Fourth Quarter . . . . . | \$0.90      | \$0.50     |
| <b>2006</b>              |             |            |
| First Quarter . . . . .  | \$1.50      | \$0.55     |
| Second Quarter . . . . . | \$1.30      | \$0.50     |
| Third Quarter . . . . .  | \$1.06      | \$0.72     |
| Fourth Quarter . . . . . | \$1.55      | \$1.05     |

As of February 28, 2007, we had 135 stockholders of record of our common stock. On February 28, 2007, the closing sales price of our common stock and warrants as reported by the Nasdaq Capital Market was \$9.57 per share and \$2.30 per warrant.

## Dividend Policy

Our policy has been to reinvest earnings to fund future growth. Accordingly, we have not declared or paid any cash dividends and do not anticipate declaring dividends on our common stock in the foreseeable future.

## Equity Compensation Plan Information

The following table sets forth, as of December 31, 2006:

- the number of shares of our common stock issuable upon exercise of outstanding options, warrants and rights, separately identified by those granted under equity incentive plans approved by our shareholders and those granted under plans, including individual compensation contracts, not approved by our shareholders (column A),
- the weighted average exercise price of such options, warrants and rights, also as separately identified (column B), and the number of shares remaining available for future issuance under such plans, other than those shares issuable upon exercise of outstanding options, warrants and rights (column C).

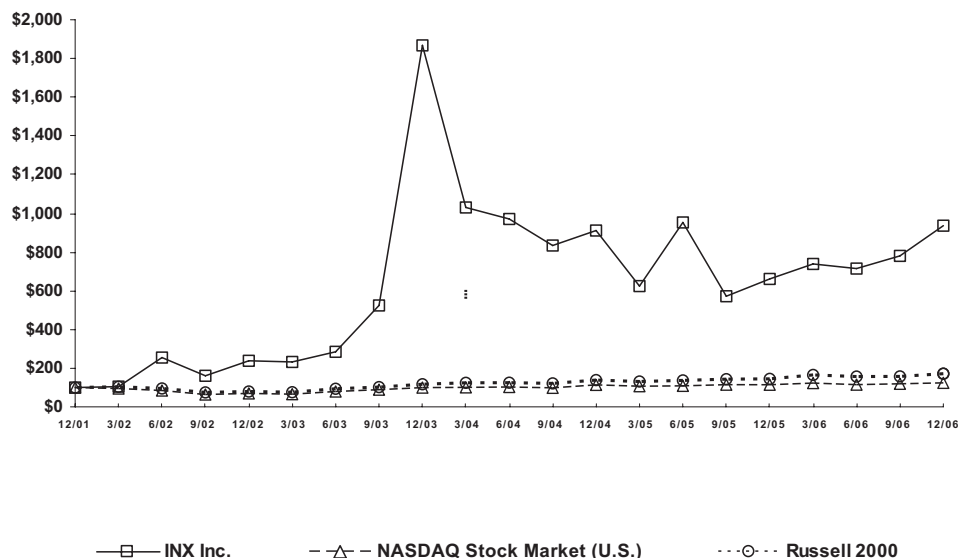
|  | <u>Column A</u>   | <u>Column B</u>   | <u>Column C</u>  |
|--|---|---|--|
|  | Number of Shares<br>to be Issued<br>Upon Exercise of<br>Outstanding Options,<br>Warrants and Rights | Weighted Average<br>Exercise Price of<br>Outstanding Options<br>Warrants and Rights | Number of Shares<br>Remaining Available<br>for Future Issuance<br>Under Equity Compensation<br>Plans (Excluding Shares<br>Reflected in Column A) |
| Equity incentive plans<br>approved by shareholders . . .     | 1,907,957   | \$3.50  | 176,644  |
| Equity incentive plans not<br>approved by shareholders . . . | —   | —   | —  |
| Totals . . . . .   | 1,907,957   | \$3.50  | 176,644  |

Equity incentive plans are further discussed in Note 10 to consolidated financial statements in Part II, Item 8.

## Stock Performance Graph

The following graph compares the performance of the Common Stock with the Nasdaq Stock Market (U.S. Companies) Index and with the Russell 2000 Index. The graph assumes that \$100 was invested on December 31, 2001, in the Common Stock and in each index and that any cash dividends were reinvested. The Company has not declared any dividends during the period covered by this graph.

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\*  
AMONG INX INC.,  
THE NASDAQ STOCK MARKET (U.S.) INDEX AND THE RUSSELL 2000 INDEX**



\* \$100 invested on 12/31/01 in stock or index-including reinvestment of dividends.

Fiscal year ending December 31.

### ASSUMED INVESTMENT WITH REINVESTMENT OF DIVIDENDS

|                            | 12/01  | 3/02   | 6/02   | 9/02   | 12/02  | 3/03   | 6/03   |
|----------------------------|--------|--------|--------|--------|--------|--------|--------|
| INX INC.                   | 100.00 | 104.76 | 254.76 | 160.71 | 238.10 | 232.14 | 284.52 |
| NASDAQ STOCK MARKET (U.S.) | 100.00 | 94.93  | 84.60  | 64.01  | 69.66  | 65.73  | 79.55  |
| RUSSELL 2000               | 100.00 | 103.98 | 95.30  | 74.90  | 79.52  | 75.95  | 93.73  |

|                            | 9/03   | 12/03   | 3/04    | 6/04   | 9/04   | 12/04  | 3/05   |
|----------------------------|--------|---------|---------|--------|--------|--------|--------|
| INX INC.                   | 523.81 | 1866.67 | 1029.76 | 970.24 | 833.33 | 910.71 | 623.81 |
| NASDAQ STOCK MARKET (U.S.) | 89.03  | 99.71   | 100.90  | 102.80 | 98.50  | 113.79 | 106.87 |
| RUSSELL 2000               | 102.24 | 117.09  | 124.42  | 125.01 | 121.44 | 138.55 | 131.16 |

|                            | 6/05   | 9/05   | 12/05  | 3/06   | 6/06   | 9/06   | 12/06  |
|----------------------------|--------|--------|--------|--------|--------|--------|--------|
| INX INC.                   | 952.38 | 571.43 | 660.71 | 738.10 | 714.29 | 779.76 | 935.71 |
| NASDAQ STOCK MARKET (U.S.) | 108.72 | 114.83 | 114.47 | 123.07 | 114.98 | 119.33 | 124.20 |
| RUSSELL 2000               | 136.82 | 143.24 | 144.86 | 165.06 | 156.76 | 157.45 | 171.47 |

This graph depicts the past performance of the Common Stock and in no way should be used to predict future performance. The Company does not make or endorse any predictions as to future share performance.

This Stock Performance Graph and the information provided in this Stock Performance Graph shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), or otherwise subject to the liabilities under that Section and shall not be deemed to be incorporated by reference by any general statement incorporating by reference this Report on Form 10-K into any filing under the Securities Act of 1933, as amended, or the Exchange Act except to the extent INX specifically incorporates by reference this Stock Performance Graph.

**Item 6. Selected Financial Data**

The following selected financial data are derived from our consolidated financial statements. The data below should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” “Risk Factors,” and our consolidated financial statements and notes.

|   | Year Ended December 31,                       |            |          |            |          |
|---|---|------------|----------|------------|----------|
|   | 2006(1)                                       | 2005(1)    | 2004     | 2003(1)    | 2002     |
|   | (Dollars in thousands, except per share data) |            |          |            |          |
| <b>Operating Data:</b>  |   |            |          |            |          |
| Revenue:  |   |            |          |            |          |
| Products . . . . .  | \$135,317                                     | \$ 94,570  | \$65,207 | \$39,369   | \$25,972 |
| Services . . . . .  | 20,696  | 12,749     | 6,280    | 4,226      | 1,748    |
| Total . . . . .   | \$156,013                                     | \$107,319  | \$71,487 | \$43,595   | \$27,720 |
| Net income (loss) from continuing operations . . . . .                          | \$ 1,511                                      | \$ (4,917) | \$ 1,110 | \$ (147)   | \$ 528   |
| Net income (loss) per share from continuing operations:                         |   |            |          |            |          |
| Basic . . . . .   | \$ 0.24                                       | \$ (0.86)  | \$ 0.24  | \$ (0.04)  | \$ 0.14  |
| Diluted . . . . .   | \$ 0.21                                       | \$ (0.86)  | \$ 0.23  | \$ (0.04)  | \$ 0.14  |
| Income (loss) from discontinued operations(2) . . . . .                         | \$ (316)                                      | \$ (2,967) | \$ 420   | \$ (1,689) | \$ (912) |
| Net income (loss) . . . . .   | \$ 1,195                                      | \$ (7,884) | \$ 1,530 | \$ (1,836) | \$ (384) |
| <b>Balance Sheet Data:</b>  |   |            |          |            |          |
| Total assets . . . . .  | \$ 62,520                                     | \$ 41,645  | \$41,139 | \$19,207   | \$15,751 |
| Interest bearing borrowings under Credit Facility . . . . .                     | 4,350   | 2,464      | 8,122    | 1,688      | —        |
| Long-term debt (including current portion) from continuing operations . . . . . | 259   | 243        | 36       | 72         | 24       |

- (1) The Datatran Network Systems acquisition was completed and initially reported in 2006, the Network Architects and InfoGroup Northwest acquisitions were initially reported in 2005, and the Digital Precision acquisition was initially reported in 2003. The 2005 and 2006 acquisitions are discussed further in Note 3 to consolidated financial statements in Part II, Item 8.
- (2) The Stratasoft and Valerent subsidiaries were discontinued in 2005 as discussed further in Note 4 to consolidated financial statements in Part II, Item 8.
- (3) No cash dividends were declared or paid during the five years ended December 31, 2006.

## **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*Please read the following discussion of our financial condition and results of operations together with "Item 6. Selected Financial Data" and our consolidated financial statements and the notes to those statements included elsewhere in this report. The following discussion and analysis contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of certain factors, including, but not limited to, those set forth under "Item 1A. Risk Factors" and elsewhere in this report.*

### **General**

We are a provider of IP communications solutions for enterprise-class organizations such as corporations, schools and federal, state and local governmental agencies. The solutions we provide are based primarily on Cisco technology and we offer our customers with implementation and support services related to the solutions we provide. We believe that our focus and expertise enables us to better compete in the markets we serve because we have significant experience implementing and supporting the critical technology building blocks of IP telephony systems and the underlying infrastructure components upon which IP telephony depends.

The market for IP communications solutions is characterized by rapidly evolving and competing technologies. We compete with larger and better financed entities. We currently have fourteen physical offices, which are located in Texas, California, Louisiana, Idaho, New Mexico, Oregon, Utah, Washington and Washington DC. We primarily market to enterprise-class organizations headquartered in, or making purchasing decisions from markets that we serve with branch offices. We plan to continue to expand throughout the U.S. by establishing additional branch offices in other markets, either by opening additional new offices or through acquisition.

We derive revenue from sales of both products and services. Services revenue has grown more rapidly than product sales recently. In 2006, 2005 and 2004, sales of products made up 86.7%, 88.1% and 91.2% of total revenue and services revenues made up 13.3%, 11.9% and 8.8% of total revenue.

A key component of our long-term operating strategies is to improve operating profitability. Our gross profit margin on product sales is lower than our gross margin on service revenues. Our gross margin on product sales was 18.6%, 15.7% and 16.6% for 2006, 2005 and 2004, respectively, and our gross margin on service revenue was 25.9%, 29.2% and 33.4% for those same periods. The market for the products we sell is competitive, and we compete with other suppliers for our customers' business. The principal factors that determine gross margin on product sales include:

- the mix of large, competitively bid sales transactions as compared to smaller, less competitive transactions;
- the mix of new customer transactions, which tend to be more competitively bid by us, as compared to transactions with existing customers, which tend to be somewhat less competitive; and
- the mix of products sold, with certain newer, advanced product categories generating higher gross margin than other, more traditional products.

The principal factors that influence gross margin on service revenue include:

- the utilization of our technical engineering resources used to perform implementation services;
- the amount of NetSurant® recurring, post-sale support services as compared to the cost of operating our NetSurant® support center, which costs are somewhat fixed;
- the mix between the different types of service.

We expect to be able to improve our gross margin on services revenues if our NetSurant® post-sale recurring support services revenue continue to increase at a more rapid rate than our implementation services revenue. This is because our cost of providing NetSurant® support services is somewhat fixed and does not increase in direct proportion to revenue.

If we are able to maintain our gross margin on product sales, improve our gross margin on services revenues and change our revenue mix to include a larger amount of service revenue our gross margin on total revenue will improve, which is a key component of our strategy to improve operating profitability.

Certain of our selling, general and administrative expenses, such as sales commissions, vary with revenue or gross profit. Certain other selling, general and administrative expenses are somewhat fixed and do not vary directly with revenue or gross profit. We hope to be able to achieve a degree of leverage on certain categories of selling, general and administrative expenses as we continue to grow, so that these expenses will become a lower percentage of revenue, which combined with improvements in gross margin would increase operating profit margin from our existing branch offices.

To the extent we continue to open new branch offices our operating profitability will be negatively impacted because we expect that opening a new branch office will typically result in operating losses from the newly opened branch office for a period of six months to over one year. This is because when we open a new branch office we must hire sales and engineering staff before we generate sales and because we incur increased levels of sales and marketing expense in order to establish our presence in the new market, and to attract new customers. However, we believe it is important to expand rapidly to obtain a national presence, and that the return on our investment from opening new offices will be significant over an approximate three to five year period, relative to the investment required, and therefore we believe it is in our best interest to open new offices even though doing so reduces near-term operating profitability.

We begin Management's Discussion and Analysis of Financial Condition and Results of Operations with an overview of our strategies for achieving our goals of revenue growth and improved profitability. From a financial perspective, these operating strategies have a number of important implications for our results of operations and financial condition.

## **Strategy**

Over the course of the next several years we plan to improve profitability by implementing the strategies discussed below. We believe that our strategies will allow us to continue to increase total revenues. We also believe our strategies will enable us to improve our gross margins on our service revenue. At the same time, we will seek to limit the growth of certain relatively fixed components of our selling, general and administrative expenses relative to the growth of revenue so that those expenses become a relatively smaller percentage of total revenues. Through a combination of increased revenue, slightly increased gross margin and somewhat lesser growth of selling, general and administrative expenses, relative to the growth of revenue, we hope to be able to increase our operating margin and increase profitability at a more rapid rate than revenue increases, particularly from our existing branch offices. We expect that selling expenses can generally be expected to increase in proportion to our revenue increases. For example, our sales and sales management staff earn sales commissions that are typically calculated as a percentage of gross profit produced. Historically, sales commissions have been approximately 27% to 31% of gross profit and we expect sales commissions to continue to consume similar percentages of total gross profit. However, we believe that if we are successful in implementing our strategies, many categories of general and administrative expenses (such as management salaries, administrative wages and professional expenses) will decrease as a percentage of our total revenues over the long term because we believe we can achieve some levels of leverage on certain of these operating expenses.

Our key operating strategies include:

- aligning ourselves with Cisco as our primary supplier for the IP communications technology that we offer;
- marketing our NetSurant® brand of post-sale support services to generate increased recurring services revenues and improve gross margin on service revenue;
- increasing the gross revenues from our higher gross margin services offerings, as compared to product sales that typically produce relatively lower gross margins;
- opening new branch offices in new markets;
- expanding geographically by acquiring complementary businesses and by opening new offices;

- marketing to larger customers as we become more of a “national” level provider of IP communications solutions; and
- developing and marketing our own custom products for certain specialized IP communications solutions.

Increases in the size and volume of the projects we undertake can challenge our cash management. For example, larger projects can reduce our available cash by requiring that we carry higher levels of inventory. Larger projects can also require other investments in working capital. This is because, in some cases, we do not receive payments from our customers for extended periods of time. Until we invoice the customer and are paid, all of the cash expended on labor and products for the project remains invested in work-in-progress or accounts receivable. We expect that we will need increasing levels of working capital in the future if we are successful in growing our business as we intend. To meet our cash requirements to support planned growth, we expect to rely on capital provided from our operations and our credit facility, which is collateralized by our accounts receivable and substantially all of our other assets.

During 2006, 2005 and 2004, 86.7%, 88.1% and 91.2% of our revenue was attributable to product sales, while 13.3%, 11.9% and 8.8% was attributable to services revenues. The gross profit margins on our services revenues have been substantially higher than those for product sales. We hope to be able to increase revenue from services at a more rapid rate than increases in our product sales revenue. We believe this is possible if we are successful in marketing our NetSurant® support services, which generate recurring services revenues. If we are successful at growing our service revenues at a more rapid rate than our product sales revenues our overall gross margin on total revenue should improve. The success of this aspect of our strategy depends in part on our ability to attract and retain highly skilled and experienced engineering employees and the acceptance by the market of our NetSurant® support services offering.

For the last three years, the largest component of our total cost of sales and service has been purchases of Cisco-centric IP telephony products. The majority of those purchases were directly from Cisco. We typically purchase from various wholesale distributors only when we cannot purchase products directly from Cisco on a timely basis. Our reliance on Cisco as the primary supplier for the network and IP telephony products we offer means that our results of operations from period to period depend substantially on the terms upon which we are able to purchase these products from Cisco and, to a much lesser extent, from wholesale distributors of Cisco’s products. Therefore, our ability to manage the largest component of our cost of sales and service is very limited and depends to a large degree on maintaining and improving our relationship with Cisco. Our cost of products purchased from Cisco can be substantially influenced by whether Cisco sponsors sales incentive programs and whether we qualify for such incentives. There is a risk that we may not meet the required incentive criteria in the future. The respective timing of when vendor incentives become earned and determinable has created material fluctuations in our gross margin on product sales in the past.

We also plan to increase our business in other geographic areas through strategic acquisitions of similar businesses or by opening our own offices. This aspect of our strategy can affect our financial condition and results of operations in many ways. The purchase price for business acquisitions and the costs of opening offices may require substantial cash and may require us to incur long term debt. The expenses associated with opening a new office in a new market may well exceed the gross profit produced on revenues attributable to such new office for some time, even if it performs as we expect. It is possible that our acquisition activities may require that we record substantial amounts of goodwill if the consideration paid for an acquisition exceeds the estimated fair value of the net identified tangible and intangible assets acquired, which we expect is likely. To the extent an acquisition results in goodwill, we will reevaluate the value of that goodwill at least annually and adjust the value as appropriate. If we determine that the value of the goodwill has been impaired, the resulting adjustment could result in a non-cash charge to earnings in the periods of revaluation.

We are developing our own custom IP communications products based on Cisco technology but to date have not generated any material revenues from the sale of such products. If we are successful in developing and marketing these new products we expect that we will generate higher levels of gross margin on the sales of such products, but developing and marketing these new products requires that we expend cash and incur research and development expenses, as well as advertising and marketing costs. New product development costs have been, and we expect will continue to be, expensed as incurred.

### **Elimination of Minority Interest in Our Former InterNetwork Experts, Inc. Subsidiary**

On March 18, 2005 we eliminated a minority interest in our former InterNetwork Experts subsidiary by exchanging the minority interest for an interest in INX. The minority interest was created in April 2004 when our former InterNetwork Experts subsidiary issued shares of its common stock as part of the purchase consideration when it acquired the assets and operations of Digital Precision. When that occurred, our ownership percentage of INX's common stock declined from 100% to approximately 92.4%, and we recognized \$162,000 of minority interest on our balance sheet upon issuance.

Since we did not own 7.6% of the former InterNetwork Experts common stock during the period in which the minority interest existed, our interest in InterNetwork Experts' profits and losses was reduced for the minority share during such period. Under accounting principles generally accepted in the United States of America, our consolidated financial statements for the period through the exchange reflects a minority interest adjustment of the reportable profits and losses of our former InterNetwork Experts subsidiary attributable to the minority ownership. For 2004, we reported income attributable to minority interest of \$117,000 in our statement of operations and a minority interest balance of \$279,000 in our balance sheet. For 2005 we reported income attributable to minority interest of \$23,000 in our statement of operations for the period through March 18, 2005 when the minority interest was eliminated, including the minority interest balance of \$302,000 in our balance sheet.

On February 1, 2005, we entered into an agreement with the former InterNetwork Experts subsidiary minority shareholder group to eliminate the InterNetwork Experts minority interest, contingent upon INX stockholder approval. Upon stockholder approval on March 18, 2005, InterNetwork Experts became a wholly-owned subsidiary of the company. The exchange of the minority interest resulted in a remeasurement of the stock options that were part of the minority interest and such remeasurement resulted in a \$5.7 million one-time non-cash charge to earnings, which was equal to the intrinsic value of the stock options on March 18, 2005. This one-time non-cash charge to earnings, which did not impact assets or liabilities, reduced reported net income and earnings per share in our quarter ended March 31, 2005. The elimination of the minority interest simplified our capital structure and eliminated the minority interest on our financial statements, but increased the shares used to compute diluted earnings per share due to the shares of our common stock issued in the exchange and because of the increased number of stock options resulting from exchanging the former InterNetwork Experts subsidiary stock options for our stock options. Based on the closing stock price of \$6.25 on March 18, 2005, the shares used in computing diluted earnings per share increased by approximately 1,161,592 shares as a result of the exchange of the minority interest.

### **Elimination of Holding Company Structure and Sale of Two Subsidiaries**

On November 3, 2005, our Board of Directors approved a plan to sell the Stratasoft and Valerent subsidiaries. This action was taken due to continuing losses at Stratasoft and the decision to build value with a focused strategy in the operations at INX. Under a Stock Purchase Agreement ("Agreement") dated January 26, 2006, we sold all outstanding shares of Stratasoft's common stock for a pretax gain on disposal of \$302. Key terms of the sale are summarized as follows:

- All outstanding Stratasoft common stock was sold for a purchase price of \$3,000, which has been or is subject to reduction as follows:
  - \$800 placed in escrow, which is available to satisfy indemnified losses, if any, as defined in the Agreement. Funds placed in escrow are excluded from the estimated gain stated above. Approximately \$448 in indemnified losses have been paid or presented for payment as of December 31, 2006.
  - \$221 representing a preliminary net working capital adjustment, as defined. The final working capital adjustment recorded during June 2006 resulted in the further reduction of the sale proceeds of \$40.
- We indemnified the buyer for potential losses as defined in the Agreement to a maximum of \$1,400, inclusive of amounts placed in escrow. Excess funds held in escrow will be released on January 26, 2008 unless retained in escrow for potential indemnified losses as allowed in the Agreement under certain circumstances.
- We may receive additional consideration in the form of 10% of the outstanding Stratasoft common stock if revenue exceeds \$10,000 for any consecutive twelve month period within two years of closing.

- We may receive additional cash consideration if Stratasoft is sold by the buyer to another party prior to January 26, 2008, for an amount in excess of \$15,000.

We incurred transaction costs of \$815 in connection with the transaction, including the \$128 value of warrants issued to the investment banker for the transaction for 40,000 shares of common stock with an exercise price of \$6 per share. The warrants expire 5 years after January 26, 2006. Additional transaction costs of up to \$120 are payable based on the final sale price. Additional costs of \$134 were recorded as a reduction of the gain on sale for space leased by INX that will not be subleased to Stratasoft in the future.

The sale of Valerent operations involved two separate transactions which were closed in October 2006. The managed services business and related inventory, property and equipment were sold to OuterNet Management, L.P. for a cash sales price of \$185. The consulting business and related property and equipment were sold to Vicano Acquisition Corp., a company owned by Valerent's former President and brother-in-law of our CEO and largest shareholder. The consulting business was sold for cash paid at closing of \$50 and a \$70 promissory note to be received in twenty-four monthly installments of \$3 plus interest of 10%. Additional sales price is due to us if certain revenue thresholds and conditions are met. We recorded a gain of \$25 on the cash component of the transactions and will record a gain on proceeds under the \$70 promissory note as received, of which \$6 was received at December 31, 2006.

## **Results of Operations**

### *Overview*

*Sources of Revenue.* Our revenue consists of product and service revenue. Product revenue consists of reselling Cisco products and limited amounts of complementary products from other manufacturers. Service revenue is generated by fees from a variety of implementation and support services. Product prices are set by the market for Cisco products and provide our lowest gross margins. Gross margin on service revenue varies based on the cost of technical resources, which are reflected as a cost of service. Certain fixed and flat fee service contracts that extend over three months or more are accounted for on the percentage of completion method of accounting.

Historically, the majority of our services revenue has been generated from implementation services, which we believe varies somewhat in proportion to our product sales. Implementation services revenue is project oriented and tends to be somewhat volatile on a quarter-to-quarter basis as projects start and stop and we redeploy technical resources to new projects. As the number, frequency and size of our projects continue to grow, we hope to achieve better utilization of our engineering resources, resulting in improved gross margins on implementation services revenue and less volatility in the amount of quarterly implementation services revenue realized. The normal sales cycle for corporate customers typically ranges from three to six months depending on the nature, scope and size of the project. Our experience with educational organizations utilizing E-Rate funding, which is a federal government funding program for schools administered by the Schools and Libraries Division Universal Services Administrative Corporation (the "SLD"), indicates that the sales cycle is generally about six to twelve months or longer.

In mid-2004, INX introduced NetSurant<sup>®</sup>, its branded support service that consists primarily of customer service personnel and a support center. This new support service offering requires that we incur the fixed cost to operate a network operations center to monitor and manage customers' systems. Until recently, this fixed cost, as compared to the level of NetSurant<sup>®</sup> service revenue has resulted in negative gross margins from this new NetSurant<sup>®</sup> service offering. We recognize support service revenue evenly over the entire service period for the customer. Eventually, we expect that the NetSurant<sup>®</sup> support offering will improve overall services gross margins.

*Gross Profit and Gross Profit Margin.* The mix of our various revenue components, each of which has substantially different levels of gross margin, materially influences our overall gross profit and gross margin in any particular quarter. In periods in which service revenue is high as compared to product sales, our gross margin generally improves as compared to periods in which we have higher levels of product sales. Our gross margin for product sales also varies depending on the type of product sold, the mix of large revenue product sales contracts, which typically have lower gross margin as compared to smaller revenue product sales contracts, which typically have higher gross margin. Gross margin percentage on product sales is generally positively influenced by repeat

business with existing customers, which are typically smaller transactions that generate slightly higher levels of gross margin as compared to large, competitively bid projects.

Our annual and quarterly gross profit and gross margin on product sales are materially affected by vendor incentives, most of which are Cisco incentive programs. The incentive programs sponsored by Cisco currently enable us to qualify for cash rebates or product pricing discounts. The most significant incentive is a Cisco incentive that is generally earned based on sales volumes of particular Cisco products and customer satisfaction levels. The amounts earned and costs incurred under these programs are recorded as a reduction of cost of goods sold, and the increased gross profit results in an increase in selling, general and administrative expenses related to sales commissions. We recognized vendor incentives of \$6,303, \$2,876, and \$3,480 in 2006, 2005 and 2004, respectively. The amounts earned under these programs are accrued when they are deemed probable and can be reasonably measured; otherwise, they are recorded when they are declared by the vendor or the cash is received, which ever is earlier. Our product cost and resulting gross profit can vary significantly from quarter to quarter depending upon vendor incentive criteria and our ability to qualify for and recognize such incentives.

A significant portion of our cost of services is comprised of labor, particularly for our implementation services revenue. Our gross margin on service revenue fluctuates from period to period depending not only upon the prices charged to customers for our services, but also upon the level of utilization of our technical staff. Management of labor cost is important to maximize gross margin. Our gross margin is also impacted by such factors as contract size, time and material pricing versus fixed fee pricing, discounting, vendor incentives and other business and marketing factors normally incurred during the conduct of business. Several years ago we purposely over staffed technical and engineering staff in order to have the technical competency necessary to gain market share and create a successful organization. Over the past several years as we have grown, we have been able to better utilize our technical and engineering staff and this has helped to improve the gross margin percentage on service revenue in more recent years as compared to several years ago. When we open new branch offices in new markets, we also must over staff technical and engineering resources in order to have the personnel necessary to win customer relationships in the new market. Because we expect to open multiple new offices in new markets over the upcoming year we expect gross margin on our implementation services to be negatively impacted by such new branch office operations. The extent to which total implementation services gross margin will be negatively impacted will vary based on the number and size of new branch offices we have recently opened for any given period, relative to the number of and size of mature branch offices.

*Selling, General and Administrative Expenses.* Our selling, general and administrative expenses include both fixed and variable expenses. Relatively fixed categories of expenses in selling, general and administrative expenses include rent, utilities, and administrative wages. Variable categories of expenses in selling, general and administrative expenses include sales commissions and travel, which will usually vary based on our sales and gross profit. Selling, general and administrative expenses also include expenses which vary significantly from period to period but not in proportion to sales or gross profit. These include legal expenses and bad debt expense, both of which vary based on factors that are difficult to predict.

A significant portion of our selling, general and administrative expenses relate to personnel costs, some of which are variable and others that are relatively fixed. Our variable personnel costs consist primarily of sales commissions. Sales commissions are typically calculated based upon our gross profit on a particular sales transaction and thus generally fluctuate because of the size of the transaction and the mix of associated products and services with our overall gross profit. Historically, sales commission expense has been approximately 27% to 31% of gross profit, and we expect that it will continue to approximate that level in the future. Bad debt expense generally fluctuates somewhat in proportion to sales levels, although not always in the same periods as increases or decreases in sales. Legal expense varies based on legal issue activity, which can vary substantially from period to period. Other selling, general and administrative expenses are relatively fixed and do not vary in direct proportion to increases in revenue, but will generally increase over time as the organization grows. We believe that we can achieve some level of leverage on these somewhat fixed operating expenses, relative to revenue growth, and if we are successful in doing so that this will help to increase our net operating margin.

*Acquisitions.* Under an Asset Purchase Agreement dated February 3, 2006, we purchased the assets and operations of Datatran Network Systems (“DNS”). DNS is a specialized provider of network solutions serving

the Southern California market. DNS designs, implements and supports solutions based on Cisco technologies with a primary focus on IP Telephony. We completed the acquisition simultaneously with the execution of the Asset Purchase Agreement. The consideration paid at closing pursuant to the Asset Purchase Agreement was \$1,000 in cash, including \$100 placed in escrow under holdback provisions defined in the Asset Purchase Agreement and 71,003 shares of our common stock valued at \$500. Legal and other costs of \$47 were paid in connection with the transaction, of which \$32 was paid in cash and \$15 was paid through the issuance of 2,105 shares of common stock. Additional consideration is payable based on the DNS branch office revenue during the twelve-month period ending February 28, 2007. If the revenue for that period (i) equals or exceeds \$9,000 but is less than \$9,250, then the amount of the additional purchase consideration will be \$125, (ii) equals or exceeds \$9,250 but is less than \$9,500, then the amount of the additional purchase consideration will be \$250, (iii) equals or exceeds \$9,500 but is less than \$10,000, then the amount of the additional purchase consideration will be \$375, (iv) equals or exceeds \$10,000 then the amount of the additional purchase consideration will be \$500 or (v) is less than \$9,000, then there will be no additional purchase consideration. At our option, 50% of any additional purchase price consideration, if any, may be paid in the form of common stock. Additional purchase price consideration, if any, will be recorded as goodwill.

Effective May 26, 2005, we acquired the operations and certain assets of Network Architects, Corp. (“Network Architects”), a data network and IP telephony systems design, installation and support business with branches in Albuquerque, New Mexico, and El Paso, Texas. We paid cash at closing in the amount of \$2,000, common stock valued at \$2,000, and payment of a note payable to a bank in the amount of \$300. We incurred legal and other costs of \$65 in connection with the transaction. Additional purchase price consideration valued at \$965 and recorded as goodwill was paid to Network Architects in June 2006 for achievement of certain operating profit milestones during the twelve-month period ended May 31, 2006. The consideration was comprised of \$394 paid in cash and 97,413 shares of our common stock. We will pay Network Architects additional purchase price consideration if certain financial milestones are achieved during 2007 and 2008. We will issue Network Architects a maximum of 75,000 shares of common stock following each of the twelve-month periods ending May 31, 2007 and 2008 if operating profit during such periods exceeds \$660 and \$726, respectively. If operating profit is less than the applicable milestone for any of the two years, the number of shares of common stock issuable will be equal to 75,000 multiplied by the percentage of actual operating profit during the period as compared to the applicable milestone. Additional purchase price consideration, if any, will be recorded as goodwill.

Effective June 29, 2005, we acquired the operations and certain assets of the InfoGroup Northwest, Inc. (“InfoGroup”) network solutions business with branches in Seattle, Washington, and Portland and Eugene, Oregon. We paid cash at closing in the amount of \$1,900 and shares of our common stock valued at \$500. Legal, broker, and other costs of \$123, were incurred in connection with the transaction, of which \$12 was paid through the issuance of 1,586 shares of common stock and the remainder paid in cash. Additional purchase price consideration valued at \$1,430 and recorded as goodwill was paid to InfoGroup in August 2006 for achievement of certain operating profit milestones during the twelve-month period ending June 30, 2006. The consideration consisted of \$715 paid in cash and \$715 in shares of our common stock. Additionally, cash and stock valued at \$71 was paid to the broker of the transaction.

*Tax Loss Carryforward.* Because of our operating losses in 2003 and 2005, we have accumulated a net operating loss carryforward for federal income tax purposes that, at December 31, 2006, was approximately \$2,369. Since United States tax laws limit the time during which an NOL may be applied against future taxable income and tax liabilities, we may not be able to take full advantage of our NOL carryforward for federal income tax purposes. The carryforward will expire during the period 2023 through 2025 if not otherwise used. A change in ownership, as defined by federal income tax regulations, could significantly limit the company’s ability to utilize its carryforward. If we achieve sustained profitability, which may not happen, the use of net operating loss carryforwards would reduce our tax liability and increase our net income and available cash resources. When all operating loss carryforwards have been used or have expired, we would again be subject to increased tax expense.

*Period Comparisons.* The following tables set forth, for the periods indicated, certain financial data derived from our consolidated statements of operations. Percentages shown in the table below are percentages of total revenue, except for the product and service components of cost of goods sold and gross profit, which are percentages of product and service revenue, respectively.

|  | Year Ended December 31, |              |                   |              |                 |              |
|--|-------------------------|--------------|-------------------|--------------|-----------------|--------------|
|  | 2006                    |              | 2005              |              | 2004            |              |
|  | Amount                  | %            | Amount            | %            | Amount          | %            |
|  | (Dollars in thousands)  |              |                   |              |                 |              |
| Revenue:   |                         |              |                   |              |                 |              |
| Products . . . . .   | \$135,317               | 86.7         | \$ 94,570         | 88.1         | \$65,207        | 91.2         |
| Services . . . . .   | <u>20,696</u>           | <u>13.3</u>  | <u>12,749</u>     | <u>11.9</u>  | <u>6,280</u>    | <u>8.8</u>   |
| Total revenue . . . . .  | <u>156,013</u>          | <u>100.0</u> | <u>107,319</u>    | <u>100.0</u> | <u>71,487</u>   | <u>100.0</u> |
| Gross profit:  |                         |              |                   |              |                 |              |
| Products . . . . .   | 25,132                  | 18.6         | 14,855            | 15.7         | 10,844          | 16.6         |
| Services . . . . .   | <u>5,365</u>            | <u>25.9</u>  | <u>3,721</u>      | <u>29.2</u>  | <u>2,097</u>    | <u>33.4</u>  |
| Total gross profit . . . . .                                       | 30,497                  | 19.5         | 18,576            | 17.3         | 12,941          | 18.1         |
| Selling, general and administrative expenses . . . . .             | <u>28,710</u>           | <u>18.4</u>  | <u>22,759</u>     | <u>21.2</u>  | <u>11,268</u>   | <u>15.8</u>  |
| Operating income (loss) . . . . .                                  | 1,787                   | 1.1          | (4,183)           | (3.9)        | 1,673           | 2.3          |
| Interest and other (income) expense, net . . . . .                 | 232                     | 0.1          | 236               | 0.2          | 96              | 0.1          |
| Income tax expense . . . . .                                       | 44                      | 0.0          | 475               | .4           | 350             | .5           |
| Minority interest . . . . .  | <u>—</u>                | <u>0.0</u>   | <u>23</u>         | <u>0.0</u>   | <u>117</u>      | <u>.1</u>    |
| Net income (loss) from continuing operations . . . . .             | 1,511                   | 1.0          | (4,917)           | (4.5)        | 1,110           | 1.6          |
| Income (loss) from discontinued operations, net of taxes . . . . . | <u>(316)</u>            | <u>(0.2)</u> | <u>(2,967)</u>    | <u>(2.8)</u> | <u>420</u>      | <u>.5</u>    |
| Net income (loss) . . . . .  | <u>\$ 1,195</u>         | <u>0.8</u>   | <u>\$ (7,884)</u> | <u>(7.3)</u> | <u>\$ 1,530</u> | <u>2.1</u>   |

**Year Ended December 31, 2006 Compared to Year Ended December 31, 2005**

*Total Revenue.* Total revenue increased by \$48,694, or 45.4%, to \$156,013 from \$107,319. Products revenue increased by \$40,747 or 43.1%, to \$135,317 from \$94,570. The increase in products revenue is primarily due to the full year revenue contribution from acquisitions and growth in our Federal Division business, partially offset by the absence of revenue from two large education projects generated in 2005. Services revenue increased by \$7,947 or 62.3%, to \$20,696 from \$12,749. The increase in services revenue is primarily due to the full year revenue contribution from acquisitions, growth in the NetSurant® post-sale recurring support services revenue, and increased Federal government contract revenue.

*Gross Profit.* Total gross profit increased by \$11,921, or 64.2%, to \$30,497 from \$18,576. Overall gross profit as a percentage of sales increased to 19.5% from 17.3%. Gross profit on product sales increased \$10,277, or 69.2%, to \$25,132 from \$14,855 and, as a percentage of product sales, to 18.6% from 15.7%. Products gross profit percentage improved due to a greater amount of large volume low margin projects in 2005 than 2006 and reduced costs of sales resulting from higher Cisco rebates. Cisco rebates represented 4.7% and 3.0% of products sales in 2006 and 2005, respectively. Gross profit on services revenue increased \$1,644 or 44.2% to \$5,365 from \$3,721 and gross profit as a percent of services revenue decreased to 25.9% from 29.2%. The decrease in services gross margin was the result of the increased cost of service related to hiring new engineering staff prior to generating additional service revenue, and higher NetSurant® costs incurred to support increased current business and expected future growth.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses increased by \$5,951, or 26.1% to \$28,710 from \$22,759. As a percentage of total revenue, these expenses decreased to 18.4% from 21.2%. The decrease in selling, general and administrative expenses as a percentage of sales was due to a one-time noncash charge of \$5,729 recorded in March 2005 for the remeasurement of options exchanged as part of the purchase of the minority interest in the former InterNetwork Experts, Inc. subsidiary. Excluding this one-time charge, 2005 selling, general and administrative expenses were \$17,030 or 15.9% of total 2005 revenue. 2006 selling, general and administrative expenses increased due to costs to open new offices, full year costs in acquired locations, additional sales compensation costs on substantially higher revenues, additional sales and administrative personnel costs from headcount increases. The 2006 adoption of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment", increased 2006 selling, general and administrative expenses by \$350. We expect our future selling, general and administrative expenses to continue to increase for anticipated revenue growth. However, we expect to limit the increase of selling, general and administrative expenses so that these expenses grow at a lesser rate than revenue increases because some of these expenses are relatively fixed in nature.

*Operating Income (Loss).* Operating income increased \$5,970 to income of \$1,787 from a loss of \$4,183, primarily due to the 2005 remeasurement of options expense which resulted in a charge of \$5,729, increased gross profit resulting from higher revenues and improved margins, partially offset by increased selling, general and administrative expenses in 2006.

*Interest and Other Income (Expense), net.* Interest and other income (expense), net, changed by \$4 to an expense of \$232 from an expense of \$236 primarily due lower average borrowings under our credit facility.

*Loss from Discontinued Operations, net of tax.* Loss from discontinued operations decreased by \$2,651, to a loss of \$316 from a loss of \$2,967. The loss from discontinued operations of \$316 in 2006 consisted of a loss from operations of \$1,118, partially offset by the gain on disposal of Stratasoft in January 2006 of \$302, a \$469 gain from settlement of a lawsuit in the Computer Products Division, and a \$31 gain from the sale of Valerent. The loss from discontinued operations of \$2,967 in 2005 consisted of a loss from operations of \$2,973, the cumulative effect of the change in Stratasoft's method of applying the percentage of completion accounting method of \$566, a gain from the adjustment of previously recorded accruals in the Telecom and Computer Products Divisions of \$106, and an income tax benefit of \$466.

*Net Income (Loss).* Net income increased \$9,079 to net income of \$1,195 from a net loss of \$7,884, primarily due to the 2005 remeasurement of options expense of \$5,729, reduced loss from discontinued operations of \$2,651, and increased gross profit resulting from higher revenues and improved margins, partially offset by increased selling, general and administrative expenses in 2006.

#### ***Year Ended December 31, 2005 Compared to Year Ended December 31, 2004***

*Total Revenue.* Total revenue increased by \$35,832, or 50.1%, to \$107,319 from \$71,487. Products revenue increased by \$29,363 or 45.0%, to \$94,570 from \$65,207. The increase in products revenue is primarily due to the revenue contribution from 2005 acquisitions and large projects for Austin Independent School District and CenterPoint Energy. Services revenue increased by \$6,469 or 103.0% to \$12,749 from \$6,280. The increase in services revenue is primarily due to the revenue contribution from 2005 acquisitions, growth in the NetSurant® post-sale recurring support services revenue, and increased Federal government contract revenue.

*Gross Profit.* Total gross profit increased by \$5,635, or 43.5%, to \$18,576 from \$12,941. Gross profit as a percentage of sales decreased to 17.3% from 18.1%, due to the decrease in products and services margins as a percent of sales in 2005 as compared to 2004. Gross profit on the products revenue component increased \$4,011 or 37.0%, to \$14,855 from \$10,844. Product gross margin decreased to 15.7% from 16.6% primarily due to lower vendor rebates in 2005 due to the initial recognition of vendor rebates on the accrual basis beginning in 2004. In 2004, information became readily available from the vendor so that the incentives earned were reasonably determinable. As a result, Cisco rebates represented 3.0% and 5.3% of products sales in 2005 and 2004, respectively. Gross profit on services revenue increased \$1,624 or 77.4% to \$3,721 from \$2,097 and gross profit as a percent of services revenue decreased to 29.2% from 33.4%. The decrease in services gross margin was primarily as a result of lower service margins in acquired locations.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses increased by \$11,491, or 102.0% to \$22,759 from \$11,268. As a percentage of total revenue, these expenses increased to 21.2% from 15.8%. The increase in selling, general and administrative expenses as a percentage of sales was due to a one-time noncash charge of \$5,729 recorded in March 2005 for the remeasurement of options exchanged as part of the purchase of the minority interest in the former InterNetwork Experts, Inc. subsidiary. Excluding this one-time charge, 2005 selling, general and administrative expenses were \$17,030 or 15.9% of total 2005 revenue, approximating the same relationship to total revenue as in 2004.

*Operating Income (Loss).* Operating income decreased \$5,856 to a loss of \$4,183 from income of \$1,673, primarily due to the 2005 remeasurement of options expense which resulted in a charge of \$5,729.

*Interest and Other Income (Expense), net.* Interest and other income (expense), net, changed by \$140 to expense of \$236 from expense of \$96, primarily due to increased borrowings under our credit facility resulting from delays in payment by the Schools and Libraries Division of the Universal Services Administrative Corporation on school district accounts receivable and due to funding the cash portion of the purchase price for acquisitions.

*Income (Loss) from Discontinued Operations, net of tax.* Loss from discontinued operations increased by \$3,387, to a loss of \$2,967 from income of \$420. The loss from discontinued operations of \$2,967 in 2005 consisted of a loss from operations of \$2,973, the cumulative effect of the change in Stratasoft's method of applying the percentage of completion accounting method of \$566, a gain from the adjustment of previously recorded accruals in the Telecom and Computer Products Divisions of \$106, and an income tax benefit of \$466. The income from discontinued operations of \$420 in 2004 consisted of income from operations of \$14, a gain from the adjustment of previously recorded accruals in the Telecom and Computer Products Divisions of \$57, and an income tax benefit of \$349.

*Net Income (Loss).* Net income decreased \$9,414 to a net loss of \$7,884 from net income of \$1,530, primarily due to the \$5,729 noncash charge for stock option remeasurement and \$3,387 increased loss from discontinued operations. Net income from continuing operations decreased to a net loss of \$4,917 from a net profit of \$1,110 primarily due to the \$5,729 noncash charge for stock option remeasurement and increased interest and income tax expense.

## Quarterly Results

The following table sets forth certain unaudited quarterly financial information for each of our last eight quarters and, in the opinion of management, includes all adjustments (consisting of only normal recurring adjustments) that we consider necessary for a fair presentation of the information set forth therein. Our quarterly results may vary significantly depending on factors such as the timing of large customer orders, timing of new product introductions, adequacy of product supply, variations in our product costs, variations in our product mix, promotions, seasonal influences and fluctuations in competitive pricing pressures. The results of any particular quarter may not be indicative of results for the full year or any future period.

|  | 2006            |                 |                 |                 | 2005            |                 |                 |                   |
|--|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-------------------|
|  | Fourth Quarter  | Third Quarter   | Second Quarter  | First Quarter   | Fourth Quarter  | Third Quarter   | Second Quarter  | First Quarter     |
| (Dollars in thousands, except share and per share amounts) |                 |                 |                 |                 |                 |                 |                 |                   |
| Revenue:   |                 |                 |                 |                 |                 |                 |                 |                   |
| Products . . . . .   | \$39,837        | \$39,847        | \$33,322        | \$22,311        | \$20,331        | \$28,922        | \$25,543        | \$19,774          |
| Services . . . . .   | 5,978           | 5,397           | 5,356           | 3,965           | 4,178           | 4,241           | 2,822           | 1,508             |
| Total revenue . . . . .                                    | <u>\$45,815</u> | <u>\$45,244</u> | <u>\$38,678</u> | <u>\$26,276</u> | <u>\$24,509</u> | <u>\$33,163</u> | <u>\$28,365</u> | <u>\$21,282</u>   |
| Gross profit:  |                 |                 |                 |                 |                 |                 |                 |                   |
| Products . . . . .   | \$ 7,722        | \$ 6,632        | \$ 6,360        | \$ 4,418        | \$ 3,932        | \$ 4,106        | \$ 3,480        | \$ 3,337          |
| Services . . . . .   | 1,587           | 1,517           | 1,272           | 989             | 1,072           | 1,349           | 976             | 324               |
| Total gross profit . . . . .                               | 9,309           | 8,149           | 7,632           | 5,407           | 5,004           | 5,455           | 4,456           | 3,661             |
| Selling, general and administrative expenses . . . . .     | 8,432           | 7,432           | 7,001           | 5,845           | 5,160           | 4,545           | 4,044           | 9,010             |
| Operating income (loss) . . . . .                          | <u>\$ 877</u>   | <u>\$ 717</u>   | <u>\$ 631</u>   | <u>\$ (438)</u> | <u>\$ (156)</u> | <u>\$ 910</u>   | <u>\$ 412</u>   | <u>\$ (5,349)</u> |
| Income (loss) from continuing operations . . . . .         | \$ 860          | \$ 562          | \$ 613          | \$ (524)        | \$ (91)         | \$ 466          | \$ 246          | \$ (5,538)        |
| Income (loss) from discontinued operations . . . . .       | (164)           | (291)           | 143             | (4)             | (632)           | (701)           | (664)           | (970)             |
| Net income (loss) . . . . .                                | <u>\$ 696</u>   | <u>\$ 271</u>   | <u>\$ 756</u>   | <u>\$ (528)</u> | <u>\$ (723)</u> | <u>\$ (235)</u> | <u>\$ (418)</u> | <u>\$ (6,508)</u> |
| Income (loss) from continuing operations per share:        |                 |                 |                 |                 |                 |                 |                 |                   |
| Basic . . . . .  | \$ 0.13         | \$ 0.10         | \$ 0.10         | \$ (0.09)       | \$ (0.02)       | \$ 0.08         | \$ 0.04         | \$ (1.06)         |
| Diluted . . . . .  | \$ 0.11         | \$ 0.09         | \$ 0.08         | \$ (0.09)       | \$ (0.02)       | \$ 0.08         | \$ 0.04         | \$ (1.06)         |
| Net income (loss) per share:                               |                 |                 |                 |                 |                 |                 |                 |                   |
| Basic . . . . .  | \$ 0.11         | \$ 0.08         | \$ 0.12         | \$ (0.09)       | \$ (0.12)       | \$ (0.04)       | \$ (0.07)       | \$ (1.25)         |
| Diluted . . . . .  | \$ 0.09         | \$ 0.07         | \$ 0.10         | \$ (0.09)       | \$ (0.12)       | \$ (0.04)       | \$ (0.07)       | \$ (1.25)         |

One acquisition was completed in the first quarter of 2006, Datatran Network Systems, and two acquisitions were completed in the second quarter of 2005, Network Architects and InfoGroup Northwest (see Note 3 to consolidated financial statements in Part II, Item 8). The second and third quarters of 2005 also reflected large projects for Austin Independent School District and CenterPoint Energy. Growth in the locations acquired in 2005 and 2006 fueled revenue increases in the second, third and fourth quarters of 2006 combined with increased revenue growth in previously existing locations during the last half of 2006.

Our gross profit has fluctuated between quarters primarily due to changes in our revenue mix between products and services revenues and variations in Cisco vendor rebates. Services gross profit and gross margin varied primarily based on the level of utilization of billable technical staff and the type of service revenues generated, which can vary from period to period and result in varying levels of gross profit and gross margin. Increased products revenue in the second, third and fourth quarters of 2006 did not result in lower gross margins as was experienced in 2005 due to the larger number of smaller projects.

The respective timing of when vendor incentives become earned and determinable can create significant quarter to quarter gross margin fluctuations. During the fourth quarter of 2006, additional incentives of \$691 were recorded as a change in estimate increasing 2006 income from continuing operations and net income. While we expect vendor incentives will remain earned and determinable in future periods, we do not have any assurance that we will continue to meet the vendor incentive criteria required to receive the incentive or that the vendor will continue to offer incentive programs during the future.

The unusually high selling, general and administrative expense in our first quarter ended March 31, 2005 was primarily due to a \$5,729 one-time non-cash charge related to the remeasurement of stock options.

Net loss from continuing operations in the first quarter of 2005 reflects the \$5,729 charge for the remeasurement of stock options resulting from the elimination of the InterNetwork Experts, Inc. minority interest as discussed further in Note 11 to consolidated financial statements in Part II, Item 8.

## **Critical Accounting Policies**

### ***Revenue Recognition***

We have a number of different revenue sources for which revenue is recognized differently based on the following policies:

*Products revenue* occurs when products manufactured or otherwise provided by other parties are purchased and resold to a customer and product payment is not contingent upon performance of installation or service obligations. If product acceptance and payment are contingent on installation or service obligations as specified in the customer contract, revenue is not recognized until installation occurs. Revenue is recognized from the sales of hardware when the rights and risks of ownership have passed to the customer and upon shipment or receipt by the customer, depending on the terms of the sales contract with the customer. We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed or determinable, and collectibility is reasonably assured. Amounts billed to customers for shipping and handling are classified as revenue.

We sell hardware maintenance contracts that are serviced and supported solely by a third party, who is the primary obligor of these contracts. There are multiple factors under EITF 99-19, but the primary obligor is a strong factor in determining whether we act as a principal or agent and whether gross or net revenue presentation is appropriate. As we have concluded that we are more of an agent in the sale of hardware maintenance contracts, revenue is reported net of the cost of the hardware maintenance contracts from the third party.

For arrangements where the customer agrees to purchase products but we retain possession until the customer requests shipment, or “bill and hold” arrangements, revenue is not recognized until delivery to the customer has occurred and all other revenue recognition criteria have been met.

*Software* is accounted for in accordance with Statement of Position No. 97-2, “Software Revenue Recognition,” and all related interpretations. Revenue from the sales of software not requiring significant modification or customization is recognized upon delivery or installation. Installation services for third party software do not include significant alterations to its features or functionality. Third party software vendors provide all post-contract support for software sold. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectibility is reasonably assured.

*Technical support services revenue*, consisting of remote monitoring and management of customers’ IP telephony and network infrastructure equipment and applications, is recognized ratably over the term of the underlying customer contract. Commission costs paid in advance are deferred and recognized ratably over the term of the underlying customer contract.

*Revenue for fixed and flat fee services contracts* related to customized network and IP telephony solutions are recognized under a proportional performance model utilizing an input based approach (labor hours). Our contracts function similar to a time and materials type contract and generally do not specify or quantify interim deliverables or milestones. Such service contracts encompass the design and installation of IP telephony and computer networks under which customers receive the benefit of services provided over the period of contract performance.

*Other service revenue* is earned from providing stand-alone services such as billings for engineering and technician time, installation and programming services, which are provided on either an hourly basis or a flat-fee basis, and the service component of maintenance and repair service ticket transactions. These services are contracted for separately from any product sale. Other service revenues are recognized when the service is performed and when collection is reasonably assured. Revenue arrangements generally do not include specific customer acceptance criteria. In instances where final acceptance of the system or solution is specified by the customer, revenue is deferred until all acceptance criteria have been met.

*Arrangements with multiple deliverables* are arrangements under which a combination of products and services are provided to customers. Such arrangements are evaluated under Emerging Issues Task Force Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables," ("EITF 00-21"), which addresses certain aspects of accounting by a vendor for arrangements under which the vendor will perform multiple revenue generating activities. The application of the appropriate accounting guidance requires judgment and is dependent upon the specific transaction and whether the sale includes hardware, software, services or a combination of these items.

We enter into product and service contracts for customers that are generally considered a single arrangement and which include separate units of accounting for product and for service. Product primarily consists of IP telephony and computer network infrastructure components and third party software. Service encompasses the design and installation of IP telephony and computer networks and installation of third party software. Installation services for third party software do not include significant alterations to its features or functionality. All products and services are regularly sold separately. For products and services sold in a single arrangement, the product is typically delivered first and the related services are completed within four to six weeks. Product is shipped, billed, and recognized as revenue independent of services because:

- The customer is required to pay the product billing in its entirety independent of any services performed.
- The product has value to the customer on a stand alone basis and pricing is comparable whether sold with or without services.
- The product is standard equipment not significantly altered by installation.
- Installation of the product can be performed by many other companies.
- Although there is a general right of return relative to delivered product, delivery of the undelivered items is considered probable and is substantially in our control .

We recognize revenue for multiple element arrangements based on the relative fair value of the separate elements. Comparable products and services are sold on a stand alone basis and under multiple element arrangements at the same prices. Stand alone pricing is vendor-specific objective evidence under EITF 00-21. Customers are not required to and frequently do not select the same vendor for product and service. The customers' decision does not impact the pricing of the portion of the bid selected.

Contracts and customer purchase orders are generally used to determine the existence of an arrangement. Shipping documents and customer acceptance, when applicable, are used to verify delivery. Determination that the fee is fixed or determinable is based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. Accruals for estimated sales returns and other allowances and deferrals are recorded as a reduction of revenue at the time of revenue recognition. These provisions are based on contract terms and prior claims experience and involve significant estimates. If these estimates are significantly different from actual results, our revenue could be impacted.

We maintain allowances for doubtful accounts receivable for estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances might be required.

Credit and collections policy inherent in our revenue recognition policy is the determination of the collectibility of amounts due from our customers, which requires us to use estimates and exercise judgment. We routinely monitor our customer's payment history and current credit worthiness to determine that collectibility is reasonably assured and, then in some instances, require letters of credit in support of contracted amounts.

This requires us to make frequent judgments and estimates in order to determine the appropriate period to recognize a sale to a customer and the amount of valuation allowances required for doubtful accounts. We record provisions for doubtful accounts when it becomes evident that the customer will not be able to make the required payments either at contractual due dates or in the future. Changes in the financial condition of our customers, either adverse or positive, could impact the amount and timing of any additional provision for doubtful accounts that may be required.

***Vendor Incentive Recognition***

We participate in vendor incentive programs, including a significant vendor incentive program with our primary vendor, Cisco. These incentives are generally earned based on sales volume and customer satisfaction levels. The amounts earned under these programs are accrued when they are deemed probable and can be reasonably measured; otherwise, they are recorded when they are declared by the vendor or the cash is received, whichever is earlier. As a result of these estimates, the amount of rebates declared by the vendor, or the amount of rebates received in cash, the effect of vendor incentives on cost of goods can vary significantly between quarterly and annual reporting periods. Failure to achieve the requirements set by the vendor to earn a particular incentive could result in us not receiving a vendor incentive and result in lower gross margin on our product sales revenue. The incentives are recorded as a reduction of cost of goods. Selling, general and administrative expenses are increased for any associated commission expense and payroll tax related to the incentives.

***Share-Based Compensation Expense***

On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), “Share-Based Payment,” (“SFAS 123R”) which requires the measurement and recognition of compensation expense based on estimated fair values for share-based payment awards. SFAS 123R supersedes our previous accounting under Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees” (“APB 25”) for periods beginning in 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 (“SAB 107”) relating to SFAS 123R. We have utilized the guidance of SAB 107 in the adoption of SFAS 123R.

SFAS 123R requires all share-based payments to be recognized in the results of operations at their grant-date fair values. We adopted SFAS 123R using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of our 2006 fiscal year. Under this transition method, compensation cost recognized in 2006 includes: (a) compensation cost for all share-based payments granted prior to but not yet vested as of December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123, and (b) compensation cost for all share-based payments granted subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. In accordance with the modified prospective method of adoption, our results of operations and financial position for prior periods have not been restated.

We use the Black-Scholes option pricing model to calculate the grant-date fair value of an award. The fair value of options granted during the 2006, 2005 and 2004 periods were calculated using the following estimated weighted average assumptions:

|                                    | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|------------------------------------|-------------|-------------|-------------|
| Expected volatility . . . . .      | 63.1%       | 63.9%       | 79.8%       |
| Expected term (in years) . . . . . | 6.3         | 8.0         | 8.0         |
| Risk-free interest rate . . . . .  | 4.7%        | 4.4%        | 3.6%        |
| Expected dividend yield . . . . .  | 0%          | 0%          | 0%          |

Expected volatility is based on historical volatility over the period IP communications solutions was our primary line of business. Beginning in 2006, we used the simplified method outlined in SAB 107 to estimate expected lives for options granted during the period. The risk-free interest rate is based on the yield on zero-coupon U.S. Treasury securities for a period that is commensurate with the expected term assumption. We have not historically issued any dividends and do not expect to in the future.

We use the straight-line attribution method to recognize expense for unvested options. The amount of share-based compensation recognized during a period is based on the value of the awards that are ultimately expected to vest. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. We will re-evaluate the forfeiture rate annually and adjust it as necessary, and the adjustments could be material.

## Liquidity and Capital Resources

### Sources of Liquidity

Our principal sources of liquidity are collections from our accounts receivable and our credit facility with Castle Pines Capital (the "Credit Facility"), which we believe are sufficient to meet our short-term and long-term liquidity requirements. We use the Credit Facility to finance the majority of our purchases of inventory, and to provide working capital when our cash flow from operations is insufficient. In 2006, we experienced negative cash flow from operating activities of continuing operations of \$26 and negative cash flow from discontinued operations of \$684. During 2006 the increase in use of our Credit Facility and cash flow from operations approximated the increase in accounts receivable and inventory. Our working capital increased slightly to \$7,632 at December 31, 2006 from \$7,392 at December 31, 2005.

*Accounts Receivable.* The timing of our collection of accounts receivable and payments of our accounts payable is one of the principal influences on our cash flow from operations. We typically sell our products and services on short-term credit terms. We try to minimize our credit risk by performing credit checks, obtaining letters of credit in certain instances, and conducting our own collection efforts. Our accounts receivable, net of allowance for doubtful accounts, were \$42,424 and \$24,903 at December 31, 2006 and 2005, respectively. The increase in accounts receivable was attributable to significantly increased sales in the fourth quarter of 2006 compared to 2005.

*Inventory.* We had inventory of \$1,157 and \$79 at December 31, 2006 and 2005, respectively. The higher level of 2006 inventory is attributable to customer orders to be shipped in the first quarter of 2007. We try to minimize the amount of inventory on hand to reduce the risk that the inventory will become obsolete or decline in value. We are able to do this by relying on the ready availability of products from our principal suppliers. As noted above, we rely principally on our Credit Facility to finance our inventory purchases.

*Accounts Payable.* We rely on our Credit Facility to finance a substantial portion of our trade accounts payable under terms ranging from 30 to 60 days. Credit Facility balances within terms are non-interest bearing and classified as accounts payable in our balance sheet. Credit Facility balances outstanding in excess of terms are interest bearing and classified as notes payable in our balance sheet. Our accounts payable were \$28,798 and \$13,825 at December 31, 2006 and 2005, respectively. The increase in accounts payable was attributable to significantly increased purchases directly related to increased sales in the fourth quarter of 2006 compared to 2005.

### Contractual Obligations

Our contractual cash obligations with terms in excess of one year consist of lease obligations, substantially all of which are for office space. All notes payable and other debt, including our Credit Facility discussed above, have remaining terms of less than one year. The following table summarizes contractual cash obligations with terms in excess of one year as of December 31, 2006:

| <u>Contractual Obligations</u>          | <u>Payments Due by Period</u> |                             |                  |                  |                          |
|---|-------------------------------|-----------------------------|------------------|------------------|--------------------------|
|   | <u>Total</u>                  | <u>Less Than<br/>1 Year</u> | <u>1-3 Years</u> | <u>4-5 Years</u> | <u>After<br/>5 Years</u> |
|   | (Dollars in thousands)        |                             |                  |                  |                          |
| Lease obligations . . . . .             | \$4,011                       | \$ 897                      | \$1,781          | \$835            | \$498                    |
| Purchase obligations . . . . .          | 776                           | 469                         | 307              | —                | —                        |
| Total contractual obligations . . . . . | <u>\$4,787</u>                | <u>\$1,366</u>              | <u>\$2,088</u>   | <u>\$835</u>     | <u>\$498</u>             |

Purchase obligations represent contractual requirements under a software license agreement. We do not have material purchase obligations for inventory. We purchase inventory to fulfill in-hand orders from customers and we

try to minimize the amount of inventory on hand to reduce the risk that the inventory will become obsolete or decline in value. We are able to do this by relying on the ready availability of products from our principal suppliers.

We expect to be able to meet our contractual cash payment obligations by their due dates through cash generated from operations, augmented, if needed, by borrowings under the Credit Facility.

*Credit Facility.* We have a \$40.0 million senior credit facility with Castle Pines Capital LLC (“CPC”) to provide inventory financing and to fund working capital requirements. Key terms of the Agreement are summarized as follows:

- The Agreement provides a discretionary line of credit up to a maximum aggregate amount of \$40.0 million to purchase inventory from CPC approved vendors.
- The Agreement provides a working capital revolving line of credit under the above line of credit with an aggregate outstanding sublimit of \$10.0 million.
- The working capital revolving line of credit incurs interest payable monthly at the rate of prime plus 0.5%.
- The Agreement contains customary covenants regarding maintenance of insurance coverage, maintenance of and reporting collateral, and submission of financial statements. The Agreement also contains restrictive financial covenants measured as of the end of each calendar quarter as detailed further below.
- The line of credit is collateralized by substantially all of our assets.
- The Agreement has a two year term ending December 26, 2007 and automatically renews for one year periods unless (1) 60 days notice is received from CPC, (2) we are in default, or (3) there is a change in vendor participation. We expect to renew the Agreement, but there is no assurance that financing will be available or the terms will be as favorable as the current Agreement.

As of December 31, 2006, borrowing capacity and availability were as follows (amounts in thousands):

|  |                 |
|--|-----------------|
| Total Credit Facility . . . . .              | \$ 40,000       |
| Borrowing base limitation . . . . .          | <u>(8,177)</u>  |
| Total borrowing capacity . . . . .           | 31,823          |
| Less interest-bearing borrowings . . . . .   | (4,350)         |
| Less non-interest bearing advances . . . . . | <u>(25,991)</u> |
| Total unused availability . . . . .          | <u>\$ 1,482</u> |

The “unused availability” is the amount not borrowed, but eligible to be borrowed. The borrowing base restrictions generally restrict our borrowings under the Credit Facility to 85% of the eligible receivables, 100% of our Floorplanned inventory and 75% of Cisco vendor rebates receivable.

We use the Credit Facility to finance purchases of Cisco products from Cisco and from certain wholesale distributors. Cisco provides 60-day terms, and other wholesale distributors typically provide 30-day terms. Balances under the Credit Facility that are within those respective 60-day and 30-day periods (the “Free Finance Period”) do not accrue interest and are classified as accounts payable in our balance sheet. We refer to non-interest bearing balances as “inventory floor plan borrowings”.

To the extent that we have credit availability under the Credit Facility, it gives us the ability to extend the payment terms past the Free Finance Period. Amounts extended past the Free Finance Period accrue interest and are classified as notes payable on our balance sheet. These extended payment balances under the Credit Facility accrue interest at the prime rate (8.25% at December 31, 2006) plus 0.5%.

As defined in the Credit Facility there are restrictive covenants that are measured at each quarter and year end. These covenants require us to:

- maintain Minimum Tangible Net Worth of \$8.0 million;
- maintain a maximum Debt to Tangible Net Worth ratio of 6.0 to 1;

- maintain Minimum Working Capital of not less than \$6.5 million; and
- maintain a Current Ratio of not less than 1.10 to 1.0.

At December 31, 2006, we were in compliance with the loan covenants, and we anticipate that we will be able to comply with the loan covenants during the next twelve months. If we violate any of the loan covenants, we would be required to seek waivers from CPC for those non-compliance events. If CPC refused to provide waivers, the amount due under the Credit Facility could be accelerated and we could be required to seek other sources of financing.

*Cash Flows.* During 2006, our cash decreased by \$802. Operating activities used \$710, investing activities used \$2,606 and financing activities provided \$2,514.

*Operating Activities.* Operating activities used \$710 in 2006 as compared to providing cash of \$8,050 in 2005 and using cash of \$10,488 in 2004. Adjustments for non-cash-related items of \$1,991 included \$1,178 from depreciation and amortization, \$415 from share-based compensation, and \$316 from discontinued operations, net of tax.

Changes in asset and liability accounts used \$3,212. The most significant source was accounts payable which increased \$14,981 from increased purchases of product for resale to our customers. Significant uses of cash were increased accounts receivable of \$17,584 resulting from growth in the business and increased inventory of \$1,053 for customer orders shipping in the first quarter of 2007.

Discontinued operations used \$684 in cash due to operating losses, partially offset by the collection of accounts and notes receivable.

*Investing Activities.* Investing activities used \$2,606 in 2006 compared to the use of \$5,084 in 2005 and \$931 in 2004. Investing activities related to cash paid for acquisitions were \$2,177 in 2006 and \$4,562 in 2005. Our investing activities related to capital expenditures in all three years were primarily related to purchases of computer equipment and software, and to a lesser degree, leasehold improvements. Discontinued operations provided cash from investing activities of \$1,492 as a result of the sales of Stratasoft and Valerent during 2006 compared to using cash of \$77 and \$89 for capital expenditures in 2005 and 2004, respectively.

*Financing Activities.* Financing activities provided \$2,514 compared to using \$5,344 in 2005 and providing \$14,145 in 2004. Borrowings under the Credit Facility provided cash of \$1,886 in 2006, used cash of \$5,658 in 2005, and provided cash of \$6,423 in 2004. Proceeds from an offering of equity securities provided \$7,548 in 2004. Our changes in stock price resulted in stock option holders exercising stock options, which provided \$613, \$209, and \$280 in 2006, 2005, and 2004, respectively.

## **Recent Accounting Pronouncements**

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides related guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure. FIN 48 is effective beginning January 1, 2007. The adoption of FIN 48 is not expected to have a material effect on the Company's financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This statement clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The adoption of SFAS 157 is not expected to have a material impact on the Company's consolidated financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 ("SAB 108"). SAB 108 provides guidance on the consideration of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The staff believes registrants must quantify the impact of correcting all misstatements, including both carryover and reversing effects of prior year misstatements, on the current year consolidated financial statements. The staff prescribes two approaches to assessing the materiality of misstatements; the "rollover" approach, which quantifies misstatements based on the amount of error originating in the current year

income statement and the “iron curtain approach”, which quantifies misstatements based on the effects of correcting the cumulative effect existing in the balance sheet at the end of the current year. If under either approach, misstatements are deemed material, we are required to adjust our financial statements, including correcting prior year financial statements, even though such correction was and continues to be immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require us to amend previously filed reports, rather such corrections may be made the next time we file our prior year statements.

Since inception the Company recorded audit professional fees in the year under audit and tax professional fees in the year for which the tax returns were filed. Generally accepted accounting principles require audit and tax professional fees to be expensed as incurred, which are primarily in the year subsequent to the year under audit or year for which tax returns are filed. Prior to 2006, the difference between the two methods was immaterial to the Company’s financial position and results of operations. Applying the guidance of SAB 108, the Company corrected its accounting for audit and tax fees in 2006 by reducing the January 1, 2006 retained deficit in the amount of \$125 for the cumulative effect of the correction.

**Item 7A. *Quantitative and Qualitative Disclosures About Market Risk***

**Interest Rate Risk**

We attempt to manage our borrowings under the Castle Pines Capital Facility (“Facility”) to minimize interest expense. The interest rate of the Facility is the prime rate plus 0.5% (see “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources”). During the year ended December 31, 2006, the interest rates of borrowings under the Facility ranged from 7.75% to 8.75%. A one percent change in variable interest rates will not have a material impact on our financial condition.

**Item 8. *Financial Statements and Supplementary Data***

**INX INC.**

**INDEX TO FINANCIAL STATEMENTS  
AND FINANCIAL STATEMENT SCHEDULE**

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders of INX Inc.:

We have audited the accompanying consolidated balance sheets of INX Inc. (formerly I-Sector Corporation) (a Delaware corporation) and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of INX Inc. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to the consolidated financial statements, effective January 1, 2006 the Company adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payments." Also as discussed in Note 2 to the consolidated financial statements, the Company recorded a cumulative effect adjustment as of January 1, 2006, in connection with the adoption of SEC Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements."

/s/ GRANT THORNTON LLP

Houston, Texas  
February 27, 2007

**INX INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

|   | <b>December 31,</b>                                       |                 |
|---|---|-----------------|
|   | <b>2006</b>   | <b>2005</b>     |
|   | <b>(In thousands, except share and par value amounts)</b> |                 |
| <b>ASSETS</b>   |   |                 |
| Current Assets:   |   |                 |
| Cash and cash equivalents . . . . .   | \$ 1,795  | \$ 2,597        |
| Accounts receivable — trade, net of allowance of \$299 and \$161 . . . . .                            | 42,424  | 24,903          |
| Inventory . . . . .   | 1,157   | 79              |
| Other current assets . . . . .  | 2,067   | 881             |
| Current assets of discontinued operations . . . . .   | 19  | 2,564           |
| Total current assets . . . . .  | 47,462  | 31,024          |
| Property and equipment, net of accumulated depreciation of \$2,414 and \$2,344 . . . . .              | 3,854   | 2,050           |
| Goodwill . . . . .  | 10,891  | 7,121           |
| Intangible assets, net of accumulated amortization of \$1,264 and \$1,007 . . . . .                   | 283   | 372             |
| Other assets . . . . .  | —   | 21              |
| Noncurrent assets of discontinued operations . . . . .  | 30  | 1,057           |
| Total assets . . . . .  | <b>\$62,520</b>   | <b>\$41,645</b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |   |                 |
| Current Liabilities:  |   |                 |
| Notes payable and current portion of long-term debt . . . . .   | \$ 4,609  | \$ 2,707        |
| Accounts payable . . . . .  | 28,798  | 13,825          |
| Accrued payroll and related costs . . . . .   | 3,362   | 2,216           |
| Accrued expenses . . . . .  | 1,676   | 1,480           |
| Other current liabilities . . . . .   | 1,260   | 468             |
| Current liabilities of discontinued operations . . . . .  | 125   | 2,936           |
| Total current liabilities . . . . .   | 39,830  | 23,632          |
| Other long-term liabilities . . . . .   | 306   | —               |
| Long-term liabilities of discontinued operations . . . . .  | —   | 7               |
| Commitments and Contingencies   |   |                 |
| Stockholders' Equity:   |   |                 |
| Preferred stock, \$.01 par value, 5,000,000 shares authorized, no shares issued . . . . .             | —   | —               |
| Common stock, \$.01 par value, 15,000,000 shares authorized, 6,603,070 and 5,975,626 issued . . . . . | 66  | 60              |
| Additional paid-in capital . . . . .  | 30,598  | 27,546          |
| Retained deficit . . . . .  | (8,280)   | (9,600)         |
| Total stockholders' equity . . . . .  | 22,384  | 18,006          |
| Total liabilities and stockholders' equity . . . . .  | <b>\$62,520</b>   | <b>\$41,645</b> |

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

**INX INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

|   | Year Ended December 31,                            |            |           |
|---|--|------------|-----------|
|   | 2006   | 2005       | 2004      |
|   | (In thousands, except share and per share amounts) |            |           |
| Revenue:  |  |            |           |
| Products . . . . .  | \$ 135,317   | \$ 94,570  | \$ 65,207 |
| Services . . . . .  | 20,696   | 12,749     | 6,280     |
| Total revenue . . . . .   | 156,013  | 107,319    | 71,487    |
| Cost of goods and services:   |  |            |           |
| Products . . . . .  | 110,185  | 79,715     | 54,363    |
| Services . . . . .  | 15,331   | 9,028      | 4,183     |
| Total cost of goods and services . . . . .                                      | 125,516  | 88,743     | 58,546    |
| Gross profit . . . . .  | 30,497   | 18,576     | 12,941    |
| Selling, general and administrative expenses . . . . .                          | 28,710   | 22,759     | 11,268    |
| Operating income (loss) . . . . .   | 1,787  | (4,183)    | 1,673     |
| Interest expense . . . . .  | 273  | 297        | 205       |
| Other (income) expense, net . . . . .   | (41)   | (61)       | (109)     |
| Income (loss) from continuing operations before income taxes . . . . .          | 1,555  | (4,419)    | 1,577     |
| Income tax expense . . . . .  | 44   | 475        | 350       |
| Income (loss) from continuing operations before minority interest . . . . .     | 1,511  | (4,894)    | 1,227     |
| Minority interest . . . . .   | —  | 23         | 117       |
| Net income (loss) from continuing operations . . . . .                          | 1,511  | (4,917)    | 1,110     |
| Income (loss) from discontinued operations, net of taxes . . . . .              | (316)  | (2,967)    | 420       |
| Net income (loss) . . . . .   | \$ 1,195   | \$ (7,884) | \$ 1,530  |
| Net income (loss) per share:  |  |            |           |
| Basic:  |  |            |           |
| Net income (loss) from continuing operations before minority interest . . . . . | \$ 0.24  | \$ (0.86)  | \$ 0.27   |
| Minority interest . . . . .   | —  | —          | (0.03)    |
| Income (loss) from discontinued operations, net of taxes . . . . .              | (0.05)   | (0.52)     | 0.09      |
| Net income (loss) per share . . . . .   | \$ 0.19  | \$ (1.38)  | \$ 0.33   |
| Diluted:  |  |            |           |
| Net income (loss) from continuing operations before minority interest . . . . . | \$ 0.21  | \$ (0.86)  | \$ 0.25   |
| Minority interest . . . . .   | —  | —          | (0.02)    |
| Income (loss) from discontinued operations, net of taxes . . . . .              | (0.05)   | (0.52)     | 0.08      |
| Net income (loss) per share . . . . .   | \$ 0.16  | \$ (1.38)  | \$ 0.31   |
| Shares used in computing net income (loss) per share:                           |  |            |           |
| Basic . . . . .   | 6,318,674  | 5,706,323  | 4,569,507 |
| Diluted . . . . .   | 7,293,737  | 5,706,323  | 5,004,393 |

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

**INX INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

|   | <u>\$.01 Par Value<br/>Common Stock</u>            |               | <u>Additional<br/>Paid-In<br/>Capital</u> | <u>Treasury<br/>Stock</u> | <u>Retained<br/>Deficit</u> | <u>Total</u>    |
|---|--|---------------|---|---------------------------|-----------------------------|-----------------|
|   | <u>Shares</u>                                      | <u>Amount</u> |   |                           |                             |                 |
|   | (In thousands, except share and par value amounts) |               |   |                           |                             |                 |
| Balance at January 1, 2004 . . . . .  | 4,762,809  | \$48          | \$11,190                                  | \$(1,373)                 | \$(3,246)                   | \$ 6,619        |
| Revaluation of consultant options . . . . .   | —  | —             | (199)                                     | —                         | —                           | (199)           |
| Exercise of common stock options . . . . .  | 100,345  | —             | 280                                       | —                         | —                           | 280             |
| Proceeds from offering of units, net of offering costs of \$1,145 . . . . .                                 | 1,150,000  | 12            | 7,536                                     | —                         | —                           | 7,548           |
| Issuance of INX common stock net of minority interest . . . . .   | —  | —             | 71  | —                         | —                           | 71              |
| Retirement of treasury stock . . . . .  | (811,800)  | (8)           | (1,365)                                   | 1,373                     | —                           | —               |
| Net income . . . . .  | —  | —             | —   | —                         | 1,530                       | 1,530           |
| Balance at December 31, 2004 . . . . .  | 5,201,354  | 52            | 17,513                                    | —                         | (1,716)                     | 15,849          |
| Exercise of common stock options . . . . .  | 157,414  | 2             | 207                                       | —                         | —                           | 209             |
| Exchange of INX and I-Sector options . . . . .  | —  | —             | 5,729                                     | —                         | —                           | 5,729           |
| Exchange of INX and I-Sector common stock . . . . .   | 244,890  | 2             | 1,528                                     | —                         | —                           | 1,530           |
| Issuance of shares for Network Architects acquisition . . . . .   | 308,166  | 3             | 1,997                                     | —                         | —                           | 2,000           |
| Issuance of shares for InfoGroup Northwest acquisition . . . . .  | 65,102   | 1             | 512                                       | —                         | —                           | 513             |
| Issuance of stock options . . . . .   | —  | —             | 57  | —                         | —                           | 57              |
| Vesting of consultant options . . . . .   | —  | —             | 9   | —                         | —                           | 9               |
| Repurchase and retirement of common stock . . . . .   | (1,300)  | —             | (6)                                       | —                         | —                           | (6)             |
| Net loss . . . . .  | —  | —             | —   | —                         | (7,884)                     | (7,884)         |
| Balance at December 31, 2005 . . . . .  | 5,975,626  | 60            | 27,546                                    | —                         | (9,600)                     | 18,006          |
| Cumulative effect of correction of accounting for professional fees as provided under SAB 108 . . . . .     | —  | —             | —   | —                         | 125                         | 125             |
| Balance at January 1, 2006 . . . . .  | 5,975,626  | 60            | 27,546                                    | —                         | (9,475)                     | 18,131          |
| Exercise of common stock options and other . . . . .  | 332,859  | 3             | 610                                       | —                         | —                           | 613             |
| Issuance of shares for Datatran acquisition . . . . .   | 73,108   | 1             | 514                                       | —                         | —                           | 515             |
| Issuance of shares as additional purchase price consideration for Network Architects acquisition . . . . .  | 97,413   | 1             | 570                                       | —                         | —                           | 571             |
| Issuance of shares as additional purchase price consideration for InfoGroup Northwest acquisition . . . . . | 122,544  | 1             | 750                                       | —                         | —                           | 751             |
| Issuance of warrants . . . . .  | —  | —             | 128                                       | —                         | —                           | 128             |
| Common stock grant to employee . . . . .  | 1,520  | —             | 10  | —                         | —                           | 10              |
| Share-based compensation expense related to employee stock options . . . . .                                | —  | —             | 462                                       | —                         | —                           | 462             |
| Share-based compensation expense related to employee restricted stock grants . . . . .                      | —  | —             | 8   | —                         | —                           | 8               |
| Net income . . . . .  | —  | —             | —   | —                         | 1,195                       | 1,195           |
| Balance at December 31, 2006 . . . . .  | <u>6,603,070</u>                                   | <u>\$66</u>   | <u>\$30,598</u>                           | <u>\$ —</u>               | <u>\$(8,280)</u>            | <u>\$22,384</u> |

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

**INX INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

|  | Year Ended December 31, |                 |                 |
|--|-------------------------|-----------------|-----------------|
|  | 2006                    | 2005            | 2004            |
|  | (In thousands)          |                 |                 |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |                         |                 |                 |
| Net income (loss) . . . . .  | \$ 1,195                | \$(7,884)       | \$ 1,530        |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: |                         |                 |                 |
| (Income) loss from discontinued operations . . . . .   | 316                     | 2,967           | (420)           |
| Depreciation and amortization . . . . .  | 1,178                   | 949             | 661             |
| Share-based compensation expense for employee stock options and restricted stock grant . . . . .   | 415                     | —               | —               |
| Bad debt expense . . . . .   | 63                      | 9               | 70              |
| Issuance of stock grant . . . . .  | 10                      | 66              | —               |
| (Gain) loss on retirement of assets . . . . .  | 9                       | 26              | (4)             |
| Tax benefit from discontinued operations . . . . .   | —                       | (466)           | (350)           |
| Minority interest . . . . .  | —                       | 23              | 117             |
| Exchange of options in merger of subsidiary . . . . .  | —                       | 5,729           | —               |
| Changes in assets and liabilities that provided (used) cash:                                       |                         |                 |                 |
| Accounts receivable, net . . . . .   | (17,584)                | 1,678           | (18,501)        |
| Inventory . . . . .  | (1,053)                 | 302             | (140)           |
| Other current assets . . . . .   | (1,206)                 | (579)           | 485             |
| Other assets . . . . .   | 21                      | (21)            | —               |
| Accounts payable . . . . .   | 14,981                  | 3,875           | 3,981           |
| Accrued expenses . . . . .   | 837                     | 496             | 1,440           |
| Other current and long-term liabilities . . . . .  | 792                     | 468             | 317             |
| Net cash provided by (used in) continuing operations . . . . .                                     | (26)                    | 7,638           | (10,814)        |
| Net operating activities from discontinued operations . . . . .                                    | (684)                   | 412             | 326             |
| Net cash provided by (used in) operating activities . . . . .                                      | (710)                   | 8,050           | (10,488)        |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                         |                 |                 |
| Capital expenditures (net of effect of acquisitions) . . . . .                                     | (1,921)                 | (476)           | (846)           |
| Acquisition of Datatran Network Systems . . . . .  | (1,000)                 | —               | —               |
| Acquisition of InfoGroup Northwest, Inc. . . . .   | (751)                   | (1,900)         | —               |
| Acquisition of Network Architects, Corp. . . . .   | (394)                   | (2,300)         | —               |
| Proceeds of sale of fixed assets . . . . .   | —                       | 31              | 4               |
| Transaction costs paid for acquisitions . . . . .  | (32)                    | (362)           | —               |
| Net cash used in investing activities of continuing operations . . . . .                           | (4,098)                 | (5,007)         | (842)           |
| Net investing activities of discontinued operations . . . . .                                      | 1,492                   | (77)            | (89)            |
| Net cash used in investing activities . . . . .  | (2,606)                 | (5,084)         | (931)           |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |                         |                 |                 |
| Borrowings of short-term interest bearing Castle Pines Capital Credit Facility, net . . . . .      | 1,886                   | 2,464           | —               |
| Borrowings (payments) of short-term interest bearing Textron Facility, net . . . . .               | —                       | (8,122)         | 6,423           |
| Exercise of stock options . . . . .  | 613                     | 209             | 280             |
| Proceeds from other short-term borrowings . . . . .  | 407                     | 370             | —               |
| Payments of other short-term borrowings . . . . .  | (391)                   | (163)           | (25)            |
| Proceeds from unit offering, net . . . . .   | —                       | —               | 7,548           |
| Purchase of common stock . . . . .   | —                       | (6)             | —               |
| Net cash provided by (used in) financing activities of continuing operations . . . . .             | 2,515                   | (5,248)         | 14,226          |
| Net financing activities of discontinued operations . . . . .                                      | (1)                     | (96)            | (81)            |
| Net cash provided by (used in) in financing activities . . . . .                                   | 2,514                   | (5,344)         | 14,145          |
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS . . . . .</b>                              | <b>(802)</b>            | <b>(2,378)</b>  | <b>2,726</b>    |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD . . . . .</b>                                  | <b>2,597</b>            | <b>4,975</b>    | <b>2,249</b>    |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD . . . . .</b>  | <b>\$ 1,795</b>         | <b>\$ 2,597</b> | <b>\$ 4,975</b> |

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

**INX INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

|   | <u>Year Ended December 31,</u> |             |             |
|---|--------------------------------|-------------|-------------|
|   | <u>2006</u>                    | <u>2005</u> | <u>2004</u> |
|   | (In thousands)                 |             |             |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>   |                                |             |             |
| Cash paid for interest . . . . .  | \$ 219                         | \$ 426      | \$ —        |
| Cash paid for income taxes . . . . .  | \$ 14                          | \$ 42       | \$ —        |
| <b>SUPPLEMENTAL NONCASH INVESTING AND FINANCING ACTIVITIES:</b>   |                                |             |             |
| Acquisition of Datatran Network Systems:  |                                |             |             |
| Fair value of assets acquired . . . . .   | \$1,515                        | \$ —        | \$ —        |
| Common stock issued . . . . .   | (515)                          | —           | —           |
| Acquisition of Network Architects, Corp.:   |                                |             |             |
| Fair value of assets acquired . . . . .   | 965                            | 4,300       | —           |
| Common stock issued . . . . .   | (571)                          | (2,000)     | —           |
| Acquisition of InfoGroup Northwest, Inc.:   |                                |             |             |
| Fair value of assets acquired . . . . .   | 1,502                          | 2,400       | —           |
| Common stock issued . . . . .   | (751)                          | (500)       | —           |
| Acquisition of INX minority interest:   |                                |             |             |
| Common stock issued . . . . .   | —                              | 1,530       | —           |
| Minority interest acquired . . . . .  | —                              | (302)       | —           |
| Obligation under software license agreement:  |                                |             |             |
| Fair value of asset acquired . . . . .  | 775                            | —           | —           |
| Obligation incurred . . . . .   | (775)                          | —           | —           |
| Issuance of warrants in connection with sale of Stratasoft, Inc. . . . .  | (128)                          | —           | —           |
| Recognition of additional purchase price on Digital Precision acquisition<br>through issuance of INX common stock . . . . . | —                              | —           | 234         |
| Recognition of minority interest for issuance of INX common stock . . . . .   | —                              | —           | (162)       |
| Revaluation of options granted consultants . . . . .  | —                              | —           | (199)       |

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

**INX INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Years Ended December 31, 2006, 2005 and 2004**  
**(In thousands, except share and per share amounts)**

**1. Description of Business**

INX Inc. (“INX” or the “Company”) is a provider of IP communications solutions for enterprise-class organizations based primarily on Cisco System, Inc. technology. These solutions include design, implementation and support of LAN/WAN routing and switching, IP telephony, voice over IP (“VoIP”), network security, network storage and wireless networks. Effective December 31, 2005, the Company merged its wholly owned InterNetwork Experts, Inc. subsidiary with I-Sector Corporation and changed its name from I-Sector Corporation to INX Inc.

**2. Summary of Significant Accounting Policies**

*Basis of Presentation* — On November 3, 2005, the Company’s Board of Directors approved a plan to sell the Stratasoft and Valerent subsidiaries as further discussed in Note 4. Therefore, the Stratasoft and Valerent results of operations and cash flows are classified as discontinued operations for all periods presented. The assets and liabilities of Stratasoft and Valerent are classified as current and noncurrent assets and liabilities of discontinued operations in the accompanying balance sheets for all periods presented. As a result of the classification of Stratasoft and Valerent as discontinued operations, the Company reports under only one segment.

*Principles of Consolidation* — The accompanying consolidated financial statements include the accounts of INX Inc. and its subsidiaries. All significant intercompany balances and transactions have been eliminated.

*Cash and Cash Equivalents* — Cash equivalents are comprised of certain highly liquid investments with maturity of three months or less when purchased. The Company maintains its cash in bank deposit accounts, which at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts.

*Accounts Receivable* — Trade accounts receivable are recorded at the invoiced amount, are non-interest bearing and are recorded net of reserves for sales returns and allowances and an allowance for doubtful accounts. The Company extends credit to its customers in the normal course of business and generally does not require collateral or other security. The Company performs ongoing credit evaluations of its customers’ financial condition and, in some instances, requires letters of credit or additional guarantees in support of contracted amounts. Earnings are charged with a provision for doubtful accounts based on a current review of the collectibility of the accounts and using a systematic approach based on historical collections and age of the amounts due. Accounts deemed uncollectible are applied against the allowance for doubtful accounts. Accruals for estimated sales returns and other allowances and deferrals are recorded as a reduction of revenue at the time of revenue recognition. These provisions are based on contract terms and prior claims experience and involve significant estimates.

*Inventory* — Inventory consists primarily of Cisco network equipment, computer equipment and components and is valued at the lower of cost or market with cost determined on the first-in first-out method. Substantially all inventory is finished goods. Reserves to reduce inventory to market value are based on current inventory levels, historical usage and product life cycles.

*Property and Equipment* — Property and equipment are recorded at cost. Expenditures for repairs and maintenance are charged to expense when incurred, while expenditures for betterments are capitalized. Disposals are removed at cost less accumulated depreciation with the resulting gain or loss reflected in operations in the year of disposal.

*Goodwill* — Goodwill is the excess of the purchase price over the fair values assigned to the net assets acquired in business combinations. Goodwill is not amortized, but instead is subject to periodic testing for impairment. Goodwill is tested for impairment on an annual basis and more frequently if facts and circumstances indicate goodwill carrying values exceed estimated reporting unit fair values. Goodwill is written down when impaired. Based on the impairment tests performed, there was no impairment of goodwill in 2006.

*Intangible Assets* — Intangible assets are being amortized over their estimated useful lives of two to four years (see Note 6).

## INX INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

*Impairment of Long-Lived Assets* — Impairment losses are recorded on long-lived assets used in operations when events and circumstances indicate that the assets might be impaired and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amounts of those assets.

*Income Taxes* — Income taxes are accounted for under the liability method, which requires, among other things, recognition of deferred income tax liabilities and assets for the expected future tax consequences of events that have been recognized in the consolidated financial statements or tax returns. Under this method, deferred income tax liabilities and assets are determined based on the temporary differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities and the recognition of available tax carryforwards. The tax provision allocated to discontinued operations is based on the incremental tax effect after computing the tax provision on continuing operations.

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

*Revenue Recognition* — INX recognizes revenue as follows:

*Products revenue* occurs when products manufactured or otherwise provided by other parties are purchased and resold to a customer and product payment is not contingent upon performance of installation or service obligations. If product acceptance and payment are contingent on installation or service obligations as specified in the customer contract, revenue is not recognized until installation occurs. Revenue is recognized from the sales of hardware when the rights and risks of ownership have passed to the customer and upon shipment or receipt by the customer, depending on the terms of the sales contract with the customer. The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed or determinable, and collectibility is reasonably assured. Amounts billed to customers for shipping and handling are classified as revenue.

The Company sells hardware maintenance contracts that are serviced and supported solely by a third party, who is the primary obligor of these contracts. There are multiple factors under EITF 99-19, but the primary obligor is a strong factor in determining whether the Company acts as a principal or agent and whether gross or net revenue presentation is appropriate. As the Company has concluded that it is more of an agent in the sale of hardware maintenance contract, revenue is reported by the Company net of the cost of the hardware maintenance contract from the third party.

For arrangements where the customer agrees to purchase products but we retain possession until the customer requests shipment, or “bill and hold” arrangements, revenue is not recognized until delivery to the customer has occurred and all other revenue recognition criteria have been met.

*Software* is accounted for in accordance with Statement of Position No. 97-2, “Software Revenue Recognition,” and all related interpretations. Revenue from the sales of software not requiring significant modification or customization is recognized upon delivery or installation. Installation services for third party software do not include significant alterations to its features or functionality. Third party software vendors provide all post-contract support for software sold by the Company. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectibility is reasonably assured.

*Technical support services revenue*, consisting of remote monitoring and management of customers’ IP telephony and network infrastructure equipment and applications, is recognized ratably over the term of

## INX INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

the underlying customer contract. Commission costs paid in advance are deferred and recognized ratably over the term of the underlying customer contract.

*Revenue for fixed and flat fee services contracts* related to customized network and IP telephony solutions are recognized under a proportional performance model utilizing an input based approach (labor hours). The Company's contracts function similar to a time and materials type contract and generally do not specify or quantify interim deliverables or milestones. Such service contracts encompass the design and installation of IP telephony and computer networks under which customers receive the benefit of services provided over the period of contract performance.

*Other service revenue* is earned from providing stand-alone services such as billings for engineering and technician time, installation and programming services, which are provided on either an hourly basis or a flat-fee basis, and the service component of maintenance and repair service ticket transactions. These services are contracted for separately from any product sale. Other service revenues are recognized when the service is performed and when collection is reasonably assured. Revenue arrangements generally do not include specific customer acceptance criteria. In instances where final acceptance of the system or solution is specified by the customer, revenue is deferred until all acceptance criteria have been met.

*Arrangements with multiple deliverables* are arrangements under which a combination of products and services are provided to customers. Such arrangements are evaluated under Emerging Issues Task Force Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables," ("EITF 00-21"), which addresses certain aspects of accounting by a vendor for arrangements under which the vendor will perform multiple revenue generating activities. The application of the appropriate accounting guidance requires judgment and is dependent upon the specific transaction and whether the sale includes hardware, software, services or a combination of these items.

The Company enters into product and service contracts for customers that are generally considered a single arrangement and which include separate units of accounting for product and for service. Product primarily consists of IP telephony and computer network infrastructure components and third party software. Service encompasses the design and installation of IP telephony and computer networks and installation of third party software. Installation services for third party software do not include significant alterations to its features or functionality. All products and services are regularly sold separately. For products and services sold in a single arrangement, the product is typically delivered first and the related services are completed within four to six weeks. Product is shipped, billed, and recognized as revenue independent of services because:

- The customer is required to pay the product billing in its entirety independent of any services performed.
- The product has value to the customer on a stand alone basis and pricing is comparable whether sold with or without services.
- The product is standard equipment not significantly altered by installation.
- Installation of the product can be performed by many other companies.
- Although there is a general right of return relative to delivered product, delivery of the undelivered items is considered probable and is substantially in the control of the Company.

The Company recognizes revenue for multiple element arrangements based on the relative fair value of the separate elements. Comparable products and services are sold on a stand alone basis and under multiple element arrangements at the same prices. Stand alone pricing is vendor-specific objective evidence under EITF 00-21. Customers are not required to and frequently do not select the same vendor

## INX INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

for product and service. The customers' decision does not impact the pricing of the portion of the bid selected.

Contracts and customer purchase orders are generally used to determine the existence of an arrangement. Shipping documents and customer acceptance, when applicable, are used to verify delivery. Determination that the fee is fixed or determinable is based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment.

The Company records taxes applicable under EITF No. 06-3 "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)" on a net basis. Contracts and customer purchase orders are generally used to determine the existence of an arrangement. Shipping documents and customer acceptance, when applicable, are used to verify delivery. Determination that the fee is fixed or determinable is based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. Collectibility is assessed based primarily on the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer's payment history. Accruals for estimated sales returns and other allowances and deferrals are recorded as a reduction of revenue at the time of revenue recognition. These provisions are based on contract terms and prior claims experience and involve significant estimates. If these estimates are significantly different from actual results, our revenue could be impacted.

*Vendor Incentives* — INX participates in a vendor incentive program under which incentives are principally earned by sales volume, sales growth and customer satisfaction levels. The amounts earned under these programs are accrued when they are deemed probable and can be reasonably measured; otherwise, they are recorded when they are declared by the vendor or the cash is received, whichever is earlier. As a result of these estimates, the amount of rebates declared by the vendor, or the amount of rebates received in cash, the effect of vendor incentives on cost of goods can vary significantly between quarterly and annual reporting periods. The incentives are recorded as a reduction of cost of goods and services. Selling, general and administrative expenses are increased for any associated commission expense and payroll tax related to the incentives. The Company recognized vendor incentives of \$6,303, \$2,876 and \$3,480 in 2006, 2005 and 2004, respectively. During the fourth quarter of 2006, additional incentives of \$691 were recorded as a change in estimate increasing 2006 income from continuing operations and net income by \$691 or \$0.11 per share (basic) and \$0.09 per share (fully diluted). Accounts receivable from vendors of \$3,280 and \$1,217 at December 31, 2006 and 2005, respectively, are reported under "Accounts receivable — trade" in the consolidated balance sheets.

*Advertising Costs* — Advertising costs consist of print advertising and trade show materials and are expensed as incurred.

*Research and Development Costs* — Research and development expenditures are charged to operations as incurred and consist primarily of compensation costs, outside services, and expensed materials. The Company incurred research and development expenditures of \$289, \$162 and \$0 in 2006, 2005 and 2004, respectively.

*Share-Based Compensation* — On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123R") which requires the measurement and recognition of compensation expense based on estimated fair values for share-based payment awards. SFAS 123R supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") for periods beginning in 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123R. The Company has utilized the guidance of SAB 107 in its adoption of SFAS 123R.

SFAS 123R requires all share-based payments to be recognized in the results of operations at their grant-date fair values. The Company adopted SFAS 123R using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company's 2006 fiscal year. Under

## INX INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

this transition method, compensation cost recognized in 2006 includes: (a) compensation cost for all share-based payments granted prior to but not yet vested as of December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123, and (b) compensation cost for all share-based payments granted subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. In accordance with the modified prospective method of adoption, the Company's results of operations and financial position for prior periods have not been restated.

*Earnings Per Share* — Basic net income per share is computed on the basis of the weighted-average number of common shares outstanding during the periods. Diluted net income per share is computed based upon the weighted-average number of common shares plus the assumed issuance of common shares for all potentially dilutive securities using the treasury stock method (See Note 7).

*Fair Value of Financial Instruments* — INX's financial instruments consist of cash and cash equivalents, accounts receivable and accounts payable for which the carrying values approximate fair values given the short-term maturity of the instruments. The carrying value of the Company's debt instruments approximate their fair value based on estimates of rates offered to the Company for instruments with the same maturity dates and security structures.

*Recent Accounting Pronouncements* — In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides related guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure. FIN 48 is effective for the Company beginning January 1, 2007. The adoption of FIN 48 is not expected to have a material effect on the Company's financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This statement clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The adoption of SFAS 157 is not expected to have a material impact on the Company's consolidated financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 ("SAB 108"). SAB 108 provides guidance on the consideration of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The staff believes registrants must quantify the impact of correcting all misstatements, including both carryover and reversing effects of prior year misstatements, on the Company's current year consolidated financial statements. The staff prescribes two approaches to assessing the materiality of misstatements; the "rollover" approach, which quantifies misstatements based on the amount of error originating in the current year income statement and the "iron curtain approach", which quantifies misstatements based on the effects of correcting the cumulative effect existing in the balance sheet at the end of the current year. If under either approach, misstatements are deemed material, the Company is required to adjust its financial statements, including correcting prior year financial statements, even though such correction was and continues to be immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require the Company to amend previously filed reports, rather such corrections may be made the next time the Company files its prior year statements.

Since inception the Company recorded audit professional fees in the year under audit and tax professional fees in the year for which the tax returns were filed. Generally accepted accounting principles require audit and tax professional fees to be expensed as incurred, which are primarily in the year subsequent to the year under audit or year for which tax returns are filed. Prior to 2006, the difference between the two methods was immaterial to the Company's financial position and results of operations. Applying the guidance of SAB 108, the Company corrected its accounting for audit and tax fees in 2006 by reducing January 1, 2006 accrued expenses and retained deficit in the amount of \$125 for the cumulative effect of the correction.

## INX INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

#### 3. Acquisitions

The Company completed an acquisition in February, 2006 and two acquisitions during May and June, 2005. The acquisitions were consummated to improve the Company's geographical presence and enhance its technical capabilities.

##### *Datatron Network Systems*

Under an Asset Purchase Agreement dated February 3, 2006, the Company purchased the assets and operations of Datatron Network Systems ("DNS"). DNS is a specialized provider of network solutions serving the Southern California market. DNS designs, implements and supports solutions based on Cisco technologies with a primary focus on IP Telephony. The Company completed the acquisition simultaneously with the execution of the Asset Purchase Agreement.

The consideration paid at closing pursuant to the Asset Purchase Agreement was \$1,000 in cash, including \$100 placed in escrow under holdback provisions defined in the Asset Purchase Agreement and 71,003 shares of the Company's common stock valued at \$500. Legal and other costs of \$47 were paid in connection with the transaction, of which \$32 was paid in cash and \$15 was paid through the issuance of 2,105 shares of common stock. The calculation of the 71,003 shares of the Company's common stock was determined by dividing \$500 by the greater of (i) average closing price per share for the Common Stock as reported by AMEX for the five consecutive trading days ending prior to February 1, 2006 or (ii) \$4.50.

Additional consideration is payable based on the DNS branch office revenue during the twelve-month period ending February 28, 2007. If the revenue for that period (i) equals or exceeds \$9,000 but is less than \$9,250, then the amount of the additional purchase consideration will be \$125, (ii) equals or exceeds \$9,250 but is less than \$9,500, then the amount of the additional purchase consideration will be \$250, (iii) equals or exceeds \$9,500 but is less than \$10,000, then the amount of the additional purchase consideration will be \$375, (iv) equals or exceeds \$10,000 then the amount of the additional purchase consideration will be \$500 or (v) is less than \$9,000, then there will be no additional purchase consideration. At the Company's option, 50% of any additional purchase price consideration, if any, may be paid in the form of common stock. Additional purchase price consideration, if any, will be recorded as goodwill.

##### *Network Architects, Corp.*

Effective May 26, 2005, the Company acquired the operations and certain assets of Network Architects, Corp. ("Network Architects"), a data network and IP telephony systems design, installation and support business with branches in Albuquerque, New Mexico, and El Paso, Texas. The consideration paid at closing consisted of cash in the amount of \$2,000, common stock valued at \$2,000, and payment of a note payable to a bank in the amount of \$300. Legal and other costs of \$65 were paid in cash in connection with the transaction. The calculation of the 308,166 shares of Company's common stock issued was determined by dividing \$2,000 by the average closing price per share for the Common Stock as reported by AMEX for the five consecutive trading days ending May 20, 2005.

Additional purchase price consideration valued at \$965 and recorded as goodwill was paid to Network Architects in June 2006 for achievement of certain operating profit milestones during the twelve-month period ended May 31, 2006. The consideration was comprised of \$394 paid in cash and 97,413 shares of the Company's common stock valued at the average closing price per share as reported by NASDAQ for the five consecutive trading days ending June 28, 2006.

The Company will pay Network Architects additional purchase price consideration if certain financial milestones are achieved during 2007 and 2008. The Company will issue Network Architects a maximum of 75,000 shares of common stock following each of the twelve-month periods ending May 31, 2007 and 2008 if operating profit during such periods exceeds \$660 and \$726, respectively. If operating profit is less than the applicable milestone for any of the two years, the number of shares of common stock issuable by the Company will be equal to 75,000 multiplied by

**INX INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

the percentage of actual operating profit during the period as compared to the applicable milestone. Additional purchase price consideration, if any, will be recorded as goodwill.

***InfoGroup Northwest, Inc.***

Effective June 29, 2005, the Company acquired the operations and certain assets of the InfoGroup Northwest, Inc. (“InfoGroup”) network solutions business with branches in Seattle, Washington, and Portland and Eugene, Oregon. The consideration paid at closing consisted of cash in the amount of \$1,900 and common stock valued at \$500. Legal, broker, and other costs of \$123 were incurred in connection with the transaction, of which \$12 was paid through the issuance of 1,586 shares of common stock and the remainder paid in cash. The calculation of the 63,516 shares of the Company’s common stock issued was determined by dividing \$500 by the average closing price per share for the common stock as reported by AMEX for the five consecutive trading days ending June 24, 2005.

Additional purchase price consideration valued at \$1,430 and recorded as goodwill was paid to InfoGroup in August 2006 for achievement of certain operating profit milestones during the twelve-month period ending June 30, 2006. The consideration consisted of \$715 paid in cash and \$715 in shares of the Company’s common stock valued at the average closing price per share as reported by NASDAQ for the five consecutive trading days ending two days prior to August 15, 2006. Additionally, cash and stock valued at \$71 was paid to the broker of the transaction.

The following table summarizes the estimated fair values, including professional fees and other related acquisition costs, at the date of acquisition, including additional purchase price consideration subsequently paid. The Company obtained a third party valuation of certain tangible and intangible assets for each acquisition.

|   | <u>Datatron<br/>Network<br/>Systems</u> | <u>Network<br/>Architects,<br/>Corp.</u> | <u>InfoGroup<br/>Northwest,<br/>Inc.</u> |
|---|---|--|--|
| Allocated acquisition cost:   |   |  |  |
| Intangibles — customer relationships and noncompete agreements amortized over 3 years . . . . . | \$ 168                                  | \$ 241                                   | \$ 134                                   |
| Inventory . . . . .   | 25                                      | —  | —  |
| Property and equipment . . . . .  | 38                                      | 500                                      | 297                                      |
| Security and customer deposits . . . . .  | 5                                       | 4  | 15                                       |
| Goodwill . . . . .  | <u>1,311</u>                            | <u>4,584</u>                             | <u>3,580</u>                             |
| Total acquisition cost . . . . .  | <u>\$1,547</u>                          | <u>\$5,329</u>                           | <u>\$4,026</u>                           |

## INX INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

#### *Pro Forma Summary (Unaudited)*

The following pro forma consolidated amounts give effect to the Company's acquisition of DNS, Netarch and InfoGroup as if they had occurred January 1, 2005. The pro forma consolidated amounts presented below are based on continuing operations. The pro forma consolidated amounts are not necessarily indicative of the operating results that would have been achieved had the transaction been in effect and should not be construed as being representative of future operating results.

|  | Year Ended December 31, |            |
|--|-------------------------|------------|
|  | 2006                    | 2005       |
| Revenues . . . . .                                     | \$ 156,058              | \$ 132,854 |
| Net income (loss) from continuing operations . . . . . | \$ 1,392                | \$ (2,597) |
| Net income (loss) from continuing operations:          |                         |            |
| Basic . . . . .  | \$ 0.22                 | \$ (0.42)  |
| Diluted . . . . .                                      | \$ 0.19                 | \$ (0.42)  |
| Weighted average shares used in calculation:           |                         |            |
| Basic . . . . .  | 6,455,576               | 6,160,342  |
| Diluted . . . . .                                      | 7,430,639               | 6,160,342  |

#### **4. Discontinued Operations**

##### *Telecom and Computer Products Divisions*

Prior to 2004, INX sold a computer products reselling business, PBX telephone systems dealer business, and the Telecom Systems division. During 2005, the Company resolved the collectibility of certain accounts receivable of these operations and, in 2006, settled pending litigation relative to its discontinued Telecom and Computer Products Divisions as discussed further in Note 14. The impact of these changes are reflected in the gain on disposal of discontinued operations detailed below.

##### *Stratasoft and Valerent Subsidiaries*

On November 3, 2005, the Company's Board of Directors approved a plan to sell its Stratasoft and Valerent subsidiaries. This action was taken due to continuing losses at Stratasoft and the decision to build value with a focused strategy in the operations at INX. Under a Stock Purchase Agreement ("Agreement") dated January 26, 2006, INX sold all outstanding shares of Stratasoft's common stock for a pretax gain on disposal of \$302. Key terms of the sale are summarized as follows:

- All outstanding Stratasoft common stock was sold for a purchase price of \$3,000, which has been or is subject to reduction as follows:
  - \$800 placed in escrow, which is available to satisfy indemnified losses, if any, as defined in the Agreement. Funds placed in escrow are excluded from the estimated gain stated above. Approximately \$448 in indemnified losses have been paid or presented for payment as of December 31, 2006.
  - \$221 representing a preliminary net working capital adjustment, as defined. The final working capital adjustment recorded during June 2006 resulted in the further reduction of the sale proceeds of \$40.
  - The Company indemnified the buyer for potential losses as defined in the Agreement to a maximum of \$1,400, inclusive of amounts placed in escrow. Excess funds held in escrow will be released on January 26, 2008 unless retained in escrow for potential indemnified losses as allowed in the Agreement under certain circumstances.

## INX INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

- The Company may receive additional consideration in the form of 10% of the outstanding Stratasoft common stock if revenue exceeds \$10,000 for any consecutive twelve month period within two years of closing.
- The Company may receive additional cash consideration if Stratasoft is sold by the buyer to another party prior to January 26, 2008, for an amount in excess of \$15,000.

Transaction costs of \$815 were incurred by the Company in connection with the transaction, including the \$128 value of warrants issued to the investment banker for the transaction for 40,000 shares of common stock with an exercise price of \$6 per share. The warrants expire 5 years after January 26, 2006. Additional transaction costs of up to \$120 are payable based on the final sale price. Additional costs of \$134 were recorded as a reduction of the gain on sale for space leased by INX that will not be subleased to Stratasoft in the future.

The sale of Valerent operations involved two separate transactions which were closed in October 2006. The managed services business and related inventory, property and equipment were sold to OuterNet Management, L.P. for a cash sales price of \$185. The consulting business and related property and equipment were sold to Vicano Acquisition Corp., a company owned by Valerent's former President and brother-in-law of our CEO and largest shareholder. The consulting business was sold for cash paid at closing of \$50 and a \$70 promissory note to be received in twenty-four monthly installments of \$3 plus interest of 10%. Additional sales price is due to the Company if certain revenue thresholds and conditions are met. The Company recorded a gain of \$25 on the cash component of the transactions and will record a gain on proceeds under the \$70 promissory note as received, of which \$6 was received at December 31, 2006.

The results of operations and gain on disposal of discontinued operations are summarized below:

|  | Year Ended December 31, |                   |                 |
|--|-------------------------|-------------------|-----------------|
|  | 2006                    | 2005              | 2004            |
| Revenues:  |                         |                   |                 |
| Stratasoft. . . . .  | \$ 268                  | \$ 5,277          | \$ 8,201        |
| Valerent . . . . .   | <u>4,330</u>            | <u>6,662</u>      | <u>6,942</u>    |
| Total . . . . .  | <u>\$ 4,598</u>         | <u>\$11,939</u>   | <u>\$15,143</u> |
| Loss from operations of discontinued subsidiaries:                     |                         |                   |                 |
| Stratasoft. . . . .  | \$ (288)                | \$ (2,734)        | \$ (265)        |
| Valerent . . . . .   | <u>(830)</u>            | <u>(239)</u>      | <u>279</u>      |
| Total . . . . .  | (1,118)                 | (2,973)           | 14              |
| Gain on disposal of discontinued operations:                           |                         |                   |                 |
| Stratasoft. . . . .  | 302                     | —                 | —               |
| Valerent . . . . .   | 31                      | —                 | —               |
| Telecom and Computer Products Divisions . . . . .                      | 469                     | 106               | 57              |
| Cumulative effect of change in accounting method at Stratasoft . . . . | —                       | (566)             | —               |
| Income tax benefit . . . . .   | <u>—</u>                | <u>466</u>        | <u>349</u>      |
| Income (loss) from discontinued operations, net of taxes . . . . .     | <u>\$ (316)</u>         | <u>\$ (2,967)</u> | <u>\$ 420</u>   |

**INX INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

The components of assets and liabilities of discontinued operations in the accompanying balance sheets are as follows:

|  | <b>December 31,</b> |                |
|--|---------------------|----------------|
|  | <b>2006</b>         | <b>2005</b>    |
| <b>Current assets of discontinued operations:</b>        |                     |                |
| Accounts receivable, net . . . . .                       | \$ —                | \$1,533        |
| Inventory . . . . .                                      | —                   | 592            |
| Costs and earnings in excess of billings . . . . .       | —                   | 266            |
| Notes receivable and other current assets . . . . .      | 19                  | 173            |
| <b>Total . . . . .</b>                                   | <b>\$ 19</b>        | <b>\$2,564</b> |
| <b>Noncurrent assets of discontinued operations:</b>     |                     |                |
| Property and equipment, net . . . . .                    | \$ —                | \$ 392         |
| Patents, net . . . . .                                   | —                   | 653            |
| Other noncurrent assets . . . . .                        | 30                  | 12             |
| <b>Total . . . . .</b>                                   | <b>\$ 30</b>        | <b>\$1,057</b> |
| <b>Current liabilities of discontinued operations:</b>   |                     |                |
| Accounts payable . . . . .                               | \$ —                | \$ 620         |
| Billings in excess of costs and earnings . . . . .       | —                   | 201            |
| Accrued expenses . . . . .                               | 61                  | 1,376          |
| Deferred revenue . . . . .                               | 64                  | 644            |
| Current portion of long-term debt . . . . .              | —                   | 95             |
| <b>Total . . . . .</b>                                   | <b>\$125</b>        | <b>\$2,936</b> |
| <b>Long-term liabilities of discontinued operations:</b> |                     |                |
| Long-term debt . . . . .                                 | \$ —                | \$ 7           |

Prior to 2005, the discontinued Stratasoft subsidiary recognized revenue under the percentage of completion method based on the relationship of total cost incurred to total estimated cost over the duration of the project. Effective January 1, 2005, the Stratasoft segment changed its method of applying the percentage of completion accounting method to the relationship of labor cost incurred to total estimated labor cost over the duration of the project. Management believes the newly adopted method of applying the accounting principle is preferable in Stratasoft's circumstances because using labor cost as the input measure more accurately reflects the labor intensive customization and modification that now occurs to the Stratasoft hardware and software more evenly over the duration of Stratasoft's projects. Accordingly, the labor cost input method more appropriately measures the progress towards completion over the duration of Stratasoft's projects.

The change in accounting method was applied by recording the cumulative effect of the change amounting to \$566 in the loss from discontinued operations in the consolidated statement of operations for the year ended December 31, 2005. Had the change in accounting method not been made, net loss for the year ended December 31, 2005 would have decreased by \$144 or \$0.03 per share (basic and diluted). The pro forma effect has not been presented for prior periods due to the inability to accurately compute the effect of the change prior to December 31, 2004.

**INX INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**5. Property and Equipment**

Property and equipment consisted of the following:

|   | December 31, |          |
|---|--------------|----------|
|   | 2006         | 2005     |
| Equipment . . . . .                                 | \$ 305       | \$ 287   |
| Computer equipment and software . . . . .           | 4,242        | 2,220    |
| Furniture and fixtures . . . . .                    | 831          | 1,074    |
| Leasehold improvements . . . . .                    | 785          | 708      |
| Vehicles . . . . .                                  | 105          | 105      |
|   | 6,268        | 4,394    |
| Accumulated depreciation and amortization . . . . . | (2,414)      | (2,344)  |
| Total . . . . .                                     | \$ 3,854     | \$ 2,050 |

Property and equipment are depreciated over their estimated useful lives ranging from three to ten years using the straight-line method. Depreciation expense totaled \$921, \$570 and \$364 for 2006, 2005 and 2004, respectively.

**6. Intangible Assets**

|                              | December 31, 2006           |                             | December 31, 2005           |                             | Weighted<br>Average<br>Remaining<br>Life |
|------------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|--|
|                              | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization |  |
| Amortized intangible assets: |                             |                             |                             |                             |  |
| Customer lists . . . . .     | \$1,160                     | \$ 997                      | \$1,051                     | \$ 793                      | 1.27                                     |
| Other . . . . .              | 387                         | 267                         | 328                         | 214                         | 1.72                                     |
| Total . . . . .              | \$1,547                     | \$1,264                     | \$1,379                     | \$1,007                     |  |

The estimated aggregate amortization expense for future years is as follows:

|                 |       |
|-----------------|-------|
| 2007 . . . . .  | 198   |
| 2008 . . . . .  | 73    |
| 2009 . . . . .  | 11    |
| 2010 . . . . .  | 1     |
| Total . . . . . | \$283 |

**7. Earnings Per Share**

Basic EPS is computed by dividing net income (loss) by the weighted-average number of common shares outstanding for the period. Diluted EPS is based on the weighted-average number of shares outstanding during each period and the assumed exercise of dilutive stock options and warrants less the number of treasury shares assumed to be purchased from the proceeds using the average market price of the Company's common stock for each of the periods presented.

Options to purchase 1,154,007 shares for the year ended December 31, 2005 were not used in the calculation of diluted earnings since the effect of potentially dilutive securities in computing a loss per share is antidilutive. For the years ended December 31, 2006 and December 31, 2004, no options were excluded in the calculation of diluted earnings.

**INX INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

The Company's wholly-owned subsidiary, InterNetwork Experts, Inc., had potentially dilutive options until March 2005 as discussed in Note 11. In 2004 the net loss from continuing operations for purposes of computing the earnings per share increased \$29 for the assumed exercise of InterNetwork Experts, Inc. options under the treasury method, and in 2005 the net income from continuing operations for purposes of computing the earnings per share decreased \$550 for the assumed exercise of InterNetwork Experts, Inc. options under the treasury method.

|  | <u>December 31,</u> |                   |                  |
|--|---------------------|-------------------|------------------|
|  | <u>2006</u>         | <u>2005</u>       | <u>2004</u>      |
| Numerator for basic earnings per share:  |                     |                   |                  |
| Net income (loss) from continuing operations before minority interest . . . . .  | \$ 1,511            | \$ (4,894)        | \$ 1,227         |
| Minority interest . . . . .  | —                   | (23)              | (117)            |
| Income (loss) from discontinued operations, net of taxes . . . . .   | <u>(316)</u>        | <u>(2,967)</u>    | <u>420</u>       |
| Net income (loss) . . . . .  | <u>\$ 1,195</u>     | <u>\$ (7,884)</u> | <u>\$ 1,530</u>  |
| Numerator for diluted earnings per share:  |                     |                   |                  |
| Net income (loss) from continuing operations before minority interest . . . . .  | \$ 1,511            | \$ (4,894)        | \$ 1,227         |
| Minority interest . . . . .  | —                   | (23)              | (117)            |
| INX income attributable to potential minority interest net income (loss) from continuing operations used in computing loss per share . . . . . | <u>—</u>            | <u>—</u>          | <u>(550)</u>     |
| Net income (loss) from continuing operations used in computing income (loss) per share . . . . .   | 1,511               | (4,917)           | 560              |
| Income (loss) from discontinued operations, net of taxes . . . . .   | <u>(316)</u>        | <u>(2,967)</u>    | <u>420</u>       |
| Net income (loss) . . . . .  | <u>\$ 1,195</u>     | <u>\$ (7,884)</u> | <u>\$ 980</u>    |
| Denominator for basic earnings per share — weighted-average shares outstanding . . . . .   |                     |                   |                  |
|  | 6,318,674           | 5,706,323         | 4,569,507        |
| Effect of dilutive securities:   |                     |                   |                  |
| Shares issuable from assumed conversion of common stock options and restricted stock . . . . .   | <u>975,063</u>      | <u>—</u>          | <u>434,886</u>   |
| Denominator for diluted earnings per share — weighted-average shares outstanding . . . . .   |                     |                   |                  |
|  | <u>7,293,737</u>    | <u>5,706,323</u>  | <u>5,004,393</u> |

For 2004 we did not include 50,000 warrants issued in 2004 to purchase units, nor did we include 110,000 warrants issued in 2004 to purchase common stock in determination of the dilutive shares since their exercise prices exceeded the \$7.65 per share price of the common stock on December 31, 2004. For 2006 and 2005 we did not include 625,000 and 575,000 warrants, respectively, to purchase common stock in determination of the dilutive shares since they are antidilutive.

**INX INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**8. Notes Payable and Long-Term Debt**

Notes payable and long-term debt on the accompanying balance sheets consist of the following:

|   | December 31, |         |
|---|--------------|---------|
|   | 2006         | 2005    |
| Revolving credit facility bearing interest of prime plus .5% . . . . .                        | \$4,350      | \$2,464 |
| Notes payable bearing interest of 6.25% with monthly payments of \$74 due July 2007 . . . . . | 259          | —       |
| Notes payable bearing interest of 5.25% with monthly payments of \$38 due July 2006 . . . . . | —            | 222     |
| Obligation under capital lease, imputed interest of 10% maturing November 2006 . . . . .      | —            | 21      |
| Total, all due within 12 months . . . . .   | \$4,609      | \$2,707 |

On December 27, 2005 the Company entered into a \$40,000 senior credit facility (“Agreement”) with Castle Pines Capital LLC (“CPC”) to provide inventory financing and to fund working capital requirements, replacing the \$25,000 senior credit facility with Textron Financial Corporation. Key terms of the Agreement are summarized as follows:

- The Agreement provides a discretionary line of credit up to a maximum aggregate amount of \$40,000 to purchase inventory from CPC approved vendors.
- The Agreement provides a working capital revolving line of credit under the above line of credit with an aggregate outstanding sublimit of \$10,000.
- The working capital revolving line of credit incurs interest payable monthly at the rate of prime plus .5%.
- The Agreement contains customary covenants regarding maintenance of insurance coverage, maintenance of and reporting collateral, and submission of financial statements. The Agreement also contains restrictive financial covenants measured as of the end of each calendar quarter covering current ratio, tangible net worth, minimum working capital, and total liabilities to tangible net worth ratio as defined.
- The line of credit is collateralized by substantially all assets of the Company.

Inventory floor plan borrowings are reflected in accounts payable in the accompanying consolidated balance sheets, except for \$4,350 and \$2,464 that is interest bearing and is reflected in short term debt in the accompanying consolidated balance sheets at December 31, 2006 and December 31, 2005, respectively. Borrowings accrue interest at the prime rate (8.25% at December 31, 2006) plus 0.5% on outstanding balances that extend beyond the vendor approved free interest period. At December 31, 2006, INX was in compliance with the loan covenants effective at that date and anticipates that it will be able to comply with its loan covenants for the next twelve months. In the event INX does not maintain compliance, it would be required to seek waivers from CPC for those events, which, if not obtained, could accelerate repayment and require INX to seek other sources of finance. At December 31, 2006, INX had \$30,341 outstanding on inventory floor plan finance borrowings, and the unused availability was \$1,482.

The weighted-average interest rate for borrowings under all credit line arrangements in effect during, 2006, 2005 and 2004 was 8.5%, 8.6% and 7.4%, respectively. Interest expense on continuing operations debt was \$255, \$289, and \$193 for the years ended December 31, 2006, 2005, and 2004, respectively.

**INX INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**9. Income Taxes**

The provision for income taxes consisted of the following:

|  | <u>Year Ended December 31,</u> |             |             |
|--|--------------------------------|-------------|-------------|
|  | <u>2006</u>                    | <u>2005</u> | <u>2004</u> |
| Current provision:                                   |                                |             |             |
| Federal . . . . .                                    | \$16                           | \$ 475      | \$ 591      |
| State . . . . .                                      | 28                             | —           | —           |
| Total current provision . . . . .                    | 44                             | 475         | 591         |
| Deferred benefit . . . . .                           | —                              | —           | (241)       |
| Total expense from continuing operations . . . . .   | 44                             | 475         | 350         |
| Total benefit from discontinued operations . . . . . | —                              | (466)       | (350)       |
| Total . . . . .                                      | <u>\$44</u>                    | <u>\$ 9</u> | <u>\$ —</u> |

The total provision for income taxes for continuing operations during the years ended December 31, 2006, 2005 and 2004 varied from the U.S. federal statutory rate due to the following:

|  | <u>Year Ended December 31,</u> |               |               |
|--|--------------------------------|---------------|---------------|
|  | <u>2006</u>                    | <u>2005</u>   | <u>2004</u>   |
| Federal income tax at statutory rate . . . . .     | \$ 761                         | \$(1,502)     | \$ 536        |
| Minority interest . . . . .                        | —                              | 1,956         | 40            |
| Meals and entertainment expenses . . . . .         | 59                             | 29            | 20            |
| State taxes, net of federal tax benefit . . . . .  | 19                             | —             | —             |
| Other . . . . .                                    | 15                             | (8)           | (5)           |
| Valuation allowance . . . . .                      | (810)                          | —             | (241)         |
| Total expense from continuing operations . . . . . | <u>\$ 44</u>                   | <u>\$ 475</u> | <u>\$ 350</u> |

Net deferred tax assets computed at the statutory rate related to temporary differences were as follows:

|   | <u>December 31,</u> |             |
|---|---------------------|-------------|
|   | <u>2006</u>         | <u>2005</u> |
| Net deferred tax assets (liabilities):    |                     |             |
| Accounts and notes receivable . . . . .   | \$ 234              | \$ 334      |
| Closing and severance costs . . . . .     | 16                  | 194         |
| Deferred service revenue . . . . .        | 93                  | 126         |
| Amortization of intangibles . . . . .     | (518)               | —           |
| Share-based compensation . . . . .        | 1,589               | —           |
| Accrued liabilities . . . . .             | 1,472               | —           |
| Other . . . . .                           | —                   | 141         |
| Depreciation . . . . .                    | (492)               | (148)       |
| Net operating loss carryforward . . . . . | 860                 | 1,494       |
| Total . . . . .                           | 3,254               | 2,141       |
| Less: Valuation allowance . . . . .       | (3,254)             | (2,141)     |
| Total . . . . .                           | <u>\$ —</u>         | <u>\$ —</u> |

## INX INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Due to the company's recurring losses, a valuation allowance was established to fully offset the net deferred tax assets at December 31, 2006 and 2005. The increase in the valuation allowance in 2006 was primarily attributable to an increase in deferred tax assets associated with the remeasurement of stock options that were part of the elimination of minority interest in our former Internetwork Experts, Inc. subsidiary and includes a \$648 decrease in deferred tax assets associated with the disposal of discontinuing operations.

At December 31, 2006, INX has a net operating loss (NOL) carryforward for federal income tax reporting purposes of approximately \$2,369. Since United States tax laws limit the time during which an NOL may be applied against future taxable income and tax liabilities, INX may not be able to take full advantage of its NOL carryforward for federal income tax purposes. The carryforward will expire during the period 2023 through 2025 if not otherwise used. A change in ownership, as defined by federal income tax regulations, could significantly limit the company's ability to utilize its carryforward.

INX receives an income tax benefit from stock option exercises for the difference between the fair market value of the stock issued at the time of exercise and the grant price, tax effected. This benefit will be utilized to the extent that INX has tax basis income that was not offset by the remainder of the net operating loss (NOL) carryforwards. At December 31, 2006, INX has \$605 remaining unused tax benefit attributable to stock option exercises.

#### 10. Stockholders' Equity

##### *Equity Compensation Plans*

The Company currently grants stock options under the following equity compensation plans:

*1996 Incentive Stock Plan and the 1996 Non-Employee Director Stock Option Plan* — The 1996 Incentive Stock Plan (the "1996 Incentive Plan") and the 1996 Non-Employee Director Stock Option Plan (the "Director Plan") were approved by the shareholders and no further shares may be granted under either plan. The 1996 Incentive Plan provided for the granting of incentive awards in the form of stock options, restricted stock, phantom stock, stock bonuses and cash bonuses in accordance with the provisions of the plan. The Director Plan provided for a one-time option by newly elected directors to purchase up to 5,000 common shares, after which each director was entitled to receive an option to purchase up to 5,000 common shares upon each date of re-election to INX's Board of Directors. Options granted under the Director Plan and the 1996 Incentive Plan have an exercise price equal to the fair market value on the date of grant, are fully vested at December 31, 2006, and generally expire ten years after the grant date.

*2000 Stock Incentive Plan* — INX adopted the 2000 Stock Incentive Plan (the "2000 Incentive Plan") as approved at the May 2000 annual shareholder's meeting. At the June 5, 2006 shareholder's meeting the 2000 Incentive Plan was amended to increase the number of shares of common stock available for stock option grants to 2,473,103. The 2000 Incentive Plan provides for the granting of incentive awards in the form of stock-based awards and cash bonuses in accordance with the provisions of the plan. All employees, including officers, and consultants and non-employee directors are eligible to participate in the 2000 Incentive Plan. Generally, the Compensation Committee has the discretion to determine the exercise price of each stock option under the 2000 Incentive Plan, and they expire within ten years of the grant date, except those classified as Incentive Stock Option ("ISO") grants to a 10% or greater stockholder. ISO grants to a 10% or greater stockholder expire within five years of the grant date. The exercise price of each ISO grant may not be less than 100% of the fair market value of a share of common stock on the date of grant (110% in the case of a 10% or greater stockholder). Options granted under the 2000 Incentive Plan are subject to either cliff or graded vesting, generally ranging from three to ten years. At December 31, 2006, 168,189 shares were available for future option grants under the 2000 Incentive Plan.

**INX INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

***Grant-Date Fair Value***

The Company uses the Black-Scholes option pricing model to calculate the grant-date fair value of an award. The fair value of options granted during the 2006, 2005 and 2004 periods were calculated using the following estimated weighted average assumptions:

|                                    | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|------------------------------------|-------------|-------------|-------------|
| Expected volatility . . . . .      | 63.1%       | 63.9%       | 79.8%       |
| Expected term (in years) . . . . . | 6.3         | 8.0         | 8.0         |
| Risk-free interest rate . . . . .  | 4.7%        | 4.4%        | 3.6%        |
| Expected dividend yield . . . . .  | 0%          | 0%          | 0%          |

Expected volatility is based on historical volatility over the period IP communications solutions was the primary line of business of the Company. Beginning in 2006, the Company used the simplified method outlined in SAB 107 to estimate expected lives for options granted during the period. The risk-free interest rate is based on the yield on zero-coupon U.S. Treasury securities for a period that is commensurate with the expected term assumption. The Company has not historically issued any dividends and does not expect to in the future.

***Share-Based Compensation Expense***

The Company uses the straight-line attribution method to recognize expense for unvested options. The amount of share-based compensation recognized during a period is based on the value of the awards that are ultimately expected to vest. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The Company will re-evaluate the forfeiture rate annually and adjust it as necessary, and the adjustments could be material.

Share-based compensation expense recognized under SFAS 123R for the year ended December 31, 2006 was as follows:

|   |               |  |
|---|---------------|--|
| Cost of products and services — services . . . . .                                | \$ 57         |  |
| Selling, general and administrative expenses . . . . .                            | <u>350</u>    |  |
| Share-based compensation from continuing operations before income taxes . . . . . | 407           |  |
| Income tax benefit . . . . .  | <u>—</u>      |  |
| Share-based compensation from continuing operations . . . . .                     | 407           |  |
| Share-based compensation from discontinued operations . . . . .                   | <u>55</u>     |  |
| Total share-based compensation . . . . .  | <u>\$ 462</u> |  |
| Impact of total share-based compensation on net income per share:                 |               |  |
| Basic . . . . .   | \$(0.07)      |  |
| Diluted . . . . .   | \$(0.06)      |  |

During April 2005, options for 10,000 shares were granted to an employee at an exercise price of \$0.01. The difference between the exercise price and fair market value at date of grant of \$57 was charged to earnings during the year ended December 31, 2005, with a corresponding increase in additional paid-in-capital, resulting in no impact on total stockholders' equity. The year ended December 31, 2005 also included share-based compensation expense of \$5,729 resulting from the remeasurement of stock options exchanged as part of the elimination of the InterNetwork Experts, Inc. minority interest as discussed further in Note 11. Prior to January 1, 2006, the Company accounted for its share-based compensation under the recognition and measurement principles of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations, the disclosure-only provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" and the disclosures required by SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure." In accordance

**INX INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

with APB Opinion No. 25, no share-based compensation cost was reflected in the Company's net income for grants of stock options to employees because the Company granted stock options with an exercise price equal to the market value of the stock on the date of grant. Had the Company used the fair value based accounting method for share-based compensation expense prescribed by SFAS Nos. 123 and 148 for the year ended December 31, 2005 and 2004, the Company's consolidated net loss and net loss per share would have been increased to the pro-forma amounts illustrated as follows:

|   | <u>2005</u>             | <u>2004</u>           |
|---|-------------------------|-----------------------|
| Basic and diluted:  |                         |                       |
| Net loss as reported . . . . .  | \$(7,884)               | \$1,530               |
| Add: share-based employee compensation recognized, net of related income tax effect . . . . . | 5,786                   | —                     |
| Deduct: share-based employee compensation, net of related income tax effect . . . . .         | <u>(6,461)</u>          | <u>(90)</u>           |
| Pro forma net loss . . . . .  | <u><u>\$(8,559)</u></u> | <u><u>\$1,440</u></u> |
| Net loss per share:   |                         |                       |
| Basic — as reported . . . . .   | \$ (1.38)               | \$ 0.33               |
| Basic — pro forma . . . . .   | \$ (1.50)               | \$ 0.32               |
| Diluted — as reported . . . . .   | \$ (1.38)               | \$ 0.31               |
| Diluted — pro forma . . . . .   | \$ (1.50)               | \$ 0.29               |

***Option Activity***

A summary of the activity under the Company's stock option plans for the year ended December 31, 2006 is presented below:

|   | <u>Shares</u>    | <u>Weighted<br/>Average<br/>Exercise<br/>Price</u> | <u>Weighted<br/>Average<br/>Remaining<br/>Contractual<br/>Term (Years)</u> | <u>Aggregate<br/>Intrinsic<br/>Value</u> |
|---|------------------|--|--|--|
| Options outstanding at December 31, 2005 . . . . .                            | 1,944,610        | \$2.66   |  |  |
| Granted . . . . .   | 281,867          | 7.03   |  | \$ —                                     |
| Exercised . . . . .   | (327,859)        | 1.87   |  | \$1,682                                  |
| Canceled . . . . .  | <u>(27,855)</u>  | 5.12   |  |  |
| Options outstanding December 31, 2006 . . . . .                               | <u>1,870,763</u> | \$3.42   | 6.66   | \$8,312                                  |
| Options exercisable at December 31, 2006 . . . . .                            | <u>1,420,484</u> | \$2.34   | 5.88   | \$7,837                                  |
| Options vested and options expected to vest at<br>December 31, 2006 . . . . . | <u>1,828,419</u> | \$3.37   | 6.76   | \$8,215                                  |

The total intrinsic value of options exercised during the year ended December 31, 2006, 2005 and 2004 was \$1,682, \$1,016 and \$637, respectively. The total grant-date fair value of stock options that became fully vested during the year ended December 31, 2006, 2005 and 2004 was approximately \$412, \$122 and \$417, respectively. The weighted average grant-date fair value of options granted during the year ended December 31, 2006, 2005 and 2004 was \$4.46, \$2.15 and \$7.52, respectively. As of December 31, 2006, there was \$1,543 of total unrecognized compensation cost, net of estimated forfeitures, related to unvested share-based awards, which is expected to be recognized over a weighted-average period of 3.9 years.

**INX INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

A summary of the status of nonvested shares as of December 31, 2006 and changes during the year ended December 31, 2006 is presented below:

| <u>Nonvested Shares</u>                  | <u>Shares</u> | <u>Weighted Average<br/>Grant Date<br/>Fair Value</u> |
|--|---------------|---|
| Nonvested at January 1, 2006 . . . . .   | —             | —   |
| Granted . . . . .                        | 37            | \$7.48  |
| Vested . . . . .                         | —             | —   |
| Forfeited . . . . .                      | —             | —   |
| Nonvested at December 31, 2006 . . . . . | <u>37</u>     | \$7.48  |

As of December 31, 2006, there was \$271 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plan, which is expected to be recognized over the weighted-average period of 4.4 years. No shares have vested under the Plan as of December 31, 2006.

On November 10, 2005, the Financial Accounting Standards Board (“FASB”) issued FASB Staff Position No. FAS 123R-3 “Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards.” The Company has elected to adopt the alternative transition method provided in the FASB Staff Position for calculating the tax effects of stock-based compensation pursuant to SFAS 123R. The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (“APIC pool”) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and Consolidated Statements of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123R. SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a financing cash flow, rather than as an operating cash flow as prescribed under the prior accounting rules. This requirement reduces net operating cash flows and increases net financing cash flows in periods after adoption. Total cash flow remains unchanged from what would have been reported under prior accounting rules. Since no tax benefit was recorded for share-based payment awards in the year ended December 31, 2006, the aforementioned provisions of SFAS 123R and the related FASB Staff Position No. FAS 123R-3 had no impact on the Condensed Consolidated Financial Statements.

*Capital Stock* — Holders of INX’s common stock are entitled to one vote per share on all matters to be voted on by shareholders and are entitled to receive dividends, if any, as may be declared from time to time by the Board of Directors of INX (the “Board”). Upon any liquidation or dissolution of INX, the holders of common stock are entitled, subject to any preferential rights of the holders of preferred stock, to receive a pro rata share of all of the assets remaining available for distribution to shareholders after payment of all liabilities. There are no shares of preferred stock issued or outstanding.

*Completion of Public Offering* — On May 12, 2004, the Company closed a public offering of 500,000 Units. Each Unit consists of two shares of common stock and one warrant to purchase one share of common stock at a price of \$12.45. The Units were offered at a public offering price of \$16.60 per Unit resulting in \$8,300 of proceeds less 9% underwriter discount of \$747 and underwriter expenses of \$9 for a net amount of \$7,544 before additional offering expenses. On June 2, 2004, the underwriters exercised their option to purchase 75,000 additional Units to cover over-allotments resulting in \$1,245 of proceeds less 9% underwriter discount of \$112 for a net amount of \$1,133 before additional offering expenses. The Company paid approximately \$1,145 of additional offering expenses associated with the public offering as of December 31, 2004. Net proceeds after all discounts and expenses were approximately \$7,548.

*Warrants* — Included in the units issued by INX on May 7, 2004 were 575,000 warrants to purchase common stock at an exercise price of \$12.45 per share. These warrants are exercisable through May 7, 2009 and are subject to redemption by INX at a price of \$0.25 per warrant upon 30 days notice to the holders; however, INX may only

## INX INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

redeem the warrants if the closing price for INX common stock, as reported on Nasdaq, for any five consecutive days has equaled or exceeded \$16.60.

On May 7, 2004 INX issued warrants to the underwriters to purchase up to 50,000 units at an exercise price equal to \$19.92 per unit. These warrants are exercisable during the four-year period beginning May 7, 2005 which is one year from the date of the prospectus. Pursuant to NASD Rule 2710(g), these warrants cannot be sold, transferred, assigned, pledged or hypothecated by any person for a period of one year following the effective date of the offering, except to any NASD member participating in the offering, to bona fide officers, by operation of law or if we are reorganized, so long as the securities so transferred remain subject to the same transfer restriction for the remainder of the one-year period. The holder of the representative's warrant will have, in that capacity, no voting, dividend or other stockholder rights.

In January 2007 INX issued warrants to an investor relations firm under a personal services agreement to purchase up to 50,000 shares of common stock at an exercise price equal to \$8.00 per share expiring January 1, 2009. Warrants for 25,000 shares are exercisable immediately and will result in a charge of \$40 during the first quarter of 2007. If the personal service agreement is not cancelled by the Company on or before June 30, 2007, warrants for 25,000 shares are exercisable after June 30, 2007 and will result in a charge of \$46 during the third quarter of 2007.

#### **11. Elimination of Minority Interest in InterNetwork Experts, Inc.**

On March 18, 2005, the Company acquired all of the InterNetwork Experts, Inc. shares held by a minority shareholder group in exchange for 244,890 shares of INX common stock. The transaction was recorded using the purchase method of accounting, resulting in recognition of goodwill of \$1,408 including transaction costs of \$180, elimination of \$302 in minority interests, and an increase in common stock and additional paid-in-capital of \$1,530. In connection with the transaction, InterNetwork Experts, Inc. stock options were exchanged for INX stock options, requiring remeasurement of the stock options as of the date of exchange. The resulting \$5,729 charge to earnings was reflected as an increase in selling, general, and administrative expenses with a corresponding increase in additional paid-in-capital and therefore had no impact on total stockholders' equity.

#### **12. Major Customers**

International sales were approximately 4.9%, 3.5% and 2.7% of consolidated revenues for 2006, 2005 and 2004, respectively, based on the country in which the products were delivered or services provided. No single customer represented more than 10% of 2006 consolidated revenues. The Company had one customer, Micro System Enterprise, Inc./Acclaim Professional Services ("MSE"), an agent related to the Dallas Independent School District E-Rate funded program that represented 12.8% and 20.9% of 2005 and 2004 consolidated revenue, respectively, and 11.2% of the net account receivables at December 31, 2005.

#### **13. Related Party Transactions**

Under an agreement that expired on January 31, 2007 (the "Old Lease"), the Company leased approximately 48,000 square feet of office space from Allstar Equities, Inc., ("Allstar"), wholly-owned by Mr. James H. Long, the Company's Chief Executive Officer and largest shareholder. The office space was leased under the Old Lease at the rate of \$37 per month triple net. Rental expense under this agreement amounted to approximately \$446 in each of the three years ended December 31, 2006. Due to the sale of the Company's former Stratasoft and Valerent subsidiaries, substantially less space will be required by the Company at this location. Accordingly, on October 11,

## INX INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

2006, the Company executed a new lease agreement (“New Lease”) with Allstar effective February 1, 2007, reducing the leased space to 16,488 square feet under the following terms:

- A lease term of eighty-four months ending January 31, 2014.
- Base rent of \$20 per month, gross. Under the Old Lease, occupancy expenses such as electricity, gas, water, janitorial, and security averaging approximately \$280 per year are paid by the Company. Under the New Lease these services are included in the base rent with the costs born by the landlord.
- A buildout allowance of \$31 to be used by the Company to partially offset the costs of remodeling the leased premises and first floor common areas. The buildout allowance was provided by reducing the monthly lease payment from \$21 to \$20.
- A security deposit of \$20 is required, which is a reduction from the \$38 currently held by Allstar.
- The Company has the option to terminate the lease at the end of the sixtieth or seventy-second month of the lease term. In order to exercise its option, the Company is required to provide Allstar with a minimum of 180 days advance written notice of its intent to terminate the lease. If 360 days of advance written notice is given by the Company, a termination fee of one month’s base rent is immediately payable, and if 180 days of advance written notice is given by the Company, a termination fee of two months’ base rent is immediately payable.
- At any time during the term of the lease, Allstar has the right to pay the Company in cash the amount of unamortized buildout allowance, after which the monthly basic rent payable under the lease increases from \$20 to \$21 for the remaining term of the lease.
- The Company has the option to renew the lease for two additional terms of five years each at the lesser of the then prevailing fair market rental rate or 105% of the base rent under the New Lease.

The Audit Committee of the Board of Directors engaged the services of an independent real estate consultant to evaluate the fair market rental and related lease terms for comparable facilities in Houston. Based on the recommendations of the independent consultant the Audit Committee of the Board of Directors approved the transactions contemplated by the New Lease.

The Company paid for remodeling, parking lot repaving, and other improvements of the building leased from Allstar totaling \$267, \$8, and \$12 for the years ended December 31, 2006, 2005 and 2004, respectively. The Audit Committee of the Board of Directors approved the 2006 expenditures. Under the transition to the new lease, sublease income earned by Allstar prior to expiration of the current lease is payable to the Company. At December 31, 2006, a \$26 sublease income receivable from Allstar is recorded in the accompanying balance sheet, which was paid to the Company in 2007.

#### 14. Commitments and Contingencies

*Litigation* — In August 2002, Inacom Corp. (“Inacom”) filed a lawsuit in the District Court of Douglas County, Nebraska styled *Inacom Corp v. I-Sector Corporation, f/k/a Allstar Systems, Inc.*, claiming that we owed the sum of approximately \$570 to Inacom as a result of Inacom’s termination of a Vendor Purchase Agreement between Inacom and us. The lawsuit was settled effective June 6, 2006 for \$100. The excess accrual of \$469 was credited to income from discontinued operations in the statement of operations for the year ended December 31, 2006.

On December 22, 2005, CenterPoint Energy Service Company filed a lawsuit in the District Court of Harris County, Texas styled *CenterPoint Energy Service Company, LLC v. InterNetwork Experts, Inc. (now INX, Inc.), Yellow Transportation, Inc. and Cisco Systems, Inc.* claiming damages to product during shipment estimated to be \$488 plus consequential damages, legal fees, court costs, and interest. The lawsuit is currently set for trial on April 9, 2007. The Company cannot predict the outcome of the lawsuit and, as a result, cannot be assured that this case will not have a material adverse effect on its financial position, results of operations or cash flows. Due to the uncertainty

## INX INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

surrounding the issues involved in this matter and based on the facts and circumstances known to date, the Company believes that an estimate of loss, if any, that may be incurred cannot be made at this time.

INX is also party to other litigation and claims which management believes are normal in the course of its operations. While the results of such litigation and claims cannot be predicted with certainty, INX believes the final outcome of such matters will not have a materially adverse effect on its results of operations or financial position.

*Leases* — Rent expense for the years ended December 31, 2006, 2005 and 2004 totaled approximately \$1,111, \$1,101, and \$787, respectively. Future minimum rental commitments on noncancellable operating leases with remaining terms in excess of one year amount to approximately \$897 in 2007, \$906 in 2008, \$875 in 2009, \$521 in 2010, \$314 in 2011, and \$498 thereafter.

*Obligation under Software License Agreement* — base payments of \$469 in 2007 and \$306 in 2008 are required under a three year software license agreement expiring December 14, 2009. Supplemental fees may be payable under the software license agreement based on actual network devices utilizing the software. Supplemental fees will be expensed as incurred.

*401(k) Plan* — INX maintains a 401(k) savings plan wherein it matches a portion of the employee contribution. In addition, there is a discretionary matching fund based on the net profitability of INX. All full-time employees who have completed 90 days of service with INX are eligible to participate in the plan. Declaration of the discretionary portion of the matching fund is the decision of the Board. INX has made no additional contributions to the plan for the three years ended December 31, 2006. Under the standard plan matching program, INX's expense was \$86, \$54 and \$39 for the years ended December 31, 2006, 2005 and 2004, respectively.

#### **15. Subsequent Event**

On January 19, 2007, the Company was notified that a customer was terminating a NetSurant support services contract effective February 28, 2007. Services revenue recorded under the NetSurant support service contract was \$588, \$108 and \$0 for the years ended December 31, 2006, 2005 and 2004, respectively. Under the terms of the customer's contract, a termination payment is due to the Company that is in excess of deferred costs associated with the contract. The company expects to receive payment in early 2007 and any difference in the amount received and the deferred costs will be recognized when received.

**Schedule II**  
**Valuation and Qualifying Accounts**  
**For Each of the Three Years Ended December 31, 2006**  
**(Amounts in Thousands)**

|  | <u>Balance at<br/>Beginning<br/>of Year</u> | <u>Charges to<br/>Costs and<br/>Expenses</u> | <u>Write-offs</u> | <u>Recoveries</u> | <u>Other<br/>Changes</u> | <u>Balance at<br/>End of<br/>Year</u> |
|--|---|--|-------------------|-------------------|--------------------------|---------------------------------------|
| Accumulated provision deducted from<br>related assets on balance sheet |   |  |                   |                   |                          |                                       |
| Allowance for doubtful accounts:                                       |   |  |                   |                   |                          |                                       |
| 2004.....  | \$369                                       | \$70   | \$ 37             | \$199             | \$—                      | \$601                                 |
| 2005.....  | 601   | 9  | 449               | —                 | —                        | 161                                   |
| 2006.....  | 161   | 63   | 5                 | 80                | —                        | 299                                   |

Note: amounts are reported for continuing operations only.

**Item 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

None.

**Item 9A. *Controls and Procedures***

Under the supervision and with the participation of certain members of our management, including our Chairman of the Board, Chief Executive Officer and principal financial officer, we completed an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) to the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Based on that evaluation, we and our management have concluded that, our disclosure controls and procedures at December 31, 2006 were effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC, and are designed to ensure that information required to be disclosed by us in these reports is accumulated and communicated to our management, as appropriate to allow timely decisions regarding required disclosures. During the fourth quarter of 2006, there has been no change in our internal control over financial reporting that has materially affected, or is reasonably likely to affect, our internal control over financial reporting.

We will consider further actions and continue to evaluate the effectiveness of our disclosure controls and internal controls and procedures on an ongoing basis, taking corrective action as appropriate. Management does not expect that disclosure controls and procedures or internal controls can prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable and not absolute assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. While management believes that its disclosure controls and procedures provide reasonable assurance that fraud can be detected and prevented, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected.

The certifications of INX’s Principal Executive Officer and Principal Financial Officer attached as Exhibits 31.1 and 31.2 to this Annual Report on Form 10-K include, in paragraph 4 of such certifications, information concerning INX’s disclosure controls and procedures and internal controls over financial reporting. Such certifications should be read in conjunction with the information contained in this Item 9A for a more complete understanding of the matters covered by such certifications.

**Item 9B. *Other Information.***

None.

**PART III**

Certain information required by Part III is omitted from this Report on Form 10-K since we will file a definitive Proxy pursuant to Regulation 14A of the Exchange Act (the “Proxy Statement”), not later than 120 days after the end of the fiscal year covered by this Report, and certain information included in the Proxy Statement is incorporated herein by reference.

**Item 10. *Directors, Executive Officers, and Corporate Governance***

The information required by this item regarding the Company’s directors is incorporated herein by reference to the sections entitled “PROPOSAL 1 — ELECTION OF DIRECTORS”, “EXECUTIVE COMPENSATION”, and “SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE” in the Company’s definitive Proxy Statement for the 2007 Annual Meeting of Shareholders (“Proxy Statement”). Information regarding the Company’s executive officers is set forth in Item 4 of Part I of this Report under the caption “Executive Officers of the Registrant”.

We have adopted a code of ethics that applies to the Chief Executive Officer, Chief Financial Officer, Controller and persons performing similar functions. We have also adopted a code of ethics applicable to all employees. We have

posted a copy of the codes of ethics on our Internet website at Internet address: <http://www.inxi.com>. Copies of the codes may be obtained free of charge from the Company's website at the above Internet address. We intend to disclose any amendments to, or waivers from, a provision of the code of ethics that applies to the Chief Executive Officer, Chief Financial Officer or Controller by posting such information on our website at the above address.

**Item 11. *Executive Compensation***

The information required by this item is incorporated herein by reference to the section entitled "EXECUTIVE COMPENSATION" in the Proxy Statement.

**Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

The information required by this item is incorporated herein by reference to the sections entitled "SECURITY OWNERSHIP OF MANAGEMENT AND CERTAIN BENEFICIAL OWNERS" and "EXECUTIVE COMPENSATION" in the Proxy Statement.

**Item 13. *Certain Relationships and Related Transactions, and Director Independence***

The information required by this item is incorporated herein by reference to the section entitled "CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS" in the Proxy Statement.

**Item 14. *Principal Accountant Fees and Services***

The information required by this item is incorporated herein by reference to the section entitled "INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM" in the Proxy Statement.

**PART IV**

**Item 15. *Exhibits and Financial Statement Schedules***

(a) 1. Financial Statements

The Index to Financial Statements and Financial Statement Schedule on page 44 is incorporated herein by reference as the list of financial statements required as part of this report.

2. Financial Statement Schedule

The Index to Financial Statements and Financial Statement Schedule on page 44 is incorporated herein by reference as the list of financial statement schedules required as part of this report.

3. Exhibits

See exhibit list in the Index to Exhibits is incorporated herein by reference as the list of exhibits required as part of this report.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, March 8, 2007.

INX INC.  
(Registrant)

By: /s/ JAMES H. LONG

James H. Long  
*Chief Executive Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| <u>Signature</u>                                    | <u>Capacity</u>  | <u>Date</u>   |
|---|--|---------------|
| <u>/s/ JAMES H. LONG</u><br>James H. Long           | Chief Executive Officer and Chairman of the Board of Directors | March 8, 2007 |
| <u>/s/ BRIAN FONTANA</u><br>Brian Fontana           | Vice President and Chief Financial Officer                     | March 8, 2007 |
| <u>/s/ LARRY LAWHORN</u><br>Larry Lawhorn           | Controller and Chief Accounting Officer                        | March 8, 2007 |
| <u>/s/ DONALD R. CHADWICK</u><br>Donald R. Chadwick | Director   | March 8, 2007 |
| <u>/s/ CARY GROSSMAN</u><br>Cary Grossman           | Director   | March 8, 2007 |
| <u>/s/ JOHN B. CARTWRIGHT</u><br>John B. Cartwright | Director   | March 8, 2007 |

## EXHIBIT INDEX

| <u>Exhibit No.</u> | <u>Description</u>   | <u>Filed Herewith or Incorporated by Reference From:</u>                                  |
|--------------------|--|---|
| 2.1                | Stock Purchase Agreement by and among The Resource Group International Limited and INX Inc. dated January 26, 2006 | Exhibit 2.1 to Form 8-K filed January 31, 2006  |
| 3.1                | Bylaws of the Company  | Exhibit 3.1 to Form S-1, Registration No. 333-09789, filed August 8, 1996                 |
| 3.2                | Certificate of Incorporation of the Company  | Exhibit 3.2 to Amendment 1 to Form S-1, Registration No. 333-09789, filed August 8, 1996  |
| 3.3                | Certificate of Amendment to Certificate of Incorporation of Allstar Systems, Inc., dated June 24, 1997             | Exhibit 3.4 to Amendment 5 to Form S-1, Registration No. 333-09789, filed August 8, 1996  |
| 3.4                | Certificate of Amendment to Certificate of Incorporation of Allstar Systems, Inc., dated March 5, 1999             | Exhibit 3.3 to Form 8-A, Registration No. 001-31949, filed December 29, 2003              |
| 3.5                | Certificate of Amendment to Certificate of Incorporation of Allstar Systems, Inc. dated July 10, 2000              | Exhibit 3.4 to Form 8-A, Registration No. 001-31949, filed December 29, 2003              |
| 3.6                | Certificate of Ownership and Merger  | Exhibit 3.1 to Form 8-K, Registration No. 001-31949, dated January 6, 2006                |
| 4.1                | Specimen Common Stock Certificate  | Exhibit 4.1 to Amendment 2 to Form S-1, Registration No. 333-09789, filed August 8, 1996  |
| 10.1               | Form of Employment Agreement by and between the Company and certain members of management                          | Exhibit 10.5 to Amendment 1 to Form S-1, Registration No. 333-09789, filed August 8, 1996 |
| 10.2               | Employment Agreement by and between Allstar Systems, Inc. and James H. Long, dated August 15, 1996                 | Exhibit 10.3 to Form 10-K Registration No. 001-31949, filed March 12, 2004                |
| 10.3               | Amended & Restated Allstar Systems, Inc. 1996 Incentive Stock Plan, dated effective July 1, 1997                   | Exhibit 10.10 to Form 10-K Registration No. 001-31949, filed March 12, 2004               |
| 10.4               | Amended & Restated I-Sector Corp. Stock Incentive Plan, dated effective July 28, 2003                              | Exhibit 10.11 to Form 10-K Registration No. 001-31949, filed March 12, 2004               |
| 10.5               | Amended & Restated Internetwork Experts, Inc., Stock Incentive Plan dated effective August 1, 2003                 | Exhibit 10.12 to Form 10-K Registration No. 001-31949, filed March 12, 2004               |
| 10.6               | First Amendment to I-Sector Corporation Incentive Plan   | Exhibit 10.1 to Form 8-K, Registration No. 001-31949, dated January 4, 2005               |
| 10.7               | Second Amendment to I-Sector Corporation Incentive Plan, as amended and restated                                   | Exhibit 10.2 to Form 8-K, Registration No. 001-31949, dated March 21, 2005                |
| 10.8               | Third Amendment to I-Sector Corporation Incentive Plan   | Exhibit 10.1 to Form 8-K, Registration No. 001-31949, dated May 17, 2005                  |
| 10.9               | Fourth Amendment to I-Sector Corporate Incentive Plan  | Exhibit 10.1 to Form 8-K, Registration No. 001-31949, filed June 6, 2006                  |
| 10.10              | Lease Agreement by and between Allstar Equities, Inc. and I-Sector Corporation, dated February 1, 2002             | Exhibit 10.32 to Form 10-K, Registration No. 000-21479, filed March 28, 2002              |
| 10.11              | Lease Agreement between INX Inc. and Allstar Equities, Inc., dated October 11, 2006                                | Exhibit 10.1 to Form 8-K, Registration No. 001-31949, filed October 12, 2006              |

| <u>Exhibit No.</u> | <u>Description</u>   | <u>Filed Herewith or Incorporated by Reference From:</u>                      |
|--------------------|--|---|
| 10.12              | Employment Agreement by and between I-Sector Corporation and Brian Fontana, dated December 20, 2004  | Exhibit 10.1 to Form 8-K, Registration No. 001-31949, filed December 20, 2004 |
| 10.13              | Confidentiality Agreement by and between I-Sector Corporation and Brian Fontana, dated December 20, 2004   | Exhibit 10.2 to Form 8-K, Registration No. 001-31949, filed December 20, 2004 |
| 10.14              | Plan and Agreement of merger among I-Sector Corporation, INX Merger Sub, Inc. and InterNetwork Experts, Inc. dated as of February 1, 2005                              | Exhibit 10.1 to Form 8-K, Registration No. 001-31949, dated February 7, 2005  |
| 10.15              | Employment Agreement by and between I-Sector Corporation and Larry Lawhorn dated April 5, 2005   | Exhibit 10.1 to Form 10-Q, Registration No. 001-31949, dated August 15, 2005  |
| 10.16              | Credit Agreement by and among Castle Pines Capital LLC, I-Sector Corporation, Valerent, Inc., InterNetwork Experts, Inc., and Stratasoft, Inc. dated December 27, 2005 | Exhibit 10.1 to Form 8-K, Registration No. 001-31949, dated December 30, 2005 |
| 10.17              | Asset Purchase Agreement by and among INX Inc., Datatran Network Systems and Mel Sarowitz dated February 3, 2006   | Exhibit 1.1 to Form 8-K filed February 6, 2006                                |
| 10.18              | Systems Integrator Agreement by and between Cisco Systems, Inc. and Internetwork Experts, Inc., dated November 13, 2001  | Exhibit 10.5 to Form 10-K, Registration No. 001-31949, dated March 12, 2004   |
| 10.19              | Amendment One, dated January 28, 2002 to Systems Integrator Agreement by and between Cisco Systems, Inc. and Internetwork Experts, Inc., dated November 13, 2001       | Exhibit 10.6 to Form 10-K, Registration No. 001-31949, dated March 12, 2004   |
| 10.20              | Amendment Two, dated November 21, 2002 to Systems Integrator Agreement by and between Cisco Systems, Inc. and Internetwork Experts, Inc., dated November 13, 2001      | Exhibit 10.6 to Form 10-K, Registration No. 001-31949, dated March 12, 2004   |
| 10.21              | Amendment Three, dated January 20, 2003 to Systems Integrator Agreement by and between Cisco Systems, Inc. and Internetwork Experts, Inc., dated November 13, 2001     | Exhibit 10.8 to Form 10-K, Registration No. 001-31949, dated March 12, 2004   |
| 10.22              | Amendment Four, dated January 16, 2004 to Systems Integrator Agreement by and between Cisco Systems, Inc. and Internetwork Experts, Inc., dated November 13, 2001      | Exhibit 10.9 to Form 10-K, Registration No. 001-31949, dated March 12, 2004   |
| 10.23              | Amendment Five, dated January 27, 2005 to Systems Integrator Agreement by and between Cisco Systems, Inc. and Internetwork Experts, Inc., dated November 13, 2001      | Exhibit 10.23 to Form 10-K, Registration No. 001-31949, dated March 27, 2006  |
| 10.24              | Amendment Six, dated April 18, 2005 to Systems Integrator Agreement by and between Cisco Systems, Inc. and Internetwork Experts, Inc., dated November 13, 2001         | Exhibit 10.24 to Form 10-K, Registration No. 001-31949, dated March 27, 2006  |
| 10.25              | Amendment Seven, dated March 2, 2006, to Systems Integrator Agreement by and between Cisco Systems, Inc. and Internetwork Experts, Inc., dated November 13, 2001       | Exhibit 10.25 to Form 10-K, Registration No. 001-31949, dated March 27, 2006  |

| <u>Exhibit No.</u> | <u>Description</u>  | <u>Filed Herewith or Incorporated by Reference From:</u>                     |
|--------------------|---|--|
| 10.26              | Amendment Eight, dated March 20, 2006, to Systems Integrator Agreement by and between Cisco Systems, Inc. and INX Inc. (formerly Internetwork Experts, Inc.), dated November 13, 2001   | Exhibit 10.26 to Form 10-K, Registration No. 001-31949, dated March 27, 2006 |
| 10.27              | Form of Change in Control Retention Agreement   | Exhibit 10.1 to Form 8-K, Registration No. 001-31949, dated December 8, 2006 |
| 10.28              | Managed Services Provider Agreement by and between INX Inc. and CA, Inc. dated March 30, 2006   | Filed herewith   |
| 10.29              | Amendment No. 1 dated December 15, 2006, to Managed Services Provider Agreement by and between INX Inc. and CA, Inc. dated March 30, 2006   | Filed herewith   |
| 10.30              | Amendment Nine, dated November 13, 2006, to Systems Integrator Agreement by and between Cisco Systems, Inc. and INX Inc. (formerly Internetwork Experts, Inc.), dated November 13, 2001 | Filed herewith   |
| 21.1               | List of Subsidiaries of the Company   | Exhibit 21.1 to Form 10-K, Registration No. 000-21479, filed March 31, 2003  |
| 23.1               | Consent of Grant Thornton LLP   | Filed herewith   |
| 31.1               | Rule 13a-14(a)/15d-14(a) Certification of Chairman and Chief Executive Officer  | Filed herewith   |
| 31.2               | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer   | Filed herewith   |
| 32.1               | Section 1350 Certification of Chief Executive Officer   | Filed herewith   |
| 32.2               | Section 1350 Certification of Chief Financial Officer   | Filed herewith   |
| 99.1               | Report of Independent Registered Public Accounting Firm   | Filed herewith   |



CA, INC.  
MANAGED SERVICES PROVIDER (MSP) AGREEMENT

Name and Address of Authorized MSP: InterNetwork Experts, Inc.  
1955 Lakeway Drive, Suite 220, Lewisville, TX 75057

Contact: Jon Groves  
Tel: 469-549-3903

E-Mail: Jonathon.Groves@netwurant.com

This MSP Agreement (“Agreement”) is entered into by CA, Inc. whose principal place of business is at One CA Plaza, Islandia, New York 11949 (“CA”) and the MSP identified above, and will commence on the Effective Date.

CA and MSP agree to the terms and conditions of this Standard MSP Agreement (“Agreement”). This Agreement authorizes MSP to provide managed services to their End Users as further defined herein.

- 3. DEFINITIONS. In this Agreement each word or phrase with the initial letter capitalized shall have the following meaning unless expressly provided otherwise. The term “Section” refers to an identified section of this Agreement. A reference to an Exhibit is to an Exhibit to this Agreement as the same may be modified by mutual agreement in writing from time to time.
  - 3.1. CA Marks means CA’s trade marks, service marks, logos, designations and insignias.
    - 1.1. CA Software means CA software products stated in Exhibit A the use of which is restricted solely to enable MSP to provide remote monitoring services to MSP End Users using a virtual computer connection to MSP End Users’ networks provide any of the following services: to monitor and provide asset management, software delivery, desktop refresh, remote control and/or help desk services. Such CA Software shall also include all corrections, Maintenance Releases, New Versions and associated Documentation thereto provided by CA to MSP, but not beta, pre-release or other special release products, which are specifically excluded from the definition of CA Software.
  - 3.2. Confidential Information means the information and materials noticed or marked by CA or MSP as confidential and proprietary. “Confidential Information” does not include information that (i) is already known to the receiving party at the time it is disclosed and has not been obtained wrongfully, (ii) becomes publicly known without fault of the receiving party, (iii) is independently developed by the receiving party, (iv) is approved for release in writing by the disclosing party, (v) is disclosed without restriction by the disclosing party to a third party, or (vi) is disclosed pursuant to legal obligations beyond the control of the disclosing and receiving parties. However, the foregoing shall not be deemed to grant to either party a license of the other party’s copyrights or patents. For purposes of this definition, CA Software shall always be deemed Confidential Information.
  - 3.3. Demonstration Software means the CA Software used internally by MSP on the computer(s) listed in the applicable Demonstration Software Order Form(s) for demonstration and support purposes.
  - 3.4. Documentation means CA’s published technical manuals that accompany the CA Software.
  - 3.5. End Users means the remote managed service third party entities for which MSP provides or shall provide remote managed services and with whom MSP has a confidentiality agreement sufficiently broad in scope to include the CA Software as defined below. MSP End Users shall not include an entity that redistributes, distributes, licenses, rents or leases CA Software to other parties in the regular course of business.
    - 1.2. End User Agreement means the terms and conditions pursuant to which an End User has access to CA Software by MSP for MSP services including access to the functionality of the CA Software. Such Agreement shall include terms and conditions that will cause End User to observe usage and confidentiality restrictions set forth herein prior to allowing End User to have such access solely for End User’s Internal Use.
    - 1.3. Effective Date means the date stated in Exhibit A.

CA Initial   /s/ DDG  

MSP Initial   /s/ JG  

Legally approved by CA Shama09



- 3.6. Internal Use means use for an End User’s internal business operations only. “Internal Use” does not include timesharing, provision of outsourcing or facilities management services.
- 3.7. Maintenance Releases means temporary fixes, error corrections, workarounds and corrections made available by CA for MSP to support the usage of CA Software, but does not include (i) New Versions or (ii) new products available from CA for an additional fee.
- 1.4. New Versions means a new version of the CA Software containing new features or functions as well as error corrections, but does not include new products available from CA for an additional fee.
- 3.8. Territory means the area identified in Exhibit A but always excluding any countries which CA is prohibited from exporting its products to as prescribed by US export laws.
- 3.9. Upgrade means any change in the usage of the CA Products (including, but not limited to the transfer of CA Products to a computer in a higher price classification, or an increase in authorized use limitation) that would result in an increase in price as determined in accordance with CA’s then current price list.
- 2. TERM. This Agreement, unless terminated earlier as provided in this Agreement, will commence on the Effective Date and will expire three (3) years from the Effective Date, subject to the term limitations specified in Exhibit A. Nothing contained in this Agreement should be interpreted as requiring either CA or MSP to renew or extend this Agreement.
- 4. APPOINTMENT.
  - 4.1. Appointment. CA appoints MSP within the Territory. This appointment is non-exclusive, with CA reserving the right to appoint other MSPs without restriction as to number and location. Subject to Section 3.2 below, CA grants a non-exclusive, non-transferable, license within the Territory to:
    - 2.1.1. utilize the CA Software in the designated Operations Center (“OC”), located at the Installation Site(s) indicated on Exhibit A, to provide remote monitoring services to MSP End Users and to process the business data of multiple MSP End Users. If MSP subsequently opens other OCs within the Territory, MSP agrees to obtain CA’s prior written approval to use the CA Software at such other OC locations and MSP further agrees to comply with any reasonable conditions imposed on MSP by CA in consideration for granting such approval. In no circumstance may MSP or any MSP End User use or access any CA Software hereunder for the benefit of any MSP End User which is itself engaged in the business of providing data processing services of any kind to its own customers, whether acting as a facilities manager, remote services provider, service bureau, outsourcer or otherwise.
    - 2.1.2. replace the CA Software with New Versions made generally available by CA from time to time if MSP pays the applicable maintenance and support fees; and
    - 4.1.1. acquire Upgrades intended for End Users from CA, on an as-needed basis if MSP shall have paid the applicable maintenance and support fees.
    - 4.1.2. provide demonstration of the MSP service to End Users or prospective end users that includes CA Software subject to the confidentiality and usage restrictions contained herein.
  - 4.2. Restrictions. The license made available to MSP is subject to the following:
    - 4.2.1. MSP shall not reverse engineer, disassemble, decompile, or otherwise attempt to discover the source code for the CA Software; redistribute, encumber, sell, rent, lease, sublicense, or otherwise transfer rights to the CA Software (except as expressly permitted hereunder); or remove or alter any trademark, logo, copyright or other proprietary notices, legends, symbols or labels in the CA Software (except as explicitly permitted hereunder). MSP shall not disclose the individual or separate pricing of the CA Software under this Agreement to any third party.
  - 2.2. Subsidiaries and Affiliates. MSP’s subsidiaries and affiliates are not permitted to access the CA Software without the prior written consent of CA.

3. PRODUCTS AND PRICING

CA Initial   /s/ DDG  

MSP Initial   /s/ JG  

Legally approved by CA Shama09



- 4.3. Eligible Products. MSP is authorized under this Agreement to utilize and market the functionality of the CA Software as part of the remote managed services provided by MSP.
- 3.1. Pricing. The fees payable by MSP will be in accordance with the Fees in Exhibit A.
- 4.4. CA Software Changes. CA reserves the right at any time to make changes or modifications to any CA Software, including without limitation changes which are required (i) for security, or (ii) to facilitate performance in accordance with published documentation. CA also reserves the right at any time to (i) increase or decrease list or recommended prices against which discounts are calculated and (ii) to discontinue the sale or availability of any CA Software at any time. CA will give 30 days notice of any list price increases or discontinuance of any CA Software. All such changes shall become effective 30 days after notice is given. Orders requesting delivery after the effective ate of a price change will be invoiced at the changed price.
- 5. MARKETING, END USER SATISFACTION, MSP OBLIGATIONS AND SUPPORT.
  - 5.1. Use of Authorized MSP Title. MSP may refer to itself, in connection with exercising its rights under this Agreement, as a “CA Authorized MSP,” but *solely* in connection with marketing the CA Software and only during the term of this Agreement.
  - 3.2. Use of CA Marks and Trade Names. MSP is authorized to use the CA Marks applicable to CA Software obtained under this Agreement in connection with its marketing of CA Software as part of the managed services provided by MSP, but only in accordance with CA’s then current trademark usage policies (including rights to monitor MSP’s use of the CA Marks) set forth on CA’s web site [www.ca.com/corp\\_identity/legal.htm](http://www.ca.com/corp_identity/legal.htm) and only during the term of this Agreement. Upon the Expiration Date or termination of this Agreement, MSP agrees to cease all display, advertising and use of any and all CA Marks and trade names. MSP recognizes CA’s or its licensors’ ownership and title to the trade names and CA Marks and the goodwill attaching to the trade names and CA Marks. MSP agrees that any goodwill that accrues because of its use of the trade names and/or CA Marks belongs to CA. MSP agrees that if it contests the CA Marks or trade names, or makes application for registration of any CA Marks or trade names without CA’s prior written consent, CA shall be entitled to terminate this Agreement immediately upon written notice to MSP. MSP agrees not to use, employ or attempt to register any trademarks or trade names that are confusingly similar to the CA Marks or trade names.
  - 3.3. Obligations using CA Marks. MSP shall not attach, remove or disfigure any CA Marks on the CA Software and shall not attach any additional marks to the CA Software except as otherwise agreed by CA. MSP shall not attach the CA Marks to any products other than the CA Software. MSP agrees not to alter or remove or obscure any copyright or other proprietary notices on or in the CA Software or related Documentation or materials. CA may from time to time use other or additional marks with respect to any CA Software. The provisions of this Agreement governing MSP’s use of the CA Marks shall also apply to such other marks.
  - 3.4. End User Satisfaction. MSP agrees that high End User satisfaction is a condition of its continued authorization by CA. Although CA has granted MSP a Territory-wide authority to remotely manage End Users with CA Software under the terms of this Agreement, MSP agrees that it will not market and distribute CA Software in areas where it does not have the ability to support the CA Software. In addition, to help ensure high End User satisfaction, MSP agrees to:
    - 5.1.1. report to CA promptly and in writing all suspected and actual problems with any CA Software;
    - 5.1.2. avoid deceptive, misleading or unethical practices that are or might be detrimental to CA or the CA Software;
    - 5.1.3. refrain from making any false or misleading representations with regard to CA or CA Software;
    - 5.1.4. refrain from making any representations, warranties or guarantees to customers with respect to the specifications, features or capabilities of CA Software that are inconsistent with the literature distributed by CA; and
    - 5.1.5. provide or cause to be provided all original media and manuals accompanying each CA Software license to the End User if applicable.
  - 5.2. MSP Obligations. MSP agrees to the following:

CA Initial  /s/ DDG

MSP Initial  /s/ JG

Legally approved by CA Shama09



- 5.2.1. MSP shall bear all costs of integrating and or implementation, including any required education services relating to the CA Software using CA Services pursuant to the MSP Support Addendum attached as Exhibit B.
- 5.2.2. MSP shall bear all costs of and all related sales and marketing expenses.
- 5.3. Support and Maintenance.
- 3.4.1. MSP First Level Support. MSP shall provide first level support for the CA Software as described in the MSP Support Addendum attached hereto, substantially similar to the level of support provided by CA to an End User,. MSP shall ensure that members of its technical staff complete sufficient training regarding the CA Software as necessary to provide first level support to MSP's End Users and MSP Channel Partners. CA shall not have any obligation to provide first level support to MSP's End Users (unless CA has entered into a maintenance agreement directly with the End User). If CA directly supports an End User, CA shall be entitled to retain the full amount of maintenance revenue received from such End User.
- 3.4.2. Second Level Support and Maintenance. CA shall provide MSP with second level support (as detailed at the following web site: <http://supportconnect.ca.com> as updated from time to time) and "Maintenance" as described below for CA Software properly licensed to MSP's End Users in return for payment by MSP of the maintenance fees set forth in Exhibit A (or purchase of any CA Software that includes annual Maintenance) and provided that MSP follows CA's standard procedures for provision of support. MSP's payment of the fee each year shall entitle MSP to the following "Maintenance" benefits: (i) the provision of second level telephone support and assistance from CA respecting the use and operation of the CA Software as well as error fixes and (ii) the provision of New Versions and enhancements of the CA Software running on new operating systems provided the same are developed and released by CA generally and delivered at no extra charge to CA's other licensees who have active maintenance plans. MSP is not entitled to second level support from CA or provision of other Maintenance benefits for End Users not under an annual maintenance plan.
- 3.4.3. Exceptions for Support. CA shall have no obligation to provide second level support to MSP for: (i) altered, damaged or modified CA Software; (ii) CA Software that is not the then-current release of the CA Software available from CA; (iii) CA Software problems caused by MSP, or the End User's negligence, hardware malfunction or other causes beyond the control of CA; (iv) CA Software installed on a hardware or operating system environment which is not supported by CA; or (v) pre-release or beta CA Software that are not part of an official CA beta program.
- 3.4.4. Demonstration Software. MSP may obtain Demonstration Software from CA. MSP must complete CA's then standard Demonstration Software order form and deliver such order form to CA for each copy of the Demonstration Software acquired by MSP under this Agreement. Demonstration Software may not be used by MSP for production purposes or transferred or sublicensed to any third party. Such licenses may only be used for demonstration and support purposes if MSP pays the applicable second level support fees and shall be subject to all of the terms, conditions and restrictions of this Agreement. Such licenses shall be returned to CA in the event of any expiration or termination of this Agreement.
6. ROYALTY REPORTING AND PAYMENT
- 3.5. On or before ten (10) days after the last business day of each calendar quarter from the Effective Date, MSP agrees to provide CA with a written report identifying the total number of handsets as identified in Exhibit A. The report shall be in the format CA shall reasonably require from time to time.
- 3.6. All amounts payable under this Agreement shall be paid in the currency stated in the Exhibit A without deduction or set off and if no currency is stated in Exhibit A then in US Dollars and all amounts are exclusive of all taxes, including sales, use or value added taxes where applicable. Upon presentation of invoices by CA, MSP shall pay any and all applicable tariffs, duties or taxes (other than franchise and income taxes for which CA is responsible) imposed or levied by any government or agency, including, without limitation, federal, state and local sales, use, value added and personal property taxes. Any claimed exemption from such tariffs, duties or taxes must be supported by a tax exemption certificate and other proper documentary evidence delivered to CA at the time of signature of this Agreement.
- 3.7. During the term of this Agreement and for a period of at least three (3) years following termination or expiry of this Agreement, MSP shall keep full, true and accurate records and accounts in accordance with generally accepted accounting practices to show the amount of fees payable to CA under this Agreement. CA shall have

CA Initial  /s/ DDGMSP Initial  /s/ JG

Legally approved by CA Shama09



the right to inspect MSP’s business premises to determine MSP’s compliance with this Agreement and to audit MSP’S books and records related to this Agreement to determine that fees paid to CA are correct. All costs of audit or inspection shall be borne by CA except that such expenses shall be borne by MSP in the event that any inspection or audit determines that MSP has underpaid fees in any period in excess of five percent (5%). MSP shall be required to pay to CA any underpaid fees and late charges thereon shown by an inspection or audit. Such audit right shall survive the termination of this Agreement for a period of three (3) years.

- 3.8. In the event any payment is not made when due, CA may also: (i) cease provision of technical support and (ii) pursue all other available legal remedies. Any such actions by CA shall not give rise to any claim by MSP for breach of this Agreement. In addition to such other rights as CA may have, MSP shall pay an annual late payment charge equal to the lesser of one and one-half percent (1.5%) of the outstanding amount or the maximum amount allowed by law on any invoice rendered by CA that is not paid when due.
- 3.9. Any dispute MSP may have concerning any invoice issued by CA to MSP must be submitted to CA within thirty (30) days from the date of receipt of the invoice. If MSP fails to do so, MSP shall have no further right to dispute the relevant invoice.

7. INTELLECTUAL PROPERTY RIGHTS, INDEMNIFICATION AND CONFIDENTIAL INFORMATION.

- 7.1. Proprietary Nature of Products and Ownership. No title to or ownership of the CA Software is transferred to MSP. Notwithstanding any provision of this Agreement to the contrary, CA owns and retains all title and ownership of all intellectual property rights in the CA Software, including all software, software master diskettes, copies of software, master diskettes, documentation and related materials that are acquired, produced or shipped by CA under this Agreement, and all modifications to and derivative works from software acquired under this Agreement made by MSP, CA or any third party. CA does not transfer any portion of such title and ownership, or any of the associated goodwill, to MSP, and this Agreement should not be construed to grant MSP any right or license, whether by implication, estoppel or otherwise, except as expressly provided. MSP agrees to be bound by and observe the proprietary nature of the CA Software. MSP agrees to take appropriate action by instruction or agreement with its employees, agents, contractors and sub-licensees who are permitted access to the CA Software to fulfill MSP’s obligations under this Agreement. Except as set forth in this Agreement, or as may be permitted in writing by CA, MSP agrees not to provide CA Software or any part or copies thereof to any third party without the prior written consent of CA.
- 3.10. Indemnification. Except as limited in Sections 7.3, 7.4 and 7.5 below, and provided MSP is not then in default under this Agreement, CA shall indemnify MSP and keep MSP indemnified from and against any and all reasonable losses and damages, costs (including reasonable legal fees), charges, claims and expenses arising from or by reason of any third party claim that the MSP’s use or possession of the CA Software provided by CA to MSP in accordance with the provisions of this Agreement infringes a third party’s copyright and/or patent. CA shall not indemnify any End User of MSP.
- 3.11. In the event that a claim is made or threatened against MSP to which the indemnity in Section 7.2 applies, then MSP shall:
  - 7.1.1. upon becoming aware of any infringement or allegations of infringement promptly notify CA of the same in writing;
  - 7.1.2. not make any admissions as to liability or compromise or agree to any settlement without CA’s prior written consent; and
  - 7.1.3. provide CA with full control of the defense and settlement negotiations and provide all reasonable assistance at CA’s expense in connection with any negotiations and litigation arising from such claims.
- 3.12. If a claim or alleged claim of infringement of any copyright and/or patent in the CA Software is made and such claim causes MSP’s use of the CA Software (or any part thereof) to be disrupted, or materially impaired, or impairs MSP’s ability to provide managed remote services to End Users, then CA may at its own option and expense:
  - 7.4.1. Procure the right for MSP to continue to use and distribute the infringing CA Software in the manner provided in this Agreement; or

CA Initial   /s/ DDG  

MSP Initial   /s/ JG  

Legally approved by CA Shama09



- 3.12.1. modify or replace the infringing or potentially infringing CA Software (or the relevant part thereof) so that there is no infringement or potential infringement and CA shall ensure that such modification or replacement provides the same, or substantially the same or improved functionality to the software being replaced and is effected by CA with minimal interruption to the business of MSP; or
- 3.12.2. if none of the foregoing alternatives is reasonably practicable, to terminate the relevant license and remove the infringing CA Software from the MSP Product and refund to MSP the fees paid to CA for the same from the point in time that the infringement first took place.
- 7.2. CA shall have no liability for infringement to the extent that the infringement results from (i) CA’s compliance with designs and/or specifications provided by MSP, (ii) use of other than the current release of the CA Software, if the infringement would have been avoided by use of the current release and if the infringement occurs more than thirty (30) days after CA has made a public announcement or notified MSP in writing that a previous release may infringe, (iii) a modification of the CA Software that was not authorized in writing by CA, (iv) use of the CA Software in combination with non-CA software, equipment or data other than as specified in the Documentation or otherwise previously approved in writing by CA for use with the CA Software, or (v) the furnishing to MSP of any information, service, or technical support by a third party not authorized by CA.
- 7.3. THE ABOVE STATES THE ENTIRE LIABILITY OF CA WITH RESPECT TO INFRINGEMENT OF PATENTS, COPYRIGHTS, TRADEMARKS OR ANY OTHER FORM OF INTELLECTUAL PROPERTY RIGHT BY ANY SOFTWARE SUPPLIED BY CA.
- 7.4. MSP Indemnification. MSP shall indemnify, defend and hold harmless CA, its officers, directors, employees, agents, successors and permitted assigns (“CA Indemnified Parties”) from and against any and all Damages, to the extent such Damages (a) arise out of or relate to a claim that the portion of the MSP services developed by MSP without the assistance of CA (“MSP Indemnifiable Material”) or any portion thereof, infringes, misappropriates, or otherwise violates any third party’s intellectual property rights; and/or (b) are based on a claim that any MSP modification or in the event that MSP (i) caused any personal injury and/or tangible property damage or harm to an End User or End User’s computer system or privacy; and/or (ii) improperly characterizes, removes or interferes with third party software, files, data, text or code or any similar claim including, without limitation, any claim of unfair competition, commercial libel or defamation, interference with contractual relations, interference with prospective economic advantages, or any violation of the Lanham Act (as codified in 15 U.S.C. 1125) or similar state law and or (iii) causes CA Software to be operated in a manner that is inconsistent to any regulatory, legal requirement that may cause a fine, impairment to CA Software or cause a third party action.
- 7.5. Defense and Settlement. Each Party shall give the other Party prompt notice of any such claim made against it, and the Parties shall cooperate in the defense of any such claim, suit or proceeding, including appeals, negotiations and any settlement or compromise thereof, provided that non-indemnifying Party must approve the terms of any settlement or compromise that may impose any unindemnified or non-monetary liability on such Party.
- 7.6. Product Tampering. Unless explicitly permitted by applicable legislation, and except as specifically permitted in this Agreement, MSP shall not, nor shall it permit any third party to: (i) copy or manufacture the CA Software or any portion thereof; (ii) translate, adapt, enhance, extend, decompile, disassemble or reverse engineer the CA Software; or (iii) use the CA Software to provide any facility management or service bureau service or otherwise use the CA Software to process the data of any third party. MSP agrees that any such works are derivative works and as such are the sole and exclusive property of CA or its licensor.
- 7.7. Allocation of Risk. The parties agree that the indemnities above and the warranties and limitations of liability mentioned below fully and fairly reflect the allocation of risk among the parties and the price of the CA Software.
- 7.8. Confidential Information. The parties agree that any Confidential Information provided under this Agreement will be held and maintained in strict confidence and shall disseminate Confidential Information only on a need-to-know basis. The party receiving Confidential information shall be permitted to disclose Confidential Information in connection with a judicial or administrative proceeding to the extent that such disclosure is required under applicable law or court order, provided that the disclosing party shall be given prompt and

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timely written notice of any such proceeding and shall offer reasonable cooperation in any effort of the other party to obtain a protective order.

8. WARRANTIES.

- 8.1. Statements of Limited Warranty. CA warrants that the CA Software will operate in accordance with the specification published by CA for the CA Software during the term of this Agreement. However, if it is determined that the CA Software fails to operate according to the said specification CA's only responsibility will be to exercise all reasonable efforts, consistent with industry standards and with reasonable care and skill, to cure any defects pursuant to its obligations in Section 5.6 above. Due to the nature of computer software CA does not warrant that operation will be error-free or uninterrupted.
- 8.2. Warranty Representations. MSP is not authorized to make any warranty commitment on CA's behalf, whether written or oral, other than those contained in the applicable CA End User Agreement
- 3.13. LIMITATION OF WARRANTIES. THE WARRANTIES DESCRIBED IN THIS SECTION 8 ARE IN LIEU OF ALL OTHER WARRANTIES, EXPRESS OR IMPLIED, INCLUDING, BUT NOT LIMITED TO, THE IMPLIED WARRANTIES OF MERCHANTABILITY, SUITABILITY, SATISFACTORY QUALITY AND FITNESS FOR A PARTICULAR PURPOSE WHICH ARE HEREBY EXCLUDED TO THE MAXIMUM PERMITTED BY LAW.

9. LIMITATION OF LIABILITY.

- 9.1. Aggregate Liability. Except for death or personal injury caused by the negligence or willful default of CA or its employees, and subject to Section 9.2 below, CA's liability for direct damages to MSP for any cause whatsoever, except as otherwise stated in this Section, and regardless of the form of action, will be limited to the amount of royalties paid by MSP for the CA Software that caused the damage or gave rise to the cause of action calculated from the period of six months prior to the date that the cause of action arose.
- 9.2. Exclusive Remedies. The remedies provided in this Agreement are the sole and exclusive remedies of the parties. In no event shall CA be liable to MSP or any other party, whether in contract or tort, for any incidental, indirect, special, consequential or unforeseeable loss or damage (including, without limitation, loss of profits, loss of business, loss of opportunity, loss or corruption of date), however arising, even if advised of the possibility of such loss or damages being incurred.
- 9.3. Third Party Claims. Except for death or personal injury caused by the negligence or willful misconduct of CA or its employees, CA shall not be liable for any claim by MSP based on any third party claim.

4. TERMINATION.

- 9.4. Termination for Cause. Either party may terminate this Agreement for the substantial breach by the other party of a material term. The terminating party will first give the other party written notice of the breach and a reasonable period of at least thirty (30) days in which to cure the alleged breach. If a cure is not achieved during the cure period, then the non-breaching party may terminate this Agreement upon written notice.
- 4.1. Termination by CA. CA may terminate this Agreement immediately if MSP fails to meet its payment obligations under this Agreement and this failure continues for ten (10) days or more following receipt of written notice from CA.
- 4.2. Insolvency, Assignment, or Bankruptcy. Subject to any mandatory laws, either party may terminate this Agreement upon written notice to the other party if the other party (i) is not paying its debts as such debts generally become due, (ii) becomes insolvent, (iii) files or has filed against it a petition (or other document) under any Bankruptcy Law or similar law, that is unresolved within sixty (60) days of the filing of such petition (or document), (iv) proposes any dissolution, liquidation, composition, financial reorganization or recapitalization with creditors, (v) makes a general assignment or trust mortgage for the benefit of creditors, or (vi) if a receiver, trustee, custodian or similar agent is appointed or takes possession of any of its property or business. CA may terminate this Agreement if there is a merger, sale of substantially all of the assets or change of control of MSP. A "change of control" shall be deemed to occur when an entity acquires fifty percent (50%)

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or more of the voting shares or equity interest in MSP or in the event of a change of a majority of the Board of Directors (or majority of the partners if a partnership) of MSP.

- 4.3. Acceleration of Payment. Upon termination of this Agreement the due dates of all outstanding invoices to MSP for licenses of CA Software will automatically be accelerated so that they become due and payable on the effective date of termination, even if longer terms had been provided previously. Unless otherwise agreed in writing to the contrary, all orders or portions of orders remaining un-shipped as of the effective date of such termination will automatically be canceled.
- 4.4. Effect of Termination on Obligations. Termination of this Agreement will not affect any pre-termination obligations of either party under this Agreement, and any termination is without prejudice to the enforcement of any un-discharged obligations existing at the time of termination. Regardless of any other provision of this Agreement, CA will not by reason of the termination of this Agreement be liable for compensation, reimbursement, or damages on account of the loss of prospective profits on anticipated sales, or on account of expenditures, investments, leases, or commitments in connection with MSP's business or goodwill, or otherwise. Except as set forth herein and below in Section 10.7, upon expiration or termination of this Agreement, MSP shall terminate any connections to the functionality of the CA Software provided by MSP to End Users and immediately return to CA, at MSP's expense: (i) all copies of the CA Software; (ii) all Demonstration Software; (iii) all Documentation; (iv) all CA Software brochures, marketing collateral and materials; and (v) all master copies of the CA Software; together with a certified statement by a duly authorized officer of MSP stating that all such CA Software and materials and any other confidential information of CA have been returned to CA or destroyed. MSP shall take such other reasonable action as may be necessary to remove its identification as a representative of the CA Software.
- 4.5. Wind Down Period. In the event of any termination of this Agreement by CA under Section or termination by MSP under Sections 10.1 or 10.3, MSP shall be entitled to provide managed services to End Users for a period not to exceed ninety (90) days subject to its continuing compliance with all terms and conditions of this Agreement.

5. GENERAL PROVISIONS.

- 9.5. Force Majeure. If either party is prevented from performing any portion of this Agreement (except the payment of money) by causes beyond its control, including civil commotion, war, governmental regulations or controls, casualty, inability to obtain materials or services or acts of God, such defaulting party will be excused from performance for the period of the delay and for a reasonable time thereafter.
- 9.6. Choice of Law / Jurisdiction. The laws of the State of New York (excluding its conflict of laws provisions) shall govern the construction and enforceability of this Agreement. The parties agree that any action arising under or relating to this Agreement or the Products shall lie within the exclusive jurisdiction of the State and Federal Courts located in Suffolk County, New York. MSP consents to the exercise of jurisdiction by any such court and agrees that process may be served on MSP in any such action by mailing same to MSP at the address set forth above. If either party is compelled to seek judicial enforcement of its rights under this Agreement, the prevailing party in any such action shall be entitled to recover its costs incurred in such action, including reasonable attorneys' fees. The United Nations Convention on Contracts for the International Sale of Goods will not apply to this Agreement.
- 9.7. Survival of Terms. The provisions of this Agreement that by their nature extend beyond the Expiration Date or other termination of this Agreement will survive and remain in effect until all obligations are satisfied.
- 9.8. Export Compliance: Regardless of any disclosure made by MSP of an ultimate destination of any CA Software, MSP warrants that MSP will not export or disclose directly or indirectly the CA Software or related technical information, documents or materials, or any direct product thereof, without the prior written consent, if required, of the US Department of Commerce. MSP further warrants that it will agree to comply with any other applicable import or export laws and regulations and ensure its MSP End Users abide by the terms contained in this clause. In addition, in the event CA consents to the exportation of the CA Software by MSP outside the Territory, MSP shall obtain all applicable licenses. MSP shall take all necessary steps to assure that CA obtains full protection of its intellectual property rights under these provisions.

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- 9.9. Waiver. No waiver of any right or remedy on one occasion by either party will be deemed a waiver of that right or remedy on any other occasion.
- 9.10. Superior Agreement. This Agreement will not be supplemented or modified by any course of dealing or usage of trade. Variance from or addition to the terms and conditions of this Agreement in any purchase order or other written notification from MSP (including but not limited to any specification of a price different than CA’s current list price, less the appropriate discount) will be of no effect, unless otherwise expressly provided in this Agreement. This Agreement may be amended or modified only by a writing signed by each party.
- 9.11. Assignment. This Agreement is not assignable by MSP, in whole or in part, without CA’s prior written consent. Any attempted assignment without CA’s written consent will be null and void.
- 9.12. Notice. Unless otherwise agreed to by the parties, all notices required under this Agreement (except those relating to product pricing, changes and upgrades) will be deemed effective when received and made in writing by either (i) registered mail, (ii) certified mail, return receipt requested (or equivalent), (iii) overnight mail, addressed and sent to the address indicated in the Agreement (or subsequently notified in writing) and to the attention of the party executing this Agreement or that person’s successor, or (iv) by telephone facsimile transfer appropriately directed to the attention of the party executing this Agreement or that person’s successor.
- 9.13. Compliance with Laws. Each party shall be responsible to comply with all applicable laws and regulations.
- 9.14. Reservation of Title. If MSP acquires inventory of CA Software under this Agreement, all such inventory shall remain the title and property of CA until CA has received full payment for the same. Any master media provided by CA to MSP shall at all times remain the property of CA and MSP shall return the same to CA upon termination or expiry of the Agreement.
- 9.15. Severability. If any term, provision, covenant or condition of this Agreement is held invalid or unenforceable for any reason, the remainder of the provisions will continue in full force and effect as if this Agreement had been executed with the invalid portion eliminated. The parties further agree to substitute for the invalid provision a valid provision that most closely approximates the intent and economic effect of the invalid provision.
- 9.16. Independent Contractors. Each party acknowledges that the parties to this Agreement are independent contractors and that it will not, except in accordance with this Agreement, represent itself as an agent or legal representative of the other.
- 9.17. Headings and Precedence. The headings provided in this Agreement are for convenience only and will not be used in interpreting or construing this Agreement. In the event of any conflict between the terms of this Agreement and any Exhibit or addendum hereto, the terms of the Exhibit or addendum shall prevail.
- 5.1. No Other Terms. This Agreement, its Exhibits and the documents referred to herein comprise the whole Agreement between the parties. All prior oral or written agreements or representations other than as included in this Agreement are hereby excluded from this Agreement.

THE PARTIES REPRESENT THAT THEY HAVE READ THIS AGREEMENT AND AGREE TO BE BOUND BY ITS TERMS AND CONDITIONS.

|  |   |
|--|---|
| <b>Accepted by: CA, Inc.</b>                 | <b>InterNetwork Experts, Inc.</b>                   |
| <b>Signed:</b> <u>/s/ David D. Gruennert</u> | <b>Signed:</b> <u>/s/ Jonathan A. Groves</u>        |
| <b>Name:</b> <u>David D. Gruennert</u>       | <b>Name:</b> <u>Jonathan A. Groves</u>              |
| <b>Title:</b> <u>Vice President Finance</u>  | <b>Title:</b> <u>Director, NetSurant Operations</u> |
| <b>Date:</b> <u>3/30/06</u>                  | <b>Date:</b> <u>3/21/06</u>                         |

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EXHIBIT A
SPECIFICATIONS FOR USAGE OF CA PRODUCTS

CA SOFTWARE

Table with 4 columns: SECTION 1 PROGRAMS, USE AUTHORIZATION, OPERATING SYSTEM, SHIPMENT REQUIRED. Rows include CA End-to-End Performance Console, CA Real-Time Performance Monitor, etc.

Table with 4 columns: SECTION 2 PROGRAMS, USE AUTHORIZATION, OPERATING SYSTEM, SHIPMENT REQUIRED. Rows include Unicenter Remote Control, Unicenter Service Plus Service Desk, etc.

(\*) Maintenance and Support for the specified CA Software expires on March 29, 2007

PRODUCT DELIVERY

Any CA Software identified with "NO" under the heading entitled "Shipment Required" above was previously delivered to MSP by CA and therefore will not be delivered to MSP at this time.

MSP OPERATIONS CENTER (OC) INSTALLATION SITE

1955 Lakeway Drive, Suite 220, Lewisville, TX 75057

TERRITORY (include target market if appropriate): North America

FEES

MSP shall pay to CA a fee inclusive of usage and maintenance of the CA Software through the expiration of the Term, in the amount of \$ 401,346.00, payable as follows:

Table with 2 columns: Due Date, Amount Due. Rows for March 30, 2006, March 30, 2007, March 30, 2008.

Nothing herein shall affect MSP's obligation to pay the License Fee and UMF (or MF, as applicable) as provided in the License.

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Thereafter, (a) continued usage and maintenance of the Section 1 Programs shall be subject to MSP’s payment of CA’s annual usage and maintenance fee, and (b) continued usage of the Section 2 Programs shall not require further payment although continued maintenance of the Section 2 Programs shall be subject to MSP’s payment of CA’s annual maintenance fee.

EFFECTIVE DATE: March 30, 2006

EXPIRATION DATE: March 29, 2009

**SPECIAL TERMS**

MSP and CA agree that the following terms and conditions amend and supplement the MSP Agreement and in the event of conflict the following shall prevail:

LICENSE TERMINATION

All Licenses and Order Forms respecting use of the CA Software granted to MSP by CA or any of its predecessors for use at the installation site set forth above are hereby terminated, subject, however, to the obligations of MSP (a) to pay all contracted payments which otherwise would have become due and payable, and (b) to maintain the confidentiality of the CA Software and comply with the non-disclosure provisions of such terminated Licenses. Any future use of or access to the CA Software by MSP at any MSP Operations Center Installation Site shall be controlled exclusively by the terms of this Agreement.

SUPPLEMENTAL FEES

MSP may increase the Use Authorization during the Term upon prior written notice to CA and payment of CA’s one-time supplemental license fee calculated as CA’s then prevailing fee schedule, with the exception of the CA Software in the below table. Notwithstanding any installment payment schedule for the initial Fees, the Supplemental Fees shall be paid within thirty (30) days after MSP’s receipt of CA’s invoice. The Supplement Fees shall be pro rated until the next anniversary of the Effective Date of the License and shall be payable in full annually thereafter. The Supplemental Fees shall be billable upon MSP giving CA notice of its desire to increase the Use Authorization, including by request that CA issue an authorization key.

| CA Performance Management Elements Universal | Cumulative # of Elements | Supplemental Fee per Element (includes Maintenance & Support) |
|--|--------------------------|---|
|  | Up to 4,999              | \$10.00   |
|  | 5,000 – 9,999            | \$9.00  |
|  | 10,000 – 14,999          | \$8.10  |
|  | 15,000 – 19,999          | \$7.29  |
|  | 20,000 – 24,999          | \$6.56  |
|  | 25,000 +                 | \$5.90  |

| VOIP Handsets<br>With or without the CA Software Components | Cumulative # of Handsets | Supplemental Fee per Handset (in increments of 1,000; includes Maintenance & Support) |
|---|--------------------------|---|
|   | Up to 9,999              | \$7.00  |
|   | 10,000 – 14,999          | \$6.30  |
|   | 15,000 – 19,999          | \$5.67  |
|   | 20,000 – 24,999          | \$5.10  |
|   | 25,000 +                 | \$4.59  |

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**EXHIBIT B**  
**MSP SUPPORT ADDENDUM**

**I. DEFINITIONS:**

- CA Customer Support – The CA Global organization responsible for providing technical support services to our customers and Partners.
- Incident – A single and specific request for technical support assistance that is tracked by an Incident number associated with an Incident tracking system.
- Normal Business Hours – 9am to 5pm ET Monday through Friday (excluding U.S. Holidays).
- SupportConnect – CA’s online support Incident management infrastructure which provides online access to StarTrak, CA’s voice related support Incident tracking system.
- Sustaining Engineering – The division within CA Development responsible for the development of patches, bugs, fixes, and other code-related remedies.

**Support Defined:**

The technical support functions described herein include the following functions:

- Answering CA Software installation, configuration or usage questions.
- Capturing initial problem definition and failure information.
- Isolating and identifying software problems.
- Providing standard fixes and workarounds to known problems.
- Providing solutions for complex problems.
- Escalating unresolved problems or those requiring formal fixes to Sustaining Engineering as appropriate.

**II. TERMS AND CONDITIONS:**

**MSP Agrees:**

0. MSP acknowledges that proper marketing and support of the CA Software is largely dependent on appropriate training of MSP sales and technical staff. MSP shall ensure that members of its sales and technical staff complete and maintain sufficient training regarding the CA Software as necessary to properly market the CA Software and provide Tier 1 Support to End Users. In the event that trained staff are reassigned to other duties or leave the employ of MSP, MSP shall promptly cause other employees to undergo the necessary minimum training programs. MSP will indemnify and defend CA against all damages, fines, costs, fees, expenses and judgments that may be rendered or assessed against CA as a result of an error or omission on the part of MSP relating to its performance hereunder.
1. MSP agrees to make best efforts to develop and maintain a level of proficiency within MSP technical support staff and meet all certifications publicly communicated by CA for the purpose of supporting professional development relevant to CA Software supported by MSP, as well as to address concerns where verifiable Incident data supports a training requirement that may be developing.
2. MSP agrees to make all reasonable attempts to identify, isolate, troubleshoot and resolve all technical support concerns reported by End Users as described in the Roles and Responsibilities section below. If the Incident is above the technical expertise of MSP’s support staff, CA Customer Support will provide technical support assistance directly to the MSP as is reasonably required.
3. MSP agrees to document and track all requests from End Users for the purposes of quality review and training needs assessment through MSP’s current Incident management solution.
4. MSP agrees to make best efforts to notify End Users of urgent CA Software notifications, alerts, bulletins, maintenance and/or release information to ensure End Users are maintaining current CA Software maintenance levels.
5. MSP agrees to make best efforts to evaluate End User satisfaction and provide semi-annual reports to evaluate such satisfaction in accordance with MSP’s current customer service survey or evaluation practices, and to share the results of those customer service surveys or evaluation activities with CA.
6. MSP agrees not to disclose any CA phone numbers or contact methods with any End User without prior written consent from CA.

**CA Agrees:**

7. CA agrees to provide MSP with historical Incident related statistics to facilitate staffing and impact assessment. This includes, but is not necessarily limited to Incident categories, resolution criteria, volumes of Incidents against distributed licenses, and other factors that may help MSP understand and plan for delivery of technical support.
8. CA will make continuous on-going training available to MSP on a reasonable basis. Training, which shall include the provision of written training materials, is available from CA at CA's standard rate per person, per day for regularly scheduled training

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conducted at a CA training facility or an MSP facility, which may be located in the US or in Canada. MSP may also choose to take other CA certified training from other sources. MSP shall bear its own travel and subsistence expenses in connection with such training.

- 9. CA agrees to make all reasonable attempts to provide MSP with relative historical Incident data to support the development of End User self-service including, raw knowledge, knowledge utilization statistics, and access to online knowledge. CA will not “republish” existing knowledge to reflect MSP marketing or branding.
- 10. CA agrees to provide and maintain within its reasonable commercial efforts, a CA Customer Support advocate outside of the CA Software support chain, within the CA Customer Support organization, to represent the MSP management team to CA Customer Support on issues outside of normal CA Software support activities.
- 11. CA agrees to notify in writing, and in advance of six (6) months, intentions to discontinue support for any currently supported CA Software contractually distributed by MSP.

**MSP and CA Agree:**

- 12. MSP and CA mutually agree to establish a target Incident volume per month reported to CA Customer Support, and MSP agrees to make all reasonable efforts to maintain the target levels. Target will be a measurement of percentage of Incidents vs. licenses distributed over the term of the Agreement. Incidents associated with code defect will not be considered in any factor.
- 13. MSP and CA agree that the scope of the CA Customer Support obligation shall extend to provide technical support to MSP exclusively and not to End Users.
- 14. CA shall provide MSP with Maintenance Releases of the CA Software made generally available by CA during the Term of the Agreement. MSP shall be responsible for distributing the Maintenance Releases only to End Users properly licensed to use the CA Software in accordance with this Agreement.
- 15. CA may provide MSP with New Versions of the CA Software made generally available by CA during the Term of this Agreement. MSP may distribute the New Versions only to End Users properly licensed to use the CA Software in accordance with this Agreement.
- 16. MSP and CA agree to make any and all reasonable attempts to share or communicate, Incident or problem resolution related information that will support future enhancements to the CA Software set-up, installation, configuration, help files or make other such reasonable enhancements to support related End User self-service infrastructure, to reduce Incident volumes to both MSP and CA through the mutual improvement of the End User experience. CA will not provide information outside the scope of the direct relationship between MSP and CA.
- 17. MSP and the Customer Support advocate agree to conduct, upon the reasonable request of either party, quarterly reviews of the overall effectiveness of the CA Customer Support relationship, identify areas for improvement and identify potential training requirements. This includes a review of performance statistics for relevant areas of the relationship provided by a CA Customer Support Senior Manager from MSP and CA. All available metrics should be used to evaluate the effectiveness of the support relationship including, but not necessarily limited to:
  - License distribution
  - End User quantities
  - Incident volumes
  - Incident telephony (ACD or Other) statistics
  - Resolution criteria
  - MSP experience
  - Escalation details
  - Incident or problem details

**III. ROLES AND RESPONSIBILITIES:**

| MSP Delivers | CA Delivers | Level of Support Definition                     |   |
|--------------|-------------|---|---|
| X            |             | <b>Tier 1 / Level 1</b><br>MSP Client Assistant | Level 1 Support includes the initial response to an End User reported Incident (and any follow-up response as appropriate), initial information gathering, entitlement and escalation to Level 2. |
| X            |             | <b>Tier 1 / Level 2</b><br>MSP Support Engineer | Level 2 Support includes some or all of the following: answering software installation, configuration or usage questions; initial problem and failure information gathering; problem isolation,   |

identification, and/or providing standard fixes and workarounds to known problems; escalating unresolved problems to a CA Support Engineer.

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| MSP Delivers | CA Delivers | Level of Support Definition                          |  |
|--------------|-------------|--|--|
|              | X           | <b>Tier 2 / Level 3</b><br>CA Support Engineer       | Level 3 Support consists of, but is not limited to, problem isolation, identification, and replication; providing standard fixes and workarounds to known problems; providing remedies for both new and known complex problems; escalating unresolved problems or those requiring formal fixes to CA Sustaining Engineering.   |
|              | X           | <b>Tier 2 / Level 4</b><br>CA Sustaining Engineering | Level 4 Support consists of advanced and engineering level problem isolation, identification, and replication for complex problems; providing new fixes and workarounds to problems; providing remedies for both new and known complex problems; resolution of problems through the generation of formal fixes; and assistance and repair requiring knowledge of software source code. |

**Contact Retention and Transfer Policy:**

MSP will retain ownership of the relationship with the End User. During the first sixty (60) days after the launch date, “warm” telephone conference calls will be used to facilitate training and development for MSP. This conference call shall consist of MSP, End User and a CA Support Engineer. Thereafter, MSP can implement a transfer policy of “warm” telephone conference / transfer or web submission of Incidents via CA’s web-based portal <http://SupportConnect.ca.com>.

MSP shall submit detailed descriptions of any reported errors. If CA is not able to replicate the error, MSP shall provide any additional information required by CA, which may include a sample program enabling replication of the error. MSP will also make its personnel available to assist in problem identification and resolution.

**IV. ENGAGEMENT PROCESS:**

**Telephone:**

CA Customer Support is available 24 hours per day, 7 days per week, and 365 days per year. Engaging CA technical support can be facilitated via telephone by way of “warm transfer” or “warm conference”.

**SupportConnect:**

Online CA Customer Support is available via CA’s web-based portal at <http://SupportConnect.ca.com>.

**Incident Severities and SupportConnect Target Response Times:**

| Severity | Definition  | Response Times During Normal Business Hours* |
|----------|---|--|
| 1**      | A “system down” or product inoperative condition impacting production. Examples include system crashes, and loss or corruption of data.       | 1 Hour                                       |
| 2        | A high-impact condition associated with the product. Examples include missing functionality, errors, and significant performance degradation. | 2 Hours                                      |
| 3        | A low-impact condition associated with the product. Examples include minor documentation issues, and confusion over error messages.           | 4 Hours                                      |
| 4        | A question about product use or implementation. Examples include minor errors, cosmetic changes or enhancements.                              | 8 Business Hours (or 1 Business Day)         |

\* CA will use its reasonable efforts to meet the Target Response Times and/or set MSP expectation with regard to remedial software support.

\*\* MSP technical contact must remain available to work on a Severity 1 issue 24 hours a day for the issue to retain a Severity 1 status. If an MSP technical contact is unavailable, CA Customer Support will re-categorize the Incident Severity level to a Severity 2.

**Incident Requirements:**

CA Software support requests must contain all pertinent information in English including Customer Site ID, Software/Revision number, Operating system/version, Platform, Problem Description, Log Files/Test Case, Problem Severity and a technical contact that is familiar with the software problem and End User environment. MSP must execute diagnostic routines if provided by CA and inform CA of the results. MSP must also verify the existence of a software problem and provide the conditions in which the problem may be duplicated.

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**V. THREAT OUTBREAK:**

CA shall make any and all reasonable attempts to resolve any identified Threat Outbreak as expeditiously as possible. CA will provide MSP with direct access to CA’s Threat Research and Development Center via the CA Security Advisor 24 hours per day, 7 days per week, 365 days per year.

**VI. ESCALATION PROCEDURE:**

Any Incident in which the End User indicates they have a critical situation can be escalated as follows:

0. The first mechanism is an escalation within the assigned technician relationship. This is done by communicating with the CA Support Engineer assigned to the Incident through Incident updates via telephone or <http://SupportConnect.ca.com>.
1. The second mechanism is to formally change the severity of the Incident in question. This can be done by asking the CA Support Engineer to upgrade the Incident severity or by calling Customer Support and asking the Client Assistant to upgrade the Incident severity and requesting a CA Support Engineer call back. This will generate an alert to the change in severity.
  - Note that a Severity 1 status will only be maintained while the MSP is present to work on the Incident unless there are clearly no actions items remaining that relate to the MSP. Severity 1 status will not remain in effect if communication failures occur and in Incidents where an MSP is unresponsive, or not available to work with Customer Support.
2. The third mechanism is to call CA Customer Support and request the Incident be escalated to the attention of the Support Supervisor.
4. The escalation path is the same during business and non-business hours; however CA Senior Management is only available during normal business hours.

**Escalation Path:**

- Support Engineer (24x7x365)
- Support Supervisor (24x7x365)
- Support Manager (24x7x365)
- Partner Operations Manager (Normal Business Hours)
- Director Partner Operations (Normal Business Hours)
- Vice President Global Support Operations (Normal Business Hours)
- Senior Vice President Customer Support (Normal Business Hours)

**VII. REPORTING REQUIREMENTS:**

Standard Reporting through CA Partnership Summary.

CA Initial  /s/ DDG

MSP Initial  /s/ JG

Legally approved by CA Shama09



CA, Inc., One CA Plaza, Islandia, New York 11749, tel: +1 631 342 6000

AMENDMENT 1  
to the MSP Agreement

March 30, 2006

between

CA, Inc. ("CA")

and

InterNetwork Experts, Inc. ("MSP")

CA and MSP agree to amend the terms and conditions of the Agreement effective December 15, 2006 as follows:

**1. Exhibit A**

Exhibit A is hereby deleted in its entirety and replaced with First Revised Exhibit A attached hereto.

**2. Term**

The Term of the Agreement is hereby extended through December 14, 2009, subject to the term limitations specified in the First Revised Exhibit A.

**3. Semi-Annual True Up**

Section 6.3.5 of the MSP Agreement titled Royalty Reporting and Payment is deleted in its entirety and replaced with the below:

"On June 15 and December 15 of each year during the Term, MSP shall report to CA in writing the Actual Use of Network Devices, Active VOIP Ports and Managed Servers (the "Reported Actual Use") for the preceding six month period. CA shall thereupon review such report and advise MSP of any applicable Supplemental Fees due in excess of the Authorized Use identified on the First Revised Exhibit A. Supplemental Fees will include Authorized Use in excess of the Authorized Use Active for the preceding six month period as well as the Authorized Use in excess of the Authorized Use Base Line for the following six month period in accordance with the Supplemental Fees section of the First Revised Exhibit A. The parties agree that in order to verify the accuracy of MSP's report, MSP will, at CA's request upon reasonable notice, grant CA access to each MSP Operations Center (OC) Installation Site, and shall provide any further information as CA may reasonably require."

**4. No Other Terms**

The Agreement, this Amendment and its Exhibits and the documents referred to herein comprise the whole Agreement between the parties. In the event of a conflict between the Amendment 1 and the MSP Agreement, the Amendment 1 terms shall prevail. All prior oral or written agreements or representations other than as included in this Agreement are hereby excluded from this Agreement.

THE PARTIES REPRESENT THAT THEY HAVE READ THIS AGREEMENT AND AGREE TO BE BOUND BY ITS TERMS AND CONDITIONS.

|  |  |
|--|--|
| <b>Accepted by: CA, Inc.</b>                 | <b>InterNetwork Experts, Inc.</b>      |
| <b>Signed:</b> <u>/s/ Srinivas Manepalli</u> | <b>Signed:</b> <u>/s/ Mark T. Helz</u> |
| <b>Name:</b> <u>Srinivas Manepalli</u>       | <b>Name:</b> <u>Mark T. Helz</u>       |
| <b>Title:</b> <u>Revenue Manager</u>         | <b>Title:</b> <u>President</u>         |
| <b>Date:</b> <u>12/28/2006</u>               | <b>Date:</b> <u>12/20/06</u>           |

CA Initial /s/ SM

MSP Initial /s/ MH

Legally approved by



**FIRST REVISED EXHIBIT A**

**SPECIFICATIONS FOR USAGE OF CA SOFTWARE**

| <b>Authorized Use – Base Line</b>         | <b>Authorized Use – Active</b>            |
|---|---|
| Network Devices (1-10 Ports) = 1,200      | Network Device Count (1-10 Ports) = 1,200 |
| Network Devices (11-25 Ports) = 800       | Network Device Count (11-25 Ports) = 800  |
| Network Devices (26+ Ports) = 2,000       | Network Device Count (26+ Ports) = 2,000  |
| <b>Total Network Device Count = 4,000</b> | <b>Total Network Device Count = 4,000</b> |
| Active VOIP Ports = 20,000                | Active VOIP Ports = 20,000                |
| Managed Servers = 50                      | Managed Servers = 50                      |

**CA SOFTWARE - LICENSED PROGRAMS**

|  | <b>SHIPMENT<br/>REQUIRED</b> |
|--|------------------------------|
| Unicenter® Network and Systems Management Managed Resource – Version 11 (Windows)    | YES                          |
| Unicenter® Management Portal   | YES                          |
| Unicenter® Network and Systems Management  | YES                          |
| Unicenter® Network and Systems Management Managed Resource 1-2 Processors-Version 11 | YES                          |
| Unicenter® ServicePlus Service Desk  | YES                          |
| Unicenter® ServicePlus Dashboard   | YES                          |
| Unicenter® Service Desk Knowledge Tools  | YES                          |
| Unicenter® Service Desk Knowledge Tools User   | YES                          |
| CA eHealth Distributed X-Large   | YES                          |
| CA eHealth Distributed Additional Distributed Consoles                               | YES                          |
| CA eHealth E2E Console   | YES                          |
| CA eHealth for Cisco Call Manager — 500 User License                                 | YES                          |
| CA eHealth for Voice — Cisco Unity and Unity Bridge — Platform Level 3               | YES                          |
| CA eHealth for Voice — Policy Manager Right to Use License                           | YES                          |
| CA eHealth for Voice — Policy Manager Per Node, 1-20 Nodes                           | YES                          |
| CA eHealth for Voice — Voice Quality Monitor Per Agent Base price                    | YES                          |
| CA eHealth for Voice — Voice Quality Monitor Per Agent, 2-4 agents                   | YES                          |
| CA eHealth for Voice — Cisco Call Manager Right to Use                               | YES                          |
| CA eHealth for Voice — Cisco Call Manager Cluster                                    | YES                          |
| CA eHealth for Voice — Cisco Call Manager 10,001 – 25,000 RD                         | YES                          |
| CA eHealth Integration for SPECTRUM  | YES                          |
| CA eHealth Live Health Application   | YES                          |
| CA eHealth Live Health Upgrade Elements  | YES                          |
| CA eHealth Remote Poller to Distributed xLarge                                       | YES                          |
| CA eHealth Service Availability  | YES                          |
| CA eHealth Systems Elements  | YES                          |
| CA System Performance Agent  | YES                          |
| CA eHealth Traffic Accountant  | YES                          |
| CA eHealth Trap Exploder   | YES                          |
| CA Spectrum Infinity NOC Unrestricted Device Management                              | YES                          |
| CA Spectrum Alarm Notification Manager for Infinity/Integrity                        | YES                          |
| CA Spectrum CA Unicenter Gateway   | YES                          |
| CA Spectrum Configuration Manager for Integrity/Infinity                             | YES                          |
| CA Spectrum Qos Manager for Infinity/Integrity                                       | YES                          |
| CA Spectrum Report Manager for Infinity/Integrity                                    | YES                          |
| CA Spectrum Report Manager Single Concurrent User License                            | YES                          |
| CA Spectrum Secure Domain Manager  | YES                          |
| CA Spectrum Secure Domain Connector  | YES                          |
| CA Spectrum Service Manager for Infinity/Integrity                                   | YES                          |

CA Initial   /s/ SM  

MSP Initial   /s/ MH  

Legally approved by

**CA SOFTWARE - LICENSED PROGRAMS**

**SHIPMENT  
REQUIRED**

|   |     |
|---|-----|
| CA Spectrum Service Manager Connector                           | YES |
| CA Spectrum Service Performance Manager for Infinity/Integrity  | YES |
| CA Spectrum Single Concurrent Administrator License             | YES |
| CA Spectrum Single Concurrent Oneclick Console Operator License | YES |
| CA Spectrum Single Concurrent User License for Service Manager  | YES |
| CA Spectrum Spectrowatch Editor for Infinity/Integrity          | YES |
| CA eHealth Universal Elements                                   | YES |
| CA Spectrum Report Manager Connector                            | YES |
| CA Spectrum SNMPv3 Management Solution                          | YES |
| CA Spectrum Southbound Gateway Unlimited                        | YES |
| CA CMDB Application Server                                      | YES |
| CA CMDB Full License  | YES |

**PRODUCT DELIVERY**

Any CA Software identified with "NO" under the heading entitled "Shipment Required" above was previously delivered to MSP by CA and therefore will not be delivered to MSP at this time. CA Software identified with a "YES" under such heading will be delivered to MSP upon execution of this agreement. The CA Software shall be delivered to MSP, either by electronic delivery or in tangible media F.O.B. Point of Shipment, as CA deems appropriate.

**MSP OPERATIONS CENTER (OC) INSTALLATION SITE**

1955 Lakeway Drive, Suite 220, Lewisville, TX 75057

**TERRITORY** (include target market if appropriate): North America

**FEES**

MSP shall pay to CA a fee inclusive of usage and maintenance of the CA Software through the expiration of the Term, in the amount of \$ 716,620.00, payable as follows:

| <b>Due Date</b>   | <b>Amount Due</b> |
|-------------------|-------------------|
| December 15, 2006 | \$150,000.00      |
| December 15, 2007 | \$283,310.00      |
| December 15, 2008 | \$283,310.00      |

MSP agrees to make the first payment listed above on or before the due date through a wire transfer. For the remaining payments, CA will send MSP an invoice containing the applicable remit to address or wire transfer information at least 30 days prior to each respective due date. As of the effective date of this Agreement, the following wire-transfer routing information applies:

Wachovia Bank, NA  
1 South Broad Street  
Mail Code PA 1227  
Philadelphia, PA 19107  
ABA# 0312-0146-7  
Account Name: CA, Inc.  
Account #2000028313816

The Fee stated above includes all remaining committed payment obligations of MSP due prior to the Effective Date of this Amendment 1 under the MSP Agreement effective March 30, 2006.

Thereafter, at least thirty (30) days prior to the end of the current Term of the Agreement, MSP shall notify CA in writing of its intention regarding renewal ("Written Notification"). MSP understands that if MSP does not elect to renew the current term of the License by way of Written Notification, usage and maintenance shall be cancelled at the end of the current term and shall be subject to a reinstatement charge.

**EFFECTIVE DATE:** December 15, 2006

**EXPIRATION DATE:** December 14, 2009

CA Initial  /s/ SM

MSP Initial  /s/ MH

Legally approved by

**SPECIAL TERMS**

**LICENSE TERMINATION**

All previous Licenses and Order Forms respecting use of the CA Software granted to MSP by CA or any of its predecessors for the use at the Installation Site set forth above are hereby terminated, subject, however, to the obligation of MSP to maintain the confidentiality of the CA Software and comply with the non-disclosure provisions of such terminated Licenses. Any future use of or access to the CA Software by MSP at any MSP Operations Center Installation Site shall be controlled exclusively by the terms of this Agreement.

**SUPPLEMENTAL FEES**

Any Supplemental Fees pursuant to Section 3 of this Amendment shall be calculated as the sum of 1) the Reported Authorized Use in excess of the Authorized Use Active for the preceding six month period; and 2) the Reported Authorized Use in excess of the Authorized Use Base Line for the following six month period; as described below. Notwithstanding any installment payment schedule for the Initial Fees, the Supplemental Fees shall be paid within thirty (30) days after MSP’s receipt of CA’s invoice.

| <b>Network Devices</b> | Annual Lease Payment (4,000-5,000) Total Network Devices | Annual Lease Payment (5001-10,000) Total Network Devices | Annual Lease Payment (10,001-25,000) Total Network Devices | Annual Lease Payment (25,001-50,000) Total Network Devices | Annual Lease Payment (50,001+) Total Network Devices |
|------------------------|--|--|--|--|--|
| 1-10 Ports             | \$29.70  | \$26.73  | \$24.06  | \$21.65  | \$19.49  |
| 11-25 Ports            | \$59.40  | \$53.46  | \$48.11  | \$43.30  | \$38.97  |
| 26+ Ports              | \$89.10  | \$80.19  | \$72.17  | \$64.95  | \$58.46  |

| <b>VOIP Ports</b> | Annual Lease Payment (20,000 - 40,000) | Annual Lease Payment (40,001-60,000) | Annual Lease Payment (60,001-80,000) | Annual Lease Payment (80,001-100,000) | Annual Lease Payment (100,001+) |
|-------------------|--|--------------------------------------|--------------------------------------|---------------------------------------|---------------------------------|
| Active Ports      | \$3.60                                 | \$3.24                               | \$2.92                               | \$2.62                                | \$2.36                          |

| <b>Servers</b>     | Annual Lease Payment (50-200) | Annual Lease Payment (201-500) | Annual Lease Payment (501-1,000) | Annual Lease Payment (1,001-5,000) | Annual Lease Payment (5,001-10,000) | Annual Lease Payment (10,001+) |
|--------------------|-------------------------------|--------------------------------|----------------------------------|------------------------------------|-------------------------------------|--------------------------------|
| Per Managed Server | \$200.00                      | \$180.00                       | \$162.00                         | \$145.80                           | \$131.22                            | \$118.10                       |

**Supplemental Fees will be calculated as follows:**

Preceding six month period Supplemental Fee = (Reported Actual Use – Authorized Use Active) X 50% X Annual Lease Payment X .5

Following six month period Supplemental Fee = (Reported Actual Use – Authorized Use Baseline) X Annual Lease Payment X .5

Example of Calculating Supplemental Fees with 1,000 additional Network Devices (1-10 Ports), which results in a Total of 5,000 Network Devices:

(Reported Actual Use – Authorized Use Active) X 50% X Annual Lease Payment X .5 = (2200 - 1200) X 50% X 29.70 X .5 = \$7,425.00 Additional payment due for preceding 6 months based on the Reported Actual Use

**Plus**

(Reported Actual Use – Authorized Use Baseline) X Annual Lease Payment X .5 = (2200 - 1200) X 29.70 X .5 = \$14,850.00 Additional payment due for following 6 months for the Authorized Use Active

Total \$22,275.00

CA Initial      /s/ SM     

MSP Initial      /s/ MH     

Legally approved by



### **AMENDMENT TO THE SYSTEMS INTEGRATOR AGREEMENT**

This Amendment (the "Amendment") to the Systems Integrator Agreement (the "Agreement") entered into by and between Cisco Systems, Inc., ("Cisco") a California corporation having its principal place of business at 170 West Tasman Drive, San Jose, California, 95134, and INX Inc. ("Integrator") having its principal place of business at 15960 Midway Road Suite 101, Addison, TEXAS, 75001, UNITED STATES, is effective the later of 13-Nov-2006 or the date of the electronic confirmation message received after this Amendment is accepted (the "Amendment Effective Date").

**WHEREAS**, as of 13-Nov-2001, Cisco and Integrator entered into the Agreement, as amended (if applicable);

**WHEREAS**, Cisco has implemented an on-line contract system; and any extension, renewal, and/or amendment to the Agreement may be in electronic format and accepted on-line by means of such system, (including these terms the "On-line Amendment") as described herein; and

**WHEREAS**, in order to implement an On-line Amendment, Cisco has delivered an e-mail to an authorized officer or representative of Integrator, which e-mail contained a link to this On-line Amendment. By clicking on the link, Integrator was presented with this On-line Amendment, which sets forth the terms and conditions of the extension, renewal and/or amendment of the Agreement and contains a means for acceptance.

**NOW THEREFORE**, the parties agree to amend the Agreement as follows:

1. The Agreement may be extended, renewed and/or amended by electronic means by accepting terms and conditions on-line and the provisions of such extension, renewal and/or amendment shall for all purposes be legally enforceable and binding on the parties as if the Agreement was extended, renewed and/or amended in writing and signed by both parties. The On-line Amendment shall be deemed signed and thus the terms hereof agreed to, if Integrator clicks on the 'Renew' button and thereby accepts the On-line Amendment. All references to writing or written amendments in the Agreement shall be deemed to include any On-line Amendment, and all references to signature shall include on-line acceptance. Integrator waives any challenge to the validity or enforceability of any renewals, extensions and/or amendments to the Agreement or the terms of any of the forgoing on the grounds that the terms of any renewal, extension and/or amendment were presented on-line or electronically or acceptance of such renewal, extension and/or amendment was electronically transmitted or accepted.
2. The term of the Agreement shall be renewed for an additional two (2) year period commencing on the Amendment Effective Date. If the Agreement expired prior to the Amendment Effective Date, any orders received and Products purchased between the date of expiration and the Amendment Effective Date shall be in all respects deemed made under the Agreement as in effect prior to this On-line Amendment.
3. The support exhibits currently in the Agreement shall be deleted in their entirety and replaced with the relevant Support Exhibits for which Integrator qualifies as posted on [http://www.cisco.com/web/partners/support/integrator\\_support\\_exhibits.html](http://www.cisco.com/web/partners/support/integrator_support_exhibits.html), which are incorporated into the Agreement by this reference.
4. The Exhibit for the Purchase and Resale of Cisco Transactional Advanced Services, posted on [http://www.cisco.com/web/partners/support/integrator\\_support\\_exhibits.html](http://www.cisco.com/web/partners/support/integrator_support_exhibits.html), is incorporated into the Agreement by this reference (collectively with the above relevant Support Exhibits in paragraph 3, the "New Exhibits").
5. To the extent that there are any pre-existing exhibits ("Superseded Exhibits") in the Agreement dealing with

subject matters which in Cisco's reasonable opinion are materially similar to those of the New Exhibits, then: (a) such Superseded Exhibits are hereby superseded by the appropriate New Exhibits, and (b) all references to such Superseded Exhibits shall be regarded as references to the appropriate New Exhibits. This paragraph applies without affecting the generality of paragraph 8 below.

6. Integrator represents and warrants that before clicking on the 'Renew' button as described in paragraph 1 above, it: (a) has obtained copies of all applicable New Exhibits by downloading such New Exhibits from [http://www.cisco.com/web/partners/support/integrator\\_support\\_exhibits.html](http://www.cisco.com/web/partners/support/integrator_support_exhibits.html), or otherwise requesting them from Cisco, and (b) has read and understood, and accepts, the terms and conditions set forth in such New Exhibits.

7. It is acknowledged that in entering into this On-line Amendment, Cisco has relied upon Integrator's representation and warranty in paragraph 6 above.

8. To the extent that there is conflict between the Agreement and this On-line Amendment, the terms of this Online Amendment shall take precedence over the terms and conditions of the Agreement with regards to the subject matter described herein.

9. All other terms and conditions of the Agreement remain unchanged and in full force and effect.

The parties hereto have caused this On-line Amendment to be accepted on-line or signed by its duly authorized officer or representative as of the Amendment Effective Date.

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We have issued our reports dated February 27, 2007, accompanying the consolidated financial statements and schedule included in the Annual Report of INX Inc. (formerly I-Sector Corporation) on Form 10-K for the year ended December 31, 2006. We hereby consent to the incorporation by reference of said reports in the Registration Statements of INX Inc. (formerly I-Sector Corporation) on Forms S-8 (File No. 333-41001, effective November 25, 1997 and File No. 333-60320, effective May 7, 2002).

/s/ GRANT THORNTON LLP

Houston, Texas  
February 27, 2007

**Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer**

I, James H. Long, certify that:

1. I have reviewed this annual report on Form 10-K of INX Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under my supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to me by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report my conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 8, 2007

/s/ JAMES H. LONG

\_\_\_\_\_  
James H. Long, Chief Executive Officer

**Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer**

I, Brian Fontana, certify that:

1. I have reviewed this annual report on Form 10-K of INX Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under my supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to me by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report my conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 8, 2007

By /s/ BRIAN FONTANA  
Brian Fontana, Vice President  
and Chief Financial Officer

**Section 1350 Certification of Principal Executive Officer**

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO SECTION 906  
OF THE SARBANES-OXLEY ACT OF 2003**

In connection with the Annual Report of INX Inc. (the "Company") on Form 10-K for the year ended December 31, 2006 (the "Report"), as filed with the Securities and Exchange Commission on the date hereof, I, James H. Long, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2003, that:

1. The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ JAMES H. LONG

\_\_\_\_\_  
James H. Long  
Chief Executive Officer

March 8, 2007



**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON SCHEDULE**

To the Stockholders of INX Inc.

In connection with our audits of the consolidated financial statements of INX Inc. (formerly I-Sector Corporation) and subsidiaries referred to in our report dated February 27, 2007, which is included in the Company's 2006 Form 10-K, we have also audited Schedule II for the years ended December 31, 2004, 2005 and 2006. In our opinion, this schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ GRANT THORNTON LLP

Houston, Texas  
February 27, 2007