

Edgar Filing: AcuNetx, Inc. - Form 10QSB

AcuNetx, Inc.
Form 10QSB
November 20, 2006

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

Form 10-QSB

(X) Quarterly Report under Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended September 30, 2006

Commission File No. 0-27857

AcuNetx, Inc.

(Exact name of small business issuer as specified in its charter)

Nevada

88-0249812

(State or other jurisdiction
of incorporation or organization)

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

1000 S. McCaslin, Suite 300, Superior, CO 80027

(Address of principal executive offices)

303-494-1681

(Issuer's telephone number)

Check whether the issuer: (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file for such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No []

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

Yes [] No [X]

As of September 30, 2006 the issuer had 57,924,814 shares of common stock outstanding.

Transitional Small Business Disclosure Format (check one) [] Yes; [X] No

CAUTIONARY NOTICE REGARDING FORWARD LOOKING STATEMENTS

This Report on Form 10-QSB contains a number of forward-looking statements that reflect management's current views and expectations with respect to our business, strategies, products, future results and events and financial performance. All statements made in this Report other than statements of historical fact, including statements that address operating performance, events or developments that management expects or anticipates will or may occur in the future, including statements related to distributor channels, volume growth, revenues, profitability, new products, acquisitions, adequacy of funds from

Edgar Filing: AcuNetx, Inc. - Form 10QSB

operations, statements expressing general optimism about future operating results and non-historical information, are forward-looking statements. In particular, the words "BELIEVE," "EXPECT," "INTEND," "ANTICIPATE," "ESTIMATE," "MAY," "WILL," variations of such words, and similar expressions identify forward-looking statements, but are not the exclusive means of identifying such statements and their absence does not mean that the statement is not forward-looking. These forward-looking statements are subject to certain risks and uncertainties, including those discussed below. Our actual results, performance or achievements could differ materially from historical results as well as those expressed in, anticipated or implied by these forward-looking statements. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Readers should not place undue reliance on these forward-looking statements, which are based on management's current expectations and projections about future events, are not guarantees of future performance, are subject to risks, uncertainties and assumptions (including those described below) and apply only as of the date of this Report. Our actual results, performance or achievements could differ materially from the results expressed in, or implied by, these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed below "Management's Discussion and Analysis and Plan of Operation," as well as those discussed elsewhere in this Report, and the risks discussed in our most recently filed Annual Report on Form 10-KSB and in the press releases and other communications to shareholders issued by us from time to time which attempt to advise interested parties of the risks and factors that may affect our business.

-2-

ACUNETX, INC. (F/K/A EYE DYNAMICS, INC.) BALANCE SHEET

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

| ASSETS | |
|-----------------------------|-----------------------|
| Current Assets | |
| Cash | \$ 92,567 |
| Accounts receivable, net | 68,611 |
| Inventory | 303,517 |
| Prepaid expenses | 93,571 |
| | ----- |
| Total Current Assets | 558,266 |
| Property and equipment, net | 29,191 |
| Goodwill | 4,823,500 |
| Other intangible assets | 127,427 |
| Deferred tax assets | 220,635 |
| Other investment | 149,363 |
| Other assets | 1,563 |
| | ----- |
| TOTAL ASSETS | \$ 5,909,945 ===== |

Edgar Filing: AcuNetx, Inc. - Form 10QSB

| LIABILITIES AND STOCKHOLDERS' EQUITY | |
|---|--------------|
| Current Liabilities | |
| Accounts payable | \$ 529,365 |
| Accrued liabilities | 277,259 |
| Notes payable, current portion | 196,782 |
| | ----- |
| Total Current Liabilities | 1,003,406 |
| Long-Term Debt | 56,999 |
| | ----- |
| Total Liabilities | 1,060,405 |
| | ----- |
| Stockholders' Equity | |
| Common stock, \$0.001 par value; 100,000,000 shares authorized; 57,924,814 shares issued and outstanding | 57,925 |
| Paid-in capital | 10,121,371 |
| Accumulated deficit | (5,329,756) |
| | ----- |
| Total Stockholders' Equity | 4,849,540 |
| | ----- |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 5,909,945 |
| | ===== |

ACUNETX, INC. (F/K/A EYE DYNAMICS, INC.)
STATEMENT OF OPERATIONS

| | FOR THREE MONTHS ENDED SEPTEMBER 30, | | F END 2006 |
|--|---|------------|------------------|
| | 2006 | 2005 | |
| ----- | ----- | ----- | ----- |
| Sales - Products | \$ 764,763 | \$ 283,005 | \$ 1,4 |
| Cost of Products | 126,337 | 122,340 | 3 |
| | ----- | ----- | ----- |
| Gross profit | 638,426 | 160,665 | 1,0 |
| | ----- | ----- | ----- |
| Operating Expenses: | | | |
| Selling, general and administrative expenses | 1,117,913 | 383,377 | 3,0 |
| Stock option expenses | 109,737 | - | 3 |
| Research and development | 28,450 | - | 2 |
| | ----- | ----- | ----- |
| Total Operating Expenses | 1,256,100 | 383,377 | 3,6 |
| | ----- | ----- | ----- |
| Operating loss | (617,674) | (222,712) | (2,6 |
| | ----- | ----- | ----- |
| Other income (expenses) | | | |
| Interest and other income | 620 | 3,753 | (|
| Loss on equity-method investments | (9,232) | - | (|

Edgar Filing: AcuNetx, Inc. - Form 10QSB

| | | | |
|--|--------------|--------------|---------|
| Interest expense | (9,902) | (194) | (|
| Total other income (expenses) | (18,514) | 3,559 | (|
| Net loss before taxes | (636,188) | (219,153) | (2,6 |
| Provision for income taxes (benefits) | - | (3,565) | |
| Net loss | \$ (636,188) | \$ (215,588) | \$ (2,6 |
| Net loss per share-basic and diluted | \$ (0.01) | \$ (0.01) | \$ |
| Weighted average number of common shares | 57,458,147 | 21,674,880 | 56,0 |

-3-

ACUNETX, INC. (F/K/A EYE DYNAMICS, INC.)
STATEMENT OF CASH FLOW

FOR NINE MONTHS ENDED SEPTEMBER 30,

2006

CASH FLOW FROM OPERATING ACTIVITIES:

| | |
|---|----------------|
| Net loss | \$ (2,688,342) |
| Adjustments to reconcile net loss to net cash used in operating activities: | |
| Depreciation | 8,879 |
| Issuance of stock and stock equity awards for services | 787,415 |
| Provision for bad debt | 9,083 |
| Provision for loan loss | -- |
| Deferred income tax (benefit) | 366 |
| Loss on investment accounted for under equity method | 37,922 |
| Write-off fixed assets | 1,174 |
| (Increase) Decrease in: | |
| Accounts Receivable | 38,405 |
| Inventory | 17,743 |
| Prepaid and Others | (4,168) |
| Increase in Accounts Payable and Accrued Liabilities | 449,928 |

NET CASH USED IN OPERATING ACTIVITIES

(1,341,595)

CASH FLOW FROM INVESTING ACTIVITIES:

| | |
|-------------------------------------|----------|
| Closing of Certificates of Deposit | 305,274 |
| Capitalization of patent costs | (27,734) |
| Capitalization of trademark | (10,072) |
| Purchase of Equipment | (5,161) |
| Repayment of Notes Receivable | -- |
| Purchase of Certificates of Deposit | -- |

NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES

262,307

CASH FLOW FROM FINANCING ACTIVITIES:

Edgar Filing: AcuNetx, Inc. - Form 10QSB

| | |
|---|-----------|
| Net proceeds from sale of common stock | 1,036,529 |
| Net proceeds from exercise of warrants | 20,000 |
| Net repayments on notes payable | (56,014) |
| | ----- |
| NET CASH PROVIDED BY FINANCING ACTIVITIES | 1,000,515 |
| | ----- |
| NET DECREASE IN CASH | (78,773) |
| CASH BALANCE AT BEGINNING OF PERIOD | 171,340 |
| | ----- |
| CASH BALANCE AT END OF PERIOD | \$ 92,567 |
| | ===== |
| Supplemental Disclosures of Cash Flow Information: | |
| Interest Paid | \$ 21,852 |
| Taxes Paid | \$ 800 |
| Taxes Refund | \$ -- |
| Schedule of noncash investing and financing activities: Issuance of common stock for: | |
| Merger adjustment | \$ 362 |
| Notes Payable | -- |
| Accrued Interest | -- |
| | ----- |
| | \$ 362 |
| | ===== |
| Note payable incurred for purchase of fixed assets | \$ 1,787 |

-4-

ACUNETX, INC. (F/K/A EYE DYNAMICS, INC.)
NOTES TO INTERIM UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2006

NOTE 1 - NATURE OF BUSINESS

AcuNetx, Inc., a Nevada corporation, (the "Company" or "AcuNetx", formerly known as Eye Dynamics, Inc. or "EDI") combines diagnostic, analytical and therapeutic devices with proprietary software to permit: health providers to diagnose and treat balance disorders and various bone deficiencies; law enforcement officers to evaluate roadside sobriety; and employers in high-risk industries to determine, in real-time, the mental fitness of their employees to perform mission-critical tasks. AcuNetx is headquartered in Superior Colorado, and has operating divisions in Torrance, California.

On December 23, 2005, the Company completed the merger with OrthoNetx, Inc. ("OrthoNetx" or "ONX"), a Colorado-based provider of medical devices for osteoplastic surgery. The acquisition was completed as a stock transaction in which ONX shareholders received the number of shares equal to the number of EDI's outstanding shares at the closing date. Following the merger, the Company changed its name to AcuNetx, Inc. and shifted its headquarters to Superior, Colorado. The President and CEO of ONX assumed the position of President and CEO of the merged company.

Edgar Filing: AcuNetx, Inc. - Form 10QSB

AcuNetx is organized around three separate divisions: (i) a medical division with neurological diagnostic equipment, (ii) a medical division with devices that create new bone, and (iii) a division with products for occupational safety and law enforcement. For all its devices, AcuNetx is integrating an information technology (IT) platform that allows the device to capture data about the physiological condition of a human being. The Company's IT platform is designed to gather data and connect the device-related data with users and support persons. Its products include the followings: (a) Neurological diagnostic equipment that measures, tracks and records human eye movements, utilizing our proprietary technology and computer software, as a method to diagnose problems of the vestibular (balance) system and other balance disorders; (b) Devices designed to test individuals for impaired performance resulting from the influences of alcohol, drugs, illness, stress and other factors that affect eye and pupil performance. These products target the occupational safety and law enforcement markets; (c) Orthopedic and craniomaxillofacial (skull and jaw) surgery products, which generate new bone through the process of distraction osteogenesis; and (d) A proprietary information technology system called SmartDevice-Connect(TM) ("SDC") that establishes product registry to individual patients and tracks device behavior for post-market surveillance, adverse event and outcomes reporting, and creates "smart devices" that gather and transmit physiological data concerning the device and its interaction with the patient.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRESENTATION OF INTERIM INFORMATION: The financial information at September 30, 2006 and for the three and nine months ended September 30, 2006 and 2005 is unaudited but includes all adjustments (consisting only of normal recurring adjustments) that the Company considers necessary for a fair presentation of the financial information set forth herein, in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") for interim financial information, and with the instructions to Form 10-QSB. Accordingly, such information does not include all of the information and footnotes required by U.S. GAAP for annual financial statements. For further information refer to the Consolidated Financial Statements and footnotes thereto included in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2005.

The results for the three and nine months ended September 30, 2006 may not be indicative of results for the year ending December 31, 2006 or any future periods.

PRINCIPLE OF CONSOLIDATION AND PRESENTATION: The accompanying financial statements include the accounts of AcuNetx, Inc. and its divisions after elimination of all intercompany accounts and transactions. Certain prior period balances have been reclassified to conform to the current period presentation.

-5-

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

USE OF ESTIMATES: The preparation of the accompanying consolidated financial statements in conformity with accounting principles generally accepted in the United States (U.S. GAAP) requires management to make certain estimates and assumptions that directly affect the results of reported assets, liabilities, revenue, and expenses. Actual results may differ from these estimates.

OTHER INTANGIBLE ASSETS: Other intangible assets consist primarily of intellectual property and trademarks. The Company capitalizes intellectual property costs as incurred, excluding costs associated with Company personnel, relating to patenting its technology. The majority of capitalized costs

Edgar Filing: AcuNetx, Inc. - Form 10QSB

represent legal fees related to a patent application. If the Company elects to stop pursuing a particular patent application or determines that a patent application is not likely to be awarded or elects to discontinue payment of required maintenance fees for a particular patent, the Company, at that time, records as expense the capitalized amount of such patent application or patent. Awarded patents will be amortized over the shorter of the economic or legal life of the patent. Trademarks are not amortized, but rather are tested for impairment at least annually. There was no impairment of other intangible assets for nine months ended September 30, 2006. The Company had no other intangible assets in 2005.

GOODWILL: Goodwill represents the excess of the purchase price in the merger with OrthoNetx (see Note 10 to interim unaudited consolidated financial statements) over the fair value of net tangible and intangible assets acquired in the merger. Goodwill amounts are not amortized, but rather are tested for impairment at least annually. There was no impairment of goodwill for nine months ended September 30, 2006. The Company had no goodwill in 2005

INVESTMENT: The Company held 20% of the issued and outstanding common stock of a Colorado privately-held company. The Company accounts for the investment using the equity method of accounting. Under the equity method, the carrying amount of the investment is increased for its proportionate share of the investee's earning or decreased for its proportionate share of the investee's loss. During the nine month period ended September 30, 2006, the Company recorded losses of \$37,922, as its pro rata share of net losses in this privately-held company. The Company had no equity method investment in 2005.

The Company monitors the investment for impairment and makes appropriate reductions in carrying value if the Company determines that an impairment charge is required based primarily on the financial condition and near-term prospects of this company.

INCOME (LOSS) PER COMMON SHARE: Basic net income (loss) per share includes no dilution and is computed by dividing net income (loss) available to common stockholders by the weighted average number of common stock outstanding for the period. Diluted earnings per share is computed by dividing net income by the weighted average number of shares outstanding and, when, diluted, potential shares from options and warrants to purchase common stock using the treasury stock method. Diluted net loss per common share does not differ from basic net loss per common share since potential shares of common stock are anti-dilutive for all periods presented.

STOCK-BASED COMPENSATION: Prior to January 1, 2006, the Company's stock option plans were accounted for under the recognition and measurement provisions of APB Opinion No. 25 (Opinion 25), "ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES," and related Interpretations, as permitted by FASB Statement No. 123, "ACCOUNTING FOR STOCK-BASED COMPENSATION" (as amended by SFAS No. 148, "ACCOUNTING FOR STOCK-BASED COMPENSATION TRANSITION AND DISCLOSURE") (collectively SFAS 123). No stock-based employee compensation cost was recognized in the Company's consolidated statements of operations through December 31, 2005, as all options granted under the plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Effective January 1, 2006, the Company adopted the fair value recognition provisions of FASB Statement No. 123(R), "SHARE-BASED PAYMENT" (SFAS 123R), using the modified-prospective-transition method. Under that 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 January 1, 2006 based on the grant date fair value calculated in accordance with the

Edgar Filing: AcuNetx, Inc. - Form 10QSB

NOTE 2 -SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

original 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 123(R).

For the three and nine months ended September 30, 2006, as a result of adopting SFAS 123(R) on January 1, 2006, the Company recognized pre-tax compensation expense related to stock options of \$109,737 and \$354,613, respectively. The following table illustrates the effect on net loss and net loss per share if the Company had applied the fair value recognition provisions of SFAS 123 to options granted under the Company's stock option plan for the three and nine months ended September 30, 2005. For purposes of this pro forma disclosure, the value of the options is estimated using the Black-Scholes option-pricing model and is being amortized to expense over the options' vesting periods.

| | Three Months ended September 30, 2005 ----- | Nine Months ended September 30, 2005 ----- |
|--|---|--|
| Net loss, as reported | \$ (215,588) | \$ (251,469) |
| Deduct: Total stock-based employee compensation expense determined under the fair value of awards , net of tax related effects | -- | 39,600 |
| | ----- | ----- |
| Pro forma net loss | \$ (215,588) ===== | \$ (291,069) ===== |
| Reported net loss per share-basic and diluted | \$ (0.01) ===== | \$ (0.01) ===== |
| Pro forma loss per share-basic and diluted | \$ (0.01) ===== | \$ (0.01) ===== |

The Company accounts for stock issued to non-employees in accordance with the provisions of SFAS No. 123 and the EITF Issue No. 00-18, "ACCOUNTING FOR EQUITY INSTRUMENTS THAT ARE ISSUED TO OTHER THAN EMPLOYEES FOR ACQUIRING, OR IN CONJUNCTION WITH SELLING, GOODS OR SERVICES." SFAS No. 123 states that equity instruments that are issued in exchange for the receipt of goods or services should be measured at the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. Under the guidance in Issue 00-18, the measurement date occurs as of the earlier of (a) the date at which a performance commitment is reached or (b) absent a performance commitment, the date at which the performance necessary to earn the equity instruments is complete (that is, the vesting date).

NEW ACCOUNTING PRONOUNCEMENTS: In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, "ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES", ("FIN 48"). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, "ACCOUNTING FOR INCOME TAXES." This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years

Edgar Filing: AcuNetx, Inc. - Form 10QSB

beginning after December 15, 2006. The Company does not expect the adoption of FIN 48 to have a material impact on its consolidated financial statements.

-7-

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, "FAIR VALUE MEASUREMENTS." SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement addresses how to calculate fair value measurements required or permitted under other accounting pronouncements. Accordingly, this statement does not require any new fair value measurements. However, for some entities, the application of the statement will change current practice. SFAS No. 157 is effective for the Company beginning January 1, 2008. The Company is currently evaluating the impact of this standard.

In September 2006, the Securities and Exchange Commission ("SEC") staff issued Staff Accounting Bulletin No. 108 ("SAB 108"), "CONSIDERING THE EFFECTS OF PRIOR YEAR MISSTATEMENTS WHEN QUANTIFYING MISSTATEMENTS IN CURRENT YEAR FINANCIAL STATEMENTS." The stated purpose of SAB 108 is to provide consistency between how registrants quantify financial statement misstatements.

Prior to the issuance of SAB 108, there have been two widely-used methods, known as the "roll-over" and "iron curtain" methods, of quantifying the effects of financial statement misstatements. The roll-over method quantifies the amount by which the current year income statement is misstated while the iron curtain method quantifies the error as the cumulative amount by which the current year balance sheet is misstated. Neither of these methods considers the impact of misstatements on the financial statements as a whole.

SAB 108 established an approach that requires quantification of financial statement misstatements based on the effects of the misstatement on each of the Company's financial statements and the related financial statement disclosures. This approach is referred to as the "dual approach" as it requires quantification of errors under both the roll-over and iron curtain methods.

SAB 108 allows registrants to initially apply the dual approach by either retroactively adjusting prior financial statements as if the dual approach had always been used, or by recording the cumulative effect of initially applying the dual approach as adjustments to the carrying values of assets and liabilities as of January 1, 2006 with an offsetting adjustment recorded to the opening balance of retained earnings.

The Company will initially apply SAB 108 using the cumulative effect transition method in connection with the preparation of the annual financial statements for the year ending December 31, 2006. The Company does not believe the adoption of SAB 108 will have a significant effect on its consolidated financial statements.

The FASB has also issued SFAS No. 155, "ACCOUNTING FOR CERTAIN HYBRID FINANCIAL INSTRUMENTS—AN AMENDMENT OF FASB STATEMENTS NO. 133 AND 140," SFAS No. 156, "ACCOUNTING FOR SERVICING OF FINANCIAL ASSETS—AN AMENDMENT OF FASB STATEMENT NO. 140," and FAS 158, "EMPLOYER'S ACCOUNTING FOR DEFINED BENEFIT PENSION AND OTHER POSTRETIREMENT PLANS," but they will not be applicable to the current operations of the Company. Therefore a description and the impact on the Company's operations and financial position for each of the pronouncements above have not been disclosed.

-8-

Edgar Filing: AcuNetx, Inc. - Form 10QSB

NOTE 3 - BALANCE SHEET DETAILS

The following tables provide details of selected balance sheet items:

ACCOUNTS RECEIVABLE, NET

| | |
|--------------------------------|-----------|
| Accounts Receivable | \$ 77,313 |
| Other Receivable | 57 |
| Allowance for Bad Debt | (8,759) |
| | ----- |
| Total Accounts Receivable, Net | \$ 68,611 |
| | ===== |

PREPAID EXPENSES AND OTHERS

| | |
|---------------------------|-----------|
| Prepaid Insurance | \$ 20,447 |
| Prepaid rent and deposit | 6,411 |
| Other Prepaid Expenses | 66,713 |
| | ----- |
| Total Prepaids and Others | \$ 93,571 |
| | ===== |

PROPERTY AND EQUIPMENT, NET

| | |
|-----------------------------------|-----------|
| Furniture and Fixtures | \$ 9,531 |
| Equipment | 50,611 |
| Software | 5,110 |
| | ----- |
| Accumulated Depreciation | 65,252 |
| | (36,061) |
| | ----- |
| Total Property and Equipment, Net | \$ 29,191 |
| | ===== |

ACCRUED LIABILITIES

| | |
|-----------------------------------|------------|
| Credit Cards Payable | \$ 27,606 |
| Warranty reserve | 8,462 |
| Accrued payroll and related taxes | 169,306 |
| Accrued consulting fees | 12,000 |
| Accrued vacation | 34,102 |
| Customer deposit | 19,000 |
| Other accrued liabilities | 6,783 |
| | ----- |
| Total Accrued Liabilities | \$ 277,259 |
| | ===== |

NOTE 4 - LONG-TERM DEBT

| | |
|---|------------|
| Installment note payable to a related party, monthly payments total \$14,263, including interest at 13%. The original note amount was \$300,000. Matures December 31, 2007. | \$ 251,739 |
| Installment note payable secured by computer equipment. Monthly payments total \$81, including interest at 18.99%. The original note amount was \$2,062. Matures July 21, 2009. | 2,042 |
| | ----- |
| Total | 253,781 |
| Less: current portion | (56,999) |

\$ 196,782
=====

-9-

NOTE 4 - LONG-TERM DEBT (CONTINUED)

The Company has a note payable to a related party which initially bears interest at 0.75% above the Wall Street Journal Prime Rate (8.0% at December 31, 2005) and matures on January 10, 2006. On January 17, 2006, the note agreement was amended to reflect that the payment date of the loan be extended for two years, that the interest rate be increased to 13% per annum and that the remaining principal balance be amortized and payable over 2 years. The note is collateralized by substantially all assets of the Company and personal guarantee by the CEO and two shareholders. As of September 30, 2006, the Company was in default of four monthly payments, aggregate of \$57,050, including accrued interest of \$8,007. Total interest expense paid to the related party for the nine months ended September 30, 2006 was \$21,710.

The following is a schedule of the maturities of long-term debt:

| Years ended December 31, | |
|--------------------------------------|------------|
| ----- | |
| 2006 (October 1 through December 31) | \$ 79,790 |
| 2007 | 172,696 |
| 2008 | 765 |
| 2009 | 530 |
| | ----- |
| | \$ 253,781 |
| | ===== |

In April 2005, the Company converted long-term notes payable of \$40,000 and accrued interest of \$6,339 into 3,591,799 shares of common stock pursuant to the conversion privileges stated in the original note agreements. As a result, the Company did not recognize any gain or loss from these conversions.

NOTE 5 - INCOME TAXES

The components of the deferred net tax assets are as follows:

| | For Three Months ended | | For Nine Months ended | |
|----------|------------------------|------------|-----------------------|------------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| ----- | | | | |
| Federal: | | | | |
| Current | \$ -- | \$ -- | \$ -- | \$ -- |
| Deferred | -- | (2,716) | 377 | (1,440) |
| | -- | (2,716) | 377 | (1,440) |
| ----- | | | | |
| State: | | | | |
| Current | -- | -- | 800 | 800 |
| Deferred | -- | (849) | (11) | (849) |
| | -- | (849) | 789 | (49) |
| ----- | | | | |
| Total | \$ -- | \$ (3,565) | \$ 1,166 | \$ (1,489) |

=====

The Company had removed the valuation allowance as of December 31, 2003 because it believed it was more likely than not that all deferred tax assets would be realized in the foreseeable future and was reflected as a credit to operations. However, as of December 31, 2005, the Company's ability to utilize its federal net operating loss carryforwards is uncertain due to the net loss of the year and the merger with OrthoNetx which has net operating loss carryforwards approximately of \$1,700,000 as of that date, and thus a valuation reserve has been provided against the Company's net deferred tax assets.

As of December 31, 2005, the Company has net operating loss carryforwards of approximately, \$3,200,000 and \$833,000 to reduce future federal and state taxable income, respectively. To the extent not utilized, the federal net operating loss carryforwards will begin to expire in fiscal 2009 and the state net operating loss carryforwards will begin to expire in fiscal 2012.

-10-

NOTE 6 - STOCKHOLDERS' EQUITY

Private Placement Offering

In September 2005, OrthoNetx commenced a private placement offering ("Offering") of equity securities to raise on a best efforts basis a maximum of \$1,500,000 in conjunction with the planned merger with Eye Dynamics discussed in Note 3. There is no minimum amount required to be raised with the Offering. The Offering consists of units priced at \$50,000 per unit. Each unit consists of (a) shares of the OrthoNetx's common stock at a price equal to the lesser of \$.22 per share or 90% of the average closing price of Eye Dynamics common stock over the 30 days prior to the closing of the merger with Eye Dynamics and (b) warrants to purchase additional shares of the OrthoNetx's common stock equal to 50% of the number of shares of common stock purchased in the Offering, exercisable for two years at \$.33 per share. Total proceeds from this offering were \$650,000; the Company received net proceeds of \$602,779 after offering expenses. Additional offering expenses of \$81,250 were paid, of which \$15,000 was paid in cash in 2005; \$16,250 was paid in cash in 2006; and the balance of \$50,000 was paid in 277,778 shares of AcuNetx's common stock. All cash proceeds were received in January 2006 and total of 3,888,892 shares of AcuNetx's common stock, including the 277,778 shares, were issued.

In March 2006, a Subscription Agreement from the 2005 Private Placement Memorandum was fulfilled in the amount of \$500,000, resulting in \$450,000 net proceeds after offering expenses. Galen Capital Group, the former financial advisor, is the investor and received 2,777,778 shares of common stock of the Company for their investment.

On September 7, 2006, the Company entered into a Placement Agency Agreement (the "Agreement") to obtain bridge financing up to \$500,000. In return, the Company issued 500,000 shares of restricted common stocks to the placement agent, of which 250,000 shares were vested upon signing of the Agreement and the balance of 250,000 shares will vest at such time as the Company and the placement agent agree to market the Company and the placement agent makes the first introduction of the Company to a prospective buyer, either by a meeting or teleconference. The shares were valued at the closing market price on the date of agreement, which was \$0.12 per share. The total of \$60,000 was charged to operations. As of September 30, 2006, no money was raised by the placement agent.

Edgar Filing: AcuNetx, Inc. - Form 10QSB

Exercise of warrants

During the first nine months of 2006, there were stock warrants exercised. The Company received total proceeds of \$20,000. No stock warrants were exercised in 2005.

Non-Executive Directors' Stock Plan

On February 27, 2006 the Board of Directors agreed to provide 300,000 shares of restricted stock to each of the four nonemployee directors as compensation for 2006 services pursuant to the 2006 Non-Executive Stock Plan established on January 1, 2006. The shares were ratified valuing at \$0.18 per share which was the closing market price on the effective date of the Plan, and were amortized on a straight-line basis over a twelve month period. For the three and nine months ended September 30, 2006, the Company recognized directors' compensation of \$40,500 and \$144,000. The Plan shall be in effect until December 31, 2006.

Increase of Authorized Shares

In March 2006, the Board of Directors approved an increase in the authorized number of shares of Common Stock to 200 million. Increase in authorized Common Stock requires shareholder approval, which will be sought at the next shareholder meeting. If approved at that time, the Articles of Incorporation will be amended.

NOTE 7 - STANDBY EQUITY DISTRIBUTION AGREEMENT

On January 31, 2006, the Company entered into a Standby Equity Distribution Agreement (SEDA) with Cornell Capital Partners, LP ("Cornell"), to finance the continued development of its products. Under the agreement, Cornell has committed to provide up to \$12 million of equity financing to be drawn down over a 24-month period at the Company's discretion. The financing will become available after the Company has filed a Registration Statement covering the securities with the Securities and Exchange Commission (the "SEC"), and the SEC has declared the Registration Statement effective. The maximum amount of each drawdown is \$500,000, and there must be at least five trading days between drawdowns.

-11-

Under the Standby Equity Distribution Agreement, each drawdown is actually a sale by the Company to Cornell of newly-issued shares of common stock, in the amount necessary to equate to the desired cash proceeds. Cornell will pay the Company 98% of, or a 2% discount to, the lowest closing bid price of the Company's common stock during the five consecutive trading day period immediately following the date the Company notifies Cornell that the Company desires to access the Standby Equity Distribution Agreement. Under the agreement, the Company may not issue Cornell a number of shares of common stock such that it would beneficially own greater than 9.99% of the Company's outstanding shares of common stock.

In addition, Cornell Capital Partners will retain 5% of each cash payment under the Standby Equity Distribution Agreement as a commitment fee. The Company also issued, as amended, 1,090,266 shares of common stock to Cornell Capital Partners as a one-time commitment fee. The 2% discount, the 5% commitment fee and the shares of common stock are considered to be underwriting discounts payable to

Edgar Filing: AcuNetx, Inc. - Form 10QSB

Cornell Capital Partners. The Company also paid \$5,000 as a due diligence fee to Cornell Capital Partners.

The Company also agreed to pay Yorkville Advisors, LLC, an affiliate of Cornell Capital Partners, a structuring fee of \$10,000 upon the earlier to occur of (i) the first drawdown under the Standby Equity Distribution Agreement, or (ii) April 21, 2006, as well as a fee of \$500 per advance made.

Under the agreement, the Company has issued three warrants to purchase the Company's common stock to Cornell. The first is a one-year warrant for 250,000 shares, with an exercise price of \$0.50 per share. The second is a two-year warrant for 250,000 shares, with an exercise price of \$1.00 per share. The third is a three year warrant for 500,000 shares, with an exercise price of \$2.00 per share. The warrants were valued at \$83,802 using Black-Scholes option-pricing model and were charged to operations.

The Company agreed to register for resale, on Form SB-2, the shares of common stock which the Company sell to Cornell Capital Partners under the Standby Equity Distribution Agreement, as well shares issuable upon exercise of the warrants and the shares issued as a commitment fee.

The Company engaged Monitor Capital, Inc., a registered broker-dealer, to act as placement agent in connection with the Standby Equity Distribution Agreement, pursuant to a Placement Agent Agreement dated as of January 31, 2006. The Company paid Monitor Capital, Inc. 57,143 shares of Common Stock as a fee under the Placement Agent Agreement. The shares were valued at \$0.175 per share. The total of \$10,000 was charged to operations.

NOTE 8 - STOCK OPTIONS

On March 27, 2006 the Board of Directors approved and adopted the 2006 Stock Incentive Plan to provide for the issuance of incentive stock options and/or nonstatutory options to all employees and nonstatutory options to consultants and other service providers. Generally, all options granted to employees and consultants expire ten and three years, respectively, from the date of grant. All options have an exercise price higher than the fair market value of the Company's stock on the date the options were granted. It is the policy of the Company to issue new shares for stock option exercised and restricted stock, rather than issue treasury shares. Options generally vest over three years. The plan reserves 14 million shares of common stock under the Plan and shall be effective through December 31, 2015.

On January 3, 2005, the Board of Directors approved the issuance of stock options to directors in the amount of 20,000 shares for each of the years from 1999 through 2004. The total options for each of directors shall be 120,000 shares. The options are vesting immediately and exercisable at \$0.15 per share through January 3, 2007.

A summary of the status of stock options issued by the Company as of September 30, 2006 and 2005 is presented in the following table.

-12-

| 2006 | | 2005 |
|------------------------|--|------------------------|
| Number of Shares | Weighted Average Exercise Price | Number of Shares |

Edgar Filing: AcuNetx, Inc. - Form 10QSB

| | | | |
|----------------------------------|-----------|---------|---------|
| Outstanding at beginning of year | 415,000 | \$ 0.15 | - |
| Granted | 6,894,102 | 0.21 | 360,000 |
| Exercised/Expired/Cancelled | - | - | - |
| Outstanding at end of period | 7,309,102 | \$ 0.21 | 360,000 |
| Exercisable at end of period | 1,309,102 | \$ 0.19 | 360,000 |

The fair value of each stock option granted is estimated on the date of grant using the Binominal Lattice option valuation model for 2006 and the Black-Scholes Merton option valuation model for 2005. Both models use the assumptions listed in the table below. Expected volatilities are based on the historical volatility of the Company's stock. The risk-free rate for periods within the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

| | 2006 | 2005 |
|--|---------|---------|
| Weighted average fair value per option granted | \$ 0.17 | \$ 0.11 |
| Risk-free interest rate | 4.41% | 3.18% |
| Expected dividend yield | 0.00% | 0.00% |
| Expected lives | 9.80 | 2.00 |
| Expected volatility | 155.69% | 163.36% |

As of September 30, 2006 there was \$786,360 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the various plans. That cost is expected to be recognized over a weighted average period of 2.25 years.

NOTE 9 - NET INCOME (LOSS) PER SHARE

The following table sets forth the computation of basic and diluted net income (loss) per share:

| | Three Months ended September 30, | | Nine Months ended September 30, |
|--|-------------------------------------|--------------|---------------------------------------|
| | 2006 | 2005 | 2006 |
| Numerator: | | | |
| Net loss | \$ (636,188) | \$ (215,588) | \$ (2,688,340) |
| Denominator: | | | |
| Weighted average number of common shares | 57,458,147 | 21,674,880 | 56,079,000 |
| Net loss per share-basic and diluted | \$ (0.01) | \$ (0.01) | \$ (0.01) |

As the Company incurred net loss for the nine months ended September 30, 2006, the effect of dilutive securities totaling 462,271 equivalent shares have been excluded from the calculation of diluted loss per share because their effect was anti-dilutive. Stock options and warrants to purchase approximately 5,503,548 shares of the Company's common stocks were outstanding, but were not included in the computation of diluted net loss per share for the three months ended

Edgar Filing: AcuNetx, Inc. - Form 10QSB

September 30, 2006 because the exercise price of the stock options and warrants was greater than the average share price of the common shares, and, therefore, the effect would have been antidilutive.

-13-

As the Company incurred net loss for the three and nine months ended September 30, 2005, the effect of dilutive securities totaling 475,384 and 2,101,182 equivalent common shares, respectively, have been excluded from the calculation of diluted net loss per share because their effect was anti-dilutive.

NOTE 10 - MERGERS AND ACQUISITIONS

Pursuant to the Agreement and Plan of Merger ("ONX Agreement") with OrthoNetx, Inc., a privately-held company in Colorado, dated September 1, 2005, the Company acquired 100% of the issued and outstanding common stock of OrthoNetx. The acquisition was completed on December 23, 2005.

OrthoNetx, Inc., which was formed in 1996, develops, manufactures, markets and supports proprietary medical devices for distraction osteogenesis (mechanically induced growth of new bone and adjacent soft tissues) to treat human bone-related tissue deficiencies and deformities, both congenital and acquired. OrthoNetx has patented and developed its GENEROS(TM) family of distraction osteogenesis devices for infants, children and adults with: (a) craniofacial deformities and mandibular, maxillary and/or alveo (dental) bone loss, and (b) deficiencies and malformations of the upper and lower limbs, and in the bones of hands and feet.

Under the terms of the ONX Agreement, the shareholders of ONX received the number of shares equal to the number of outstanding shares of EDI's common stock, including stock options and stock warrants at the closing date. As a result, each outstanding share of ONX's common stock was converted into approximately 0.805 shares of AcuNetx's common stock. Immediately upon the completion of the merger, ONX's CEO became the CEO of AcuNetx.

The acquisition was accounted for as business combination, and accordingly, the tangibles assets acquired were recorded at their fair value at December 23, 2005. The results of operations of OrthoNetx have been included in the Company's consolidated financial statements subsequent to that date. The total purchase price is \$4,706,061, and is comprised of:

| | |
|---|--------------|
| Stocks issued to acquire the outstanding common stock of OrthoNetx (22,496,966 shares at \$0.18 per share) | \$ 4,049,454 |
| Acquisition related transaction costs (3,647,818 shares at \$0.18 per share) | 656,607 |
| | ----- |
| Total purchase price | \$ 4,706,061 |
| | ===== |

The fair value of the purchase price was valued at \$0.18 per share, which represented the closing price of the Company's stock at December 23, 2005. Acquisition related transaction costs include 3,647,818 shares issued to a financial advisor of ONX. The allocation of the purchase price to assets acquired and liabilities assumed is presented in the table that follows:

| | |
|--------------------------|------------|
| Tangible assets acquired | \$ 136,169 |
| Property and equipment | 29,772 |
| Intangible assets | 89,621 |
| Goodwill | 4,823,500 |

Edgar Filing: AcuNetx, Inc. - Form 10QSB

| | |
|--------------------------|--------------|
| Other non-current assets | 187,233 |
| Liabilities assumed | (560,234) |
| | ----- |
| Total purchase price | \$ 4,706,061 |
| | ===== |

-14-

The following summary, prepared on an unaudited pro forma basis, reflects the condensed consolidated results of operations for the three and nine months ended September 30, 2005 assuming OrthoNetx had been acquired at the beginning of the periods presented:

| | Three Months ended September 30, 2005 | Nine Months ended September 30, 2005 |
|--------------------------------------|--|---|
| Net revenue | \$ 298,455 | \$ 1,022,149 |
| Net loss | \$ (574,804) | \$ (1,104,223) |
| Basic and diluted net loss per share | \$ (0.01) | \$ (0.02) |

PrivaComp, Inc.

On May 27, 2005, OrthoNetx, Inc. entered into an Agreement and Plan of Merger ("PrivaComp Agreement") with PrivaComp, Inc., a Delaware corporation that is in the business of developing technologies to provide patients with secure access to their medical records and control over their medical privacy. PrivaComp is considered a development stage company. The majority shareholder and CEO of PrivaComp is also the CEO and a shareholder/director of OrthoNetx. Under the terms of the PrivaComp Agreement, all of the issued and outstanding shares of PrivaComp stock were cancelled and converted into 1,000,000 shares of OrthoNetx's common stock.

OrthoNetx is the surviving corporation and assumed all assets and liabilities of PrivaComp, consisting primarily of developed software, a pending patent application and accounts payable. The merger was effective September 30, 2005.

PrivaComp and OrthoNetx are related through common ownership. Accordingly, the assets and liabilities of PrivaComp have been recorded by OrthoNetx at historical cost at September 30, 2005 as follows:

| | |
|-------------------------|------------|
| Assets: | |
| Intellectual Property | \$ 54,567 |
| Liabilities: | |
| Accounts Payable | (62,669) |
| | ----- |
| Net liabilities assumed | \$ (8,102) |
| | ===== |

PrivaComp had no activity during the three and nine months ended September 30, 2005, therefore, no pro forma information has been presented.

NOTE 11 - MAJOR CUSTOMERS AND CREDIT CONCENTRATION

During the three months ended September 30, 2006, a SID distributor accounted for \$601,410 or 80.1% of IntelliNetx division revenues. During the nine months ended September 30, 2006, two customers accounted for \$1,147,842 or 82.1% of

Edgar Filing: AcuNetx, Inc. - Form 10QSB

IntelliNetx division revenues.

| | |
|----------------------|--------------------|
| National distributor | \$449,567 or 32.2% |
| SID distributor | \$698,275 or 50.0% |

During the three and nine months ended September 30, 2005, the national distributor accounted for \$244,230 and \$861,180 or 86.31% and 85.89% of total revenues, respectively.

The Company maintains cash deposits with major banks, which from time to time may exceed federally insured limits. The Company periodically assesses the financial condition of the institutions and believes that the risk of any loss is minimal.

-15-

NOTE 12 - SEGMENT INFORMATION

The Company evaluates its reporting segments in accordance with SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information." The Chief Executive Officer has been identified as the Chief Operating Decision Maker as defined by SFAS No. 131. The Chief Executive Officer allocates resources to each segment based on their business prospects, competitive factors, net sales and operating results.

In 2006, the Company changed the structure of its internally organization to develop three market-oriented operating divisions: (i) IntelliNetx (INX) division, (ii) OrthoNetx (ONX) division, and (iii) VisioNetx (VNX) division. The IntelliNetx division markets patented medical devices that assist in the diagnosis of dizziness and vertigo, and rehabilitate those in danger of falling as a result of balance disorders The OrthoNetx division markets patented medical devices that mechanically induce new bone formation in patients with skeletal deformities o the face, skull, jaws, extremities and dentition. The VisioNetx division markets patented products that track and analyze human eye movements. The Company also has other subsidiaries that do not meet the quantitative thresholds of a reportable segment.

The Company reviews the operating companies' income to evaluate segment performance and allocate resources. Operating companies' income for the reportable segments excludes income taxes and amortization of goodwill. Provision for income taxes is centrally managed at the corporate level and, accordingly, such items are not presented by segment. The segments' accounting policies are the same as those described in the summary of significant accounting policies.

The Company does not track its assets by operating segments. Consequently, it is not practical to show assets by operating segments.

-16-

NOTE 12 - SEGMENT INFORMATION (CONTINUED)

Summarized financial information of the Company's results by operating segment is as follows:

Edgar Filing: AcuNetx, Inc. - Form 10QSB

| | For Three Months ended September 30, | | For Nine Months ended September 30, | |
|---|---|------------|--|-------------|
| | 2006 | 2005 | 2006 | 2005 |
| IntelliNetx Division: | | | | |
| Net revenue to external customers | \$ 750,613 | \$ 283,005 | \$1,397,318 | \$1,044,400 |
| Cost of revenue | 118,949 | 122,340 | 384,734 | 400,000 |
| Margin | \$ 631,664 | \$ 160,665 | \$1,012,584 | \$ 644,400 |
| OrthoNetx Division: | | | | |
| Net revenue to external customers | \$ 14,150 | \$ -- | \$ 22,750 | \$ -- |
| Cost of revenue | 7,388 | -- | 11,091 | -- |
| Margin | \$ 6,762 | \$ -- | \$ 11,659 | \$ -- |
| OrthoNetx Division: | | | | |
| Net revenue to external customers | \$ -- | \$ -- | \$ -- | \$ -- |
| Cost of revenue | -- | -- | -- | -- |
| Margin | \$ -- | \$ -- | \$ -- | \$ -- |
| Total Net Revenue to External Customers | \$ 764,763 | \$ 283,005 | \$1,420,068 | \$1,044,400 |
| Total Cost of Revenue | 126,337 | 122,340 | 395,825 | 400,000 |
| Total Margin | 638,426 | 160,665 | 1,024,243 | 644,400 |

Intersegment transactions are recorded at cost. The margins reported reflect only the direct controllable expenses of each line of business and do not represent the actual margins for each operating segment because they do not contain an allocation of product development, information technology, marketing and promotion, stock-based compensation, and corporate and general and administrative expenses incurred in support of the lines of business.

| | For Three Months ended September 30, | | For Ni |
|---|---|--------------|----------------|
| | 2006 | 2005 | 200 |
| Total margin for reportable segments | \$ 638,426 | \$ 160,665 | \$ 1,024,243 |
| Corporate and general and administrative expenses | (1,117,913) | (383,377) | (3,080,000) |
| Stock option expenses | (109,737) | -- | (350,000) |
| Research and development | (28,450) | -- | (220,000) |
| Interest and Other Expense | (9,902) | (194) | (200,000) |
| Loss on equity-method investments | (9,232) | -- | (300,000) |
| Interest and Other Income | 620 | 3,753 | 100,000 |
| Net loss before income taxes | \$ (636,188) | \$ (219,153) | \$ (2,680,000) |

-17-

NOTE 13 - COMMITMENTS

Sales Incentive Agreements

In April 2005, the Company entered into two individual agreements with the

Edgar Filing: AcuNetx, Inc. - Form 10QSB

national distributor and a special instrument dealer. The agreements provide that the Company will issue restricted common stock to the distributor and dealer as a sale incentive if certain conditions are reached pursuant to the agreements. As of September 30, 2006, none of these conditions are reached and the Company issued no shares.

The sales incentive agreement with the national distributor was replaced by the Marketing and Distribution Agreement in May 2006.

Marketing and Distribution Agreement

On May 25, 2006 the Company executed a new Marketing and Distribution Agreement with the national distributor. The new agreement restructures the Company's relationship with the national distributor into a nonexclusive one, so that the Company will be in a position to manufacture and sell VNG products under its own brand names, as well as through the national distributor. The agreement also changes the relationship between the Company and the national distributor so that, in general, the Company will ship the national distributor branded products directly to the end-user, receive payment from the end-user, and pay the national distributor a commission on sales. The new Agreement is for a period of eight years, provides for successive three year options, and supersedes and replaces the previous Manufacturing, Sales, Licensing, and Software Agreement and the Sales Incentive Agreement.

The Company also executed a Consulting Agreement with a consultant associated with the national distributor providing that the consultant agrees to provide advisory and consulting services to the Company for the purposes of improving the Company's VNG products and other balance-related product lines. The agreement is for a period of three years, and renews for an additional one year term.

In return, the Company agreed to issue its common stocks worth \$100,000 on May 25, 2006 and an additional \$100,000 worth of common shares on each of the seven subsequent anniversaries of the signing date, which was May 25, 2006. The Company also agreed to pay the consultant \$1,500 per day with a minimum of 30 days per year. In July 2006, the Company had issued 444,445 shares of its common stocks to the national distributor for the first \$100,000 agreed payment.

-18-

NOTE 14 - GUARANTEES AND PRODUCT WARRANTIES

The Company from time to time enters into certain types of contracts that contingently require the Company to indemnify parties against third party claims. These contracts primarily relate to: (i) divestiture agreements, under which the Company may provide customary indemnifications to purchasers of the Company's businesses or assets; (ii) certain real estate leases, under which the Company may be required to indemnify property owners for environmental and other liabilities, and other claims arising from the Company's use of the applicable premises; and (iii) certain agreements with the Company's officers, directors and employees, under which the Company may be required to indemnify such persons for liabilities arising out of their employment relationship.

The terms of such obligations vary. Generally, a maximum obligation is not explicitly stated. Because the obligated amounts of these types of agreements often are not explicitly stated, the overall maximum amount of the obligations cannot be reasonably estimated. Historically, the Company has not been obligated to make significant payments for these obligations, and no liabilities have been

Edgar Filing: AcuNetx, Inc. - Form 10QSB

recorded for these obligations on its balance sheet as of September 30, 2006.

In general, the Company offers a one-year warranty for most of the products it sold. To date, the Company has not incurred any material costs associated with these warranties. The Company provides reserves for the estimated costs of product warranties based on its historical experience of known product failure rates, use of materials to repair or replace defective products and service delivery costs incurred in correcting product failures. In addition, from time to time, specific warranty accruals may be made if unforeseen technical problems arise with specific products. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary.

The following table presents the changes in the Company's warranty reserve during the first nine months of 2006 and 2005:

| | 2006 | 2005 |
|-----------------------------------|----------|----------|
| Balance as of beginning of period | \$ 8,462 | \$ 8,884 |
| Provision for warranty | 1,051 | 2,456 |
| Utilization of reserve | (1,051) | (3,882) |
| Balance as of end of period | \$ 8,462 | \$ 7,458 |

NOTE 15 - DEPARTURE AND ELECTION OF CHAIRMAN OF THE BOARD OF DIRECTORS

On May 2, 2006, Stephen D. Moses resigned from the Board of Directors of Registrant and as Chairman of the Board of Directors. The resignation arose out of disagreements about the management and direction of the Company. The remaining Directors of the Company disagree with the assertions of Mr. Moses.

On May 3, 2006, Charles Phillips, the Company's co-founder in 1988 and currently a Director, was elected as the Chairman of the Board of Directors of the Company.

NOTE 16 - SUBSEQUENT EVENT

Subsequent to September 30, 2006, the Company sold 5,050,000 units of its equity at \$0.10 per unit and raised \$505,000. Each unit consists of one share of common stock and one warrant to purchase one share of common stock at \$0.20 per share for a period of two years.

-19-

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

BUSINESS OVERVIEW

AcuNetx is organized around three separate divisions: (i) a medical division with neurological diagnostic equipment, (ii) a medical division with devices that create new bone, and (iii) a division with products for occupational safety and law enforcement. For all its devices, AcuNetx is integrating an information technology (IT) platform that allows the device to capture data about the physiological condition of a human being. Our IT platform is designed to gather data and connect the device-related data with users and support persons. The Company's products include the following:

- o Neurological diagnostic equipment that measures, tracks and records human eye

Edgar Filing: AcuNetx, Inc. - Form 10QSB

movements, utilizing our proprietary technology and computer software, as a method to diagnose problems of the vestibular (balance) system and other balance disorders.

- o Devices designed to test individuals for impaired performance resulting from the influences of alcohol, drugs, illness, stress and other factors that affect eye and pupil performance. These products target the occupational safety and law enforcement markets.

- o Orthopedic and craniomaxillofacial (skull and jaw) surgery products, which generate new bone through the process of distraction osteogenesis.

- o A proprietary information technology system called SmartDevice-Connect (TM) ("SDC") that establishes product registry to individual patients and tracks device behavior for post-market surveillance, adverse event and outcomes reporting, and creates "smart devices" that gather and transmit physiological data concerning the device and its interaction with the patient.

RESULTS OF OPERATIONS

THREE MONTHS ENDING SEPTEMBER 30, 2006 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2005

As previously mentioned, AcuNetx, Inc. is comprised of the former Eye Dynamics, Inc. and the former OrthoNetx, Inc. This discussion compares the combined 2006 third quarter and first nine month's results with the corresponding periods of 2005, which consists solely of the former Eye Dynamics, Inc.

In May of 2006, negotiations successfully concluded with our national distributor for IntelliNetx (formerly Eye Dynamics) products. The revised contract allows exclusivity for that distributor for the Company's products they have traditionally sold, while allowing new IntelliNetx lines to be sold through a broader range of channels and partners. One significant aspect of the new contract is a shift in revenue recognition. Prior to the revised contract, IntelliNetx products would be considered purchased by the distributor and revenue would be credited at the previously agreed upon wholesale price. Under the now revised contract, shipments and title to the equipment move directly from IntelliNetx to the end customer, and IntelliNetx recognizes the revenue at

-20-

the retail price. This change will result in higher revenues for the same unit volume of sales, along with higher gross profits, as costs will not change. An offsetting increase in selling expenses occurs as the distributor is paid from the retail proceeds. The functional implementation of the changes to our distribution agreement occurred at the end of the second quarter. Material results associated with this change will be reflected from this point forward.

Revenues during the third quarter of 2006 were \$764,763, compared to \$283,005 for the corresponding period in 2005. Unit shipments were similar to the prior year. The revenue increase was driven by the systems being booked at the retail level as described above. Unit cost of sales stayed relatively static, while gross profit, as a percentage of sales increased 26.7%, again due to the shift to retail.

Total operating expenses increased by \$872,723 from \$383,377 in the third quarter of 2005 to \$1,256,100 in the third quarter of 2006. Increased selling, general and administrative expenses resulted in a loss of \$636,188 (\$0.01 per share) for the current period, compared to a loss of \$215,588 (\$0.01 per share)

Edgar Filing: AcuNetx, Inc. - Form 10QSB

for the same period in the previous year. Unit sales returned to prior year levels, with typical seasonal slowing, after negotiations with our key distributor were concluded in May. The Company has started distribution of VNG products under the IntelliNetx brand through a number of new channels, including Special Instrument Dealers. These sales should result in an improvement to the bottom line as we have negotiated a more favorable commission structure with these channels. We are working with all of our marketing channels to formulate a consistent message to highlight our product and company strengths. Sales for the OrthoNetx line of products continue at a very slow pace while the correct distribution model is sought. Most of the loss in the quarter was driven by the increase in operating expenses discussed in the nine month results below.

NINE MONTHS ENDED SEPTEMBER 30, 2006 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2005

Revenues during the first 9 months of 2006 were \$1,420,068, compared to \$1,002,699 for the corresponding period in 2005. Unit shipments were down modestly from the prior year, but this was offset with the shift in revenue recognition previously discussed. Unit cost of sales stayed relatively static, while gross profit, as a percentage of sales increased 17.9%, again due to the shift to retail revenue booking.

Total operating expenses increased by \$2,863,084, from \$798,732 in the first 9 months of 2005 to \$3,661,816 in the same period of 2006. Substantial new product development expenses as well as increased selling, general and administrative expenses resulted in a loss of \$2,688,342 (\$0.05 per share) for the current period, compared to a loss of \$251,470 (\$0.01 per share) for the same period in the previous year.

The company directed significant expenditures in the first six months of combined operations for design work on the SafetyScan product, which was completed through phase I. While funding concerns slowed direct R&D work significantly in the third quarter, work on market segmentation and strategies continued. The HawkEye product for law enforcement use was further developed and has been brought to market in beta form. Improvements of form and function in the current VNG product line were also undertaken, and the upgraded versions were shown at the American Academy of Otolaryngology meeting in Toronto. AcuNetx had a major presence at this event, and considers the results, which included sales leads, actual sales, and customer input on future product enhancement, to be above expectations. We continue to work with a large number of highly regarded potential partners in the medical, safety, and law enforcement sectors that our products serve, and anticipate that several relationships will be formalized and announced in the near future.

Standard selling, general and administrative expenses for both AcuNetx and OrthoNetx did not increase significantly, but the OrthoNetx expenses make up a significant portion of the year to year growth. The shift to recognizing revenue at the retail level for IntelliNetx products mentioned earlier has resulted in an increase in selling expense which offsets the higher gross profit for units sold through our national distributor, and will return higher contributions to net income for units sold through new channels. This change was in effect for the entire 3rd quarter.

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents as of September 30, 2006 of \$92,567 will not allow for payment of all outstanding invoices until additional financing is completed (see financing efforts below). All suppliers to the revenue generating operations of IntelliNetx are current, and can remain so with current cash and sales. Creditors have been kept informed of the financial situation of the Company, and have agreed to accept limited payment pending the close of additional financing. All have received continuing partial payments. The Company has a loan from the

Edgar Filing: AcuNetx, Inc. - Form 10QSB

founder of OrthoNetx, who is also a director, which is two months in arrears on interest as of September 30, and five months behind on principal payment. No demand for payment or default notice has been received by the Company. Once sufficient funding is in place, the parties will negotiate a revision to the loan.

-21-

We recognize that our current liquidity situation raises the question of being able to continue as a going concern. We are addressing this issue in two ways: First, we are seeking additional funding in the fourth quarter as described below, which will allow the continuation of operations through the full implementation of the SafetyScan product. Second, we intend to restructure expense and overhead parameters in a manner that will allow the company to continue to manufacture and sell our current product lines while paying current liabilities over time.

Inventory as of September 30, 2006 was \$303,517, compared to \$297,975 as of September 30, 2005. Purchasing for all VNG products has been adjusted to a level consistent with current sales volumes. OrthoNetx bone distraction product inventories, both the GenerOs CF and GenerOs SB, continue to be reduced through sales, but still offset the management improvements in VNG inventory levels. Accounts receivable as of September 30, 2006 were \$68,611. A dedicated push in July reduced the prior balance substantially, and new programs have been instituted to prevent a buildup of A/R delinquencies.

Accounts payable as of September 30, 2006 were \$529,365, compared to \$81,615 as of September 30, 2005. The change is primarily due to significant increases in activity as reflected in the combined companies' selling, general and administrative expense and an extending of payments due to liquidity issues, both discussed above. OrthoNetx had previously acquired a private firm, and has been carrying accounts payable at full value until a settlement, is resolved.

Sales prospects for the balance of 2006 should match or exceed last year's volumes, as we supplement our major distributor with new channels and sales partners. We expect to realize fourth quarter sales of our HawkEye product to the law enforcement community but not with significant quantity. In early April we announced that our VNG products have been approved by the U. S. Government Services Administration to be listed on the Federal Supply Schedule, which permits access to all military and VA hospitals around the world. A distributor has been named to focus on that channel, and we expect to see the benefit of that relationship shortly.

In July, the company began exploring the possible sale of the OrthoNetx division and its products for bone distraction as a method to raise additional funds. To date, no substantial interest has been shown, but exploratory talks with other candidates will continue.

The Company continues in an effort to raise additional capital (approximately \$2.5 million) to complete the development of its SafetyScan product, to introduce it to the marketplace, and to fund marketing and sales efforts aimed at increasing revenues associated with the Company's other product lines. Subsequent to September 30, 2006 the Company has raised \$505,000 toward this amount.

ITEM 3. CONTROLS AND PROCEDURES.

At the end of the period covered by this Form 10-QSB, the Company's

Edgar Filing: AcuNetx, Inc. - Form 10QSB

management, including the Chief Executive and Chief Financial Officers, conducted an evaluation of the effectiveness of the Company's disclosure controls and procedures. Based on this evaluation, the Chief Executive and Chief Financial Officers have determined that such controls and procedures are effective to ensure that information relating to the Company required to be disclosed in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. There have been no changes in the Company's internal controls over financial reporting that were identified during the evaluation that occurred during the Company's last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

-22-

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The Company is not a party to any material pending legal proceedings.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

In connection with a Placement Agency Agreement to obtain bridge financing up to \$500,000, the Company issued 500,000 shares of restricted common stock to the placement agent. The shares were valued at the closing market price on the date of agreement, which was \$0.12 per share.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

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

None

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS

- 31.1 Certification of the Company's Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934
- 31.2 Certification of the Company's Interim Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934
- 32.1 Certification of the Company's Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
- 32.2 Certification of the Company's Interim Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

-23-

Edgar Filing: AcuNetx, Inc. - Form 10QSB

SIGNATURES

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

Date: November 20, 2006

By: /s/ Terry Knapp

Terry Knapp, President