

Digitiliti Inc
Form 10-Q
November 20, 2008

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2008

TRANSITION REPORT UNDER SECTION 13 OR 15 (d) OF THE EXCHANGE ACT

For the transition period from _____ to _____

Commission File No. 000-53235

DIGITILITI, INC.

(Exact name of Registrant as specified in its charter)

Delaware
(State or Other Jurisdiction of
incorporation or organization)

26-1408538
(I.R.S. Employer Identification No.)

266 East 7th Street, 4th Floor

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St. Paul, Minnesota 55101

(Address of Principal Executive Offices)

(651) 925-3200

(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year,
if changed since last report)

Indicate by check mark whether the Registrant has (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 such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [] Yes [] No [X]

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer [] Accelerated filer [] Non-accelerated filer [] Smaller reporting company [X]

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 November 7, 2008, the Registrant had 25,527,664 shares of common stock issued and outstanding.

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Item 1. Financial Statements

DIGITILITI, INC.
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

| ASSETS | September 30, 2008 | December 31, 2007 |
|---|-------------------------------|------------------------------|
| CURRENT ASSETS | | |
| Cash | \$ 15,739 | \$ 241,333 |
| Accounts receivable, net of allowance of \$35,612 and \$26,990 | 660,443 | 292,542 |
| Prepaid and other current assets | 121,141 | 95,527 |
| TOTAL CURRENT ASSETS | 797,323 | 629,402 |
| PROPERTY AND EQUIPMENT, net of accumulated depreciation of \$1,261,972 and \$707,508 | | |
| | 1,076,291 | 1,433,482 |
| SOFTWARE LICENSE, net of accumulated amortization of \$480,096 and \$233,111 | | |
| | 1,308,454 | 1,153,999 |
| DEFERRED FINANCING COSTS, net of accumulated amortization of \$293,584 and \$77,049 | | |
| | 271,108 | 242,906 |
| Other assets | 6,322 | - |
| TOTAL ASSETS | \$ 3,459,498 | \$ 3,459,789 |
| LIABILITIES AND STOCKHOLDERS DEFICIT | | |
| CURRENT LIABILITIES | | |
| Accounts payable | \$ 210,073 | \$ 92,000 |
| Accrued expenses | 1,075,218 | 377,308 |
| Current maturities of note payable and other short-term debt | 419,709 | 45,906 |
| Current maturities of capital lease obligations | 373,442 | 687,159 |
| Current maturities of notes payable related parties | 316,728 | 301,716 |

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| | | |
|--|---------------------|---------------------|
| Current maturities of convertible debt | 2,558,869 | 1,062,631 |
| TOTAL CURRENT LIABILITIES | 4,954,039 | 2,566,720 |
| NOTE PAYABLE, net of current maturities | 292,860 | 439,094 |
| CAPITAL LEASE OBLIGATIONS, net of current maturities | 97,263 | 198,162 |
| CONVERTIBLE DEBT, net of unamortized discount of \$1,554,945 and \$1,082,629 | 1,408,580 | 1,054,290 |
| DEFERRED RENT | 20,389 | 21,153 |
| TOTAL LIABILITIES | 6,773,131 | 4,279,419 |
| STOCKHOLDERS DEFICIT | | |
| Common stock, \$.001 par value; 100,000,000 shares authorized, | | |
| 25,735,508 and 25,081,444 shares issued and outstanding | 25,735 | 25,081 |
| Additional paid-in capital | 9,174,880 | 6,206,496 |
| Accumulated deficit | (12,514,248) | (7,051,207) |
| TOTAL STOCKHOLDERS DEFICIT | (3,313,633) | (819,630) |
| TOTAL LIABILITIES AND STOCKHOLDERS DEFICIT | \$ 3,459,498 | \$ 3,459,789 |

See accompanying notes to consolidated financial statements.

DIGITILITI, INC.**CONSOLIDATED STATEMENTS OF OPERATIONS****(UNAUDITED)**

| | Three Months Ended | | Nine Months Ended | |
|---|---------------------------|----------------|--------------------------|-----------------|
| | September 30, | | September 30, | |
| | 2008 | 2007 | 2008 | 2007 |
| REVENUES | \$ 880,549 | \$ 369,209 | \$ 2,211,958 | \$ 870,559 |
| COST OF REVENUES | 242,612 | 262,219 | 609,249 | 725,510 |
| GROSS MARGIN | 637,937 | 106,990 | 1,602,709 | 145,049 |
| OPERATING EXPENSES | | | | |
| Selling and marketing | 195,692 | 152,081 | 520,815 | 620,918 |
| General and administrative | 1,122,346 | 841,085 | 2,898,055 | 1,864,142 |
| Depreciation and amortization | 279,131 | 138,779 | 801,449 | 564,782 |
| Research and development | 402,542 | 24,000 | 1,339,413 | 24,784 |
| Total Operating Expenses | 1,999,711 | 1,155,945 | 5,559,732 | 3,074,626 |
| LOSS FROM OPERATIONS | (1,361,774) | (1,048,955) | (3,957,023) | (2,929,577) |
| INTEREST EXPENSE | 643,294 | 168,203 | 1,506,018 | 283,506 |
| NET LOSS | \$ (2,005,068) | \$ (1,217,158) | \$ (5,463,041) | \$ (3,213,083) |
| NET LOSS PER SHARE BASIC AND DILUTED | \$ (0.08) | \$ (0.06) | \$ (0.22) | \$ (0.15) |
| WEIGHTED-AVERAGE SHARES OUTSTANDING | | | | |
| BASIC AND DILUTED | 25,701,388 | 21,286,026 | 25,386,626 | 20,842,521 |

See accompanying notes to consolidated financial statements.

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DIGITILITI, INC.**CONSOLIDATED STATEMENTS OF CASH FLOWS****(UNAUDITED)**

| | Nine Months Ended | |
|--|--------------------------|-----------------|
| | September 30, | |
| | 2008 | 2007 |
| OPERATING ACTIVITIES | | |
| Net loss | \$ (5,463,041) | \$ (3,213,016) |
| Adjustments to reconcile net loss to net cash used by operating activities: | | |
| Depreciation and amortization | 801,449 | 564,782 |
| Common stock issued for services | 568,149 | 525,000 |
| Amortization of deferred financing costs | 201,848 | 39,688 |
| Amortization of discount on convertible debt | 675,520 | 78,673 |
| Employee stock option expense | 910,402 | 336,989 |
| Common stock issued for purchase of R & D | 375,000 | - |
| Warrants issued for services | - | 67,872 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (367,900) | (124,715) |
| Prepaid and other current assets | (31,935) | 44,502 |
| Accounts payable | 155,766 | 150,528 |
| Accrued expenses | 697,909 | 92,986 |
| Deferred rent | (764) | 5,053 |
| Net cash used by operating activities | (1,477,597) | (1,431,658) |
| INVESTING ACTIVITIES | | |
| Purchases of property and equipment | (480,318) | (783,116) |
| Investment in Cyclone Holdings, Inc. | - | (175,000) |
| Net cash used by investing activities | (480,318) | (958,116) |
| FINANCING ACTIVITIES | | |
| Proceeds from issuance of convertible debt | 2,480,370 | 2,298,550 |
| Financing costs | (230,050) | (229,855) |
| Payments on capital lease obligations | (533,011) | (296,488) |
| Proceeds from note payable related party | 25,012 | - |
| Payments on notes payable related party | (10,000) | (40,598) |
| Payment on stock rescission | - | (105,000) |
| Proceeds from sales of common stock | - | 755,393 |

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| | | |
|---|------------|------------|
| Net cash provided by financing activities | 1,732,321 | 2,382,002 |
| NET DECREASE IN CASH | (225,594) | (7,772) |
| CASH | | |
| Beginning of year | 241,333 | 188,670 |
| End of year | \$ 15,739 | \$ 180,898 |

See accompanying notes to consolidated financial statements.

DIGITILITI, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' DEFICIT

(UNAUDITED)

| | Common Stock | | Additional | | Stockholders Deficit |
|--|---------------------|---------------|----------------------------|--------------------------------|---------------------------------|
| | Shares | Amount | Paid-in Capital | Accumulated Deficit | |
| Balances at December 31, 2007 | 25,081,444 | \$ 25,081 | \$ 6,206,496 | \$ (7,051,207) | (819,630) |
| Warrants issued in connection with convertible debt | - | - | 1,077,793 | - | 1,077,793 |
| Common stock issued for purchased R&D | 250,000 | 250 | 374,750 | | 375,000 |
| Common stock issued to settle debt | 108,004 | 108 | 161,898 | | 162,006 |
| Common stock issued for services | 219,760 | 219 | 405,467 | | 405,686 |
| Common stock issued for conversion of convertible debt | 76,300 | 76 | 38,074 | | 38,150 |
| Employee stock option compensation | | | 910,402 | | 910,402 |
| Net loss | | | | (5,463,041) | (5,463,041) |
| Balances at September 30, 2008 | 25,735,508 | \$ 25,734 | \$ 9,174,880 | \$ (12,514,248) | (3,313,634) |

See accompanying notes to consolidated financial statements.

DIGITILITI, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1.

Organization, Basis of Presentation and Significant Accounting Policies

The accompanying unaudited interim financial statements of Digitiliti, Inc. (the Company, or Digitiliti, and we, our us and words of similar import) have been prepared in accordance with accounting principles generally accepted in the United States of America and rules of the Securities and Exchange Commission, and should be read in conjunction with the audited financial statements and notes thereto contained in Digitiliti's audited financial statements for the year ended December 31, 2007, and its registration statement on Form 10 filed with the Securities and Exchange Commission on May 13, 2008 (the Registration Statement) and amended on August 13, 2008. In the opinion of management, all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of financial position and the results of operations for the interim periods presented have been reflected herein. The results of operations for interim periods are not necessarily indicative of the results to be expected for the full year. Notes to the consolidated financial statements, which would substantially duplicate the disclosure contained in the audited financial statements, included in Digitiliti's Registration Statement, have been omitted.

Certain prior year amounts have been reclassified to conform with the current year presentation.

The Company and Nature of Operations

Digitiliti began operations in 2004 and provides secure online data storage solutions to companies in the United States and Canada. The Company is also developing software products to offer data storage solutions for Apple networks and to other small, medium and enterprise level markets.

New Accounting Pronouncements

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*, as amended in February 2008 by FASB Staff Position (FSP) FAS 157-2, *Effective Date of FASB Statement No. 157*. SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. FSP FAS 157-2 defers the effective date of SFAS 157 for all nonfinancial assets and liabilities, except those items recognized or disclosed at fair value on an annual or more frequently recurring basis, until January 1, 2009. As such, the Company partially adopted the provisions of SFAS 157 effective January 1, 2008. The partial adoption of this statement did not have a material impact on our financial statements. We expect to adopt the remaining provisions of SFAS 157 beginning in 2009. We do not expect this adoption to have a material impact on our financial statements.

In February 2007, FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities including an Amendment of FASB Statement No. 115*. This standard permits an entity to choose to measure many financial instruments and certain other items at fair value. Most of the provisions in SFAS 159 are elective; however the amendment to SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, applies to all entities with available-for-sale securities. The fair value option established by SFAS 159 permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity will report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option: (a) may be applied instrument by instrument, with a few exceptions, such as investments otherwise accounted for by the equity method; (b) is irrevocable (unless a new election date occurs); and (c) is applied only to entire instruments and not to portions of instruments. We have adopted this statement as of January 1, 2008. The adoption created no impact to our financial statements.

2.

Going Concern

The accompanying condensed consolidated financial statements for the nine months ended September 30, 2008, and 2007, have been prepared assuming that the Company will continue as a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business.

As shown in the accompanying financial statements, we have incurred a net loss of \$5,463,041 for the nine months ended September 30, 2008. In addition, we have an accumulated deficit of \$12,514,248 and a working capital deficit of \$4,156,716 as of September 30, 2008. Further, \$2,558,869 of our convertible debt is due within the next 12 months. These conditions raise substantial doubt as to our ability to continue as a going concern.

We continue to be dependent on our ability to generate future revenues, positive cash flows and additional financing.

DIGITILITI, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Management acknowledges that its ability to continue executing its current business plan, even on a short-term basis, is dependent on its ability to obtain additional debt or equity financing. There can be no guarantee that the Company will be successful in generating future revenues, in obtaining additional debt or equity financing or that such additional debt or equity financing will be available on terms acceptable to the Company.

3.

Acquisition of Software

On March 13, 2008, Digitiliti executed a Technology Purchase Agreement (TPA) with StorageSwitch, LLC, a Colorado limited liability company (StorageSwitch), to acquire a commercially-proven technology software. This technology software compliments Digitiliti s current business model and also provides a base layer that Digitiliti will build upon to develop enhanced storage service offerings.

In connection with the purchase, we made initial cash payment of \$10,000 upon execution of the Letter of Intent in January 2008, and a cash payment of \$200,000 on the date of closing. In addition, we will make a \$40,000 cash payment payable when the software is fully developed and in production. We also issued 250,000 shares of common stock in connection with the purchase, valued at \$375,000 based upon the quoted market price of our stock on the date of the purchase. We will issue an additional 250,000 shares when the software is fully developed and in production. These shares will be valued based on the quoted market price of our stock on the date of issuance.

The software was not technologically feasible on the date of the acquisition. As a result, this transaction was accounted for as purchased research and development costs and was expensed as research and development expense in accordance with SFAS No. 2.

In conjunction with the execution of the TPA, Digitiliti and StorageSwitch also signed the following agreements; (1) a Non-Compete Agreement, (2) a Non-Disclosure Agreement, (3) a Statement of Work Agreement and (4) a Consulting Services Agreement. Under the Consulting Service Agreement, up through August 1, 2008, we will make the following payments to two principals of StorageSwitch: (1) semi-monthly cash payments of \$6,250 (totaling \$25,000 per month) and (2) the issuance of 12,480 shares of Digitiliti common stock (totaling 24,960 share of common stock per month). Stock issued under this arrangement is accounted for in accordance with EITF 96-18 and valued using the quoted market price of our common stock at the end of each month.

4.

Employee Stock Options, Warrants and Restricted Stock Awards

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In April 2008, the Company amended and restated its Certificate of Incorporation to add a class of preferred stock with 10,000,000 shares authorized at a par value of \$0.001 per share.

In April 2008, the Board of Directors approved a modification of the Company's Stock Option Plan increasing the total number of shares from 4,000,000 shares of common stock to 9,000,000 shares reserved for issuance.

In April 2008, under the approved modification of the Company's Stock Option Plan mentioned above, the Board of Directors approved the issuance of 3,900,000 stock options to new and existing employees and cancelled 525,000 options upon an employee's termination. The additional 3,900,000 stock options have a weighted average exercise price of \$0.38 per share. During the nine months ended September 30, 2008, no options were exercised, and the Company recognized \$464,268 of compensation expenses related to employee stock options.

The following table summarizes employee stock options issued and outstanding:

| | Options | Weighted average exercise price | Aggregate intrinsic value | Weighted average remaining contractual life (years) |
|-----------------------------------|-----------|--|---------------------------------|---|
| Outstanding at December 31, 2007 | 3,441,000 | \$ 0.37 | \$ - | |
| Granted | 3,900,000 | 0.38 | | |
| Exercised | - | - | | |
| Forfeited | (735,500) | 0.35 | | |
| Expired | - | - | | |
| Outstanding at September 30, 2008 | 6,605,500 | \$ 0.37 | \$ - | 4.48 |

DIGITILITI, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

On September 30, 2008, we had \$2,781,654 of unamortized employee stock option expense, which will be recognized through May 2011.

The following table summarizes stock warrants issued and outstanding:

| | Warrants | Weighted average exercise price | Aggregate intrinsic value | Weighted average remaining contractual life (years) |
|-----------------------------------|-----------|--|---------------------------------|---|
| Outstanding at December 31, 2007 | 3,536,148 | \$ 1.75 | \$ - | |
| Granted | 2,300,450 | 1.88 | | |
| Exercised | - | - | | |
| Forfeited | - | - | | |
| Expired | - | - | | |
| Outstanding at September 30, 2008 | 5,836,598 | \$ 1.80 | \$ - | 3.88 |

During the nine months ended September 30, 2008, the Company issued 250,000 shares of common stock in connection with the purchase of software and 149,760 shares of common stock for services provided in connection with the purchased software.

The software was classified as research and development and the cost was expensed on the date of purchase in accordance with SFAS No. 2. The cost of the software included the fair value of the common stock issued in connection with the purchase. The value of the stock was based on the quoted stock price on the date of the acquisition.

5.

Convertible Debt

During the nine months ended September 30, 2008, we issued \$2,300,450 in convertible debt, together with 1,150,225 warrants with an exercise price of \$1.50 and 1,150,225 warrants with an exercise price of \$2.25. During the nine months ended September 30, 2008, we recorded \$1,077,794 as a discount to the convertible debt related to the issuance of the warrants, which is being amortized using the effective interest rate over the term of the convertible debt. In addition, we incurred additional financing costs of \$230,050, which was capitalized as deferred financing cost and is also being amortized using the effective interest method over the 18-month term of the convertible debt. During the nine months ended September 30, 2008, and 2007, we recorded \$201,848 and \$39,688, respectively, of deferred financing cost amortization.

The following summarizes the financial presentation of our convertible debt at September 30, 2008, and December 31, 2007:

| | September 30, 2008 | December 31, 2007 |
|-------------------------------------|-----------------------------------|------------------------------|
| Face value of convertible debt | 5,465,000 | \$ 3,199,550 |
| Adjustments: | | |
| Discount for warrants issued | (2,338,206) | (1,260,412) |
| Amortization of debt discount | 852,341 | 177,783 |
| Conversion of debt, net of discount | (11,686) | |
| Convertible notes balance, net | 3,967,449 | \$ 2,116,921 |

DIGITILITI, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

6.

Supplementary Disclosures of Cash Flow Information

Additional cash flow information consisted of the following:

| Nine Months Ended September 30 , | 2008 | 2007 |
|---|-------------|-------------|
| | | \$ |
| Cash paid for interest | \$ 70,086 | 5,676 |
| Cash paid for taxes | - | - |
| Noncash financing and investing activities: | | |
| Conversion of debt to equity | \$ 38,150 | \$ - |
| Stock issued for Cyclone merger | - | 525,000 |
| Discount on convertible debt | 1,077,793 | 81,687 |

7.

Subsequent Events

On October 13, 2008, we completed our \$5,500,000 Second Bridge Loan Offering.

On October 13, 2008, the Board of Directors approved the offer and sale of a \$250,000 Convertible Note. The proceeds of this note will be used to supplement new product development cost and working capital. To facilitate the offering, Jonathon S. Miner, a director of the Company, guaranteed the repayment of this convertible note. In return, Mr. Miner received 100,000 warrants exercisable at \$.50 per share. The term of the warrants is five years.

On October 13, 2008, the Board of Directors accepted the resignation of Larry D. Ingwersen as director and Chief Executive Officer/President of the Company, along with the resignation of Roderick D. Johnson as Chief Operating Officer. Subsequently, the Board approved the termination of the Consulting Services Agreement between 5X Partners and the Company. Of the aggregate total of 2,850,000 stock options granted Messrs. Ingwersen and Johnson, at the time of their resignations, each party had 356,250 vested stock options, respectively. Mr. Ingwersen and Mr. Johnson forfeited the remaining 2,137,500 unvested stock options on termination of the Consulting Services Agreement, and the forfeited stock options will be returned to the Stock Option Plan for reissuance by the Board thereunder.

At this meeting, the Board approved the election of Daniel J. Herbeck as Chief Executive Officer/President, as well as Director of the Company.

In addition, the Board accepted the resignation of Laura Wenzel as a Board member of the Company and approved the elections of Roy A. Bauer and Benno G. Sand as Board members of the Company.

During October of 2008, two employees left the Company prior to full vesting of their respective stock options. Under the terms of the Company's Stock Option Plan, their unvested stock options totaling 183,065 will be forfeited and returned to the Stock Option Plan for reissuance by the Board thereunder.

Item 2. Management's Discussions and Analysis of Financial Condition and Results of Operations.

Forward-looking Statements

Statements made in this Quarterly Report which are not purely historical are forward-looking statements with respect to the goals, plan objectives, intentions, expectations, financial condition, results of operations, future performance and our business, including, without limitation, (i) our ability to raise capital, and (ii) statements preceded by, followed by or that include the words may, would, could, should, expects, projects, anticipates, believes, plans, intends, targets or similar expressions.

Forward-looking statements involve inherent risks and uncertainties, and important factors (many of which are beyond our control) that could cause actual results to differ materially from those set forth in the forward-looking statements, including the following: general economic or industry conditions, nationally and/or in the communities in which we may conduct business, changes in the interest rate environment, legislation or regulatory requirements, conditions of the securities markets, our ability to raise capital, changes in accounting principles, policies or guidelines, financial or political instability, acts of war or terrorism, other economic, competitive, governmental, regulatory and technical factors affecting our current or potential business and related matters.

Accordingly, results actually achieved may differ materially from expected results in these statements. Forward-looking statements speak only as of the date they are made. We do not undertake, and specifically disclaim, any obligation to update any forward-looking statements to reflect events or circumstances occurring after the date of such statements.

Plan of Operation

Our current business focuses on providing a cost effective data protection solution to the small to medium business (SMB) and small to medium enterprise (SME) markets. This data protection solution is geared specifically to help organizations properly manage and protect their entire network from one centralized location, with offsite redundancy. Our solution can backup and restore data on every machine in a network, including desktops, laptops, file and print servers.

We are dedicated to developing and delivering superior storage technologies and methodologies that will enable our customers to manage and protect massive data growth with ease. We combine a powerful, agent-less backup software with our remote Fortress Storage Center to deliver to our customers a powerful and effective online-offsite data backup and restore solution. We provide storage from a utility based computing philosophy, whereby customers pay only for the gigabytes of data they store in our Fortress Storage Center.

Our facilities allow us to provide offsite disaster recovery with an emphasis on intraday protection and restore for all our customers primary data centers and geographically dispersed offices or campus settings. Our Fortress Storage Center is located in the base of the former Minneapolis Federal Reserve Bank. It is a one of a kind facility that provides our web based on-demand backup/restore service (digitiliti) with all the benefits of direct fiber access to a Level 5 data center. The Fortress Storage Center has 24/7 onsite physical security, including security guards, motion detectors, security cameras, card-key access, separate cages with individual locking cabinets and ladder racking. It also has battery generator back up power, temperature and humidity controls and fire suppression systems.

Our primary focus for fiscal 2008 is increasing the number of customers using our digitiliti services. We will aggressively promote the benefits of secure, online data storage and highlight the discernible differences between digitiliti and other solutions available in the marketplace.

We will be seeking other distribution channels of our services, in addition to our in-house sales group. We will be targeting resellers that have extensive data storage knowledge and expertise and an established customer base. Our sales plan for 2008 focuses on establishing strong reseller and OEM and channel partnerships at the regional and national level that possess utility-oriented sales systems. Regional and national level partners will become our sales force. We will define and attack vertical markets specifically in the SMB/SME market. Our ability to provide outstanding training and support utilizing teleconferencing will allow us to develop a national distribution network without incurring significant support and travel costs. We will also provide our sales partners with marketing and technical material to assist their sales efforts. These marketing efforts will include development of brochures, testimonials, white papers, trade journal advertising and enhancements to our website, as well as attending a number of trade shows and speaking engagements, both locally and nationally, which will also assist in building the digitiliti brand. Finally, our sales and technical staff will be available to assist with sales opportunities as appropriate.

We have invested significant resources in 2008 to expand our digitiliti product offering by developing a new generation of leading edge software. Our new product, Pyramid, represents a significant step toward our goal to become a technology leader in the data information management marketplace. The Pyramid product is entering beta testing in Q4 with a product launch targeted for the first part of next year. This represents a delay in product release originally anticipated for Q3, 2008, due to changes in the scope of work on this product that were not anticipated and a delay in the funding required to complete development. The process of refining our digitiliti products, our sales and marketing systems, our product packaging, our infrastructure scaling methods and revenue generation offerings are well underway. We will focus on product positioning and building solid partnerships with a goal of increasing market share as well as reducing our cost of goods sold.

As a result of our sales and marketing efforts in our existing product, Pharoah, our customer base has expanded from approximately 20 in fiscal 2005; to approximately 100 in fiscal 2006; to 508 in 2007; and as of November 7, 2008, to approximately 722. Correspondingly, our annual sales have increased from \$402,638 in 2006, to \$1,329,386 in 2007 and now are now estimated to surpass \$3,000,000 by 2008 year end. This reflects an average monthly revenue exceeding \$300,000. Despite the significantly improved cash flows provided by the increased sales, the Company is experiencing and anticipates cash flow shortages resulting from new product development, product launch and potential convertible debt repayment needs.

The Company has been aggressively taking steps to reduce overall operating costs as we conserve cash. We have reduced personnel costs by 35% and gained additional efficiencies in product delivery resulting in a 10% reduction in our costs of goods sold. Further, we have reduced our contract development staff thereby reducing development expenditures by an additional 40% per month. This will not significantly impact the introduction of the Pyramid product in 2009. We continue to seek additional opportunities for operating cost reductions, while managing new product introduction timelines.

In addition, we are evaluating other opportunities to raise additional capital by pursuing strategic alternatives including, but not limited to: equity, debt, asset sales and lease restructure. To facilitate a 2009 roll-out of our new Pyramid product, we estimate funds required in the range between \$3 million and \$5 million. As a result of our cost containment initiatives, this reflects a \$2 million reduction in funds required to roll-out the new product and support 2009 operations.

Our increase in customer count and overall sales have been funded, in large part, through our \$5.5 million offering of 12% convertible notes initiated in March 2007. These convertible notes reflected a \$0.50 per share conversion rate upon expiration of an 18-month maturity date, currently resulting in principal and accrued interest as detailed below:

| Periods | Total convertible notes issued | Total accrued interest on convertible | Total accrued interest and convertible | Due date for accrued interest and convertible |
|---------|--------------------------------|---------------------------------------|--|---|
|---------|--------------------------------|---------------------------------------|--|---|

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| | | notes | notes | notes for Qtr. Ended |
|---------|------------|-----------|------------|-------------------------|
| Q1 2007 | \$ 401,050 | \$ 80,298 | \$ 481,346 | September 2008 |
| Q2 2007 | 707,500 | 123,384 | 830,884 | December 2008 |
| Q3 2007 | 1,165,000 | 170,165 | 1,335,165 | March 2009 |
| Q4 2007 | 926,000 | 114,977 | 1,040,977 | June 2009 |
| Q1 2008 | 808,500 | 66,598 | 872,098 | September 2009 |
| Q2 2008 | 945,500 | 54,651 | 1,000,151 | December 2009 |
| Q3 2008 | 546,450 | 15,924 | 562,374 | March 2010 |

Total

At this time, we are implementing an action plan of approaching our convertible note holders to request a restructuring of this debt through an extension of the due dates of their respective convertible notes or to encourage them to convert their respective convertible notes. Although there is no guarantee that our note holders will agree to either of these two options, recent communications with a number of convertible note holders has indicated an overall willingness by some note holders to extend or convert their convertible note. However, if we are unable to restructure this debt, we may not be able to pay the convertible notes that are due and become due, with accrued interest. This would have a substantial adverse impact on our ability to continue our business operations.

We are also working on positioning Mythos, an internally developed storage solution for the MAC Market. Mythos has not been brought to market. We are considering several options for Mythos, including but not limited to outright sale of the software or exclusive licensing.

Results of Operations

For the three month periods ended September 30, 2008, and 2007

Our sales for the September 30, 2008, quarter increased \$511,340 to \$880,549 compared to \$369,209 for the quarter ended September 30, 2007. The increase in revenue is a direct result of an increase in customers under contract and the resulting terabytes of data added to our Fortress Storage Center, combined with the growth in existing customer data. Consistent with this pattern of growth, our customer base grew from 243 as of September 30, 2007 to 720 as of September 30, 2008. The growth of customer contracts is a direct result of the heavy emphasis we have placed on marketing our digitiliti service. Our efforts included attending industry tradeshow throughout the country, as well as revamping our website. We also concentrated significant resources refining our product presentation, product positioning and pricing models. Finally, we continued to enhance our network of resellers throughout the country by providing strong dealer support services and offering a compelling pricing program.

Our quarterly gross margin reflects an increase of \$530,947 with a gross margin of \$637,937 through September 30, 2008, versus \$106,990 through September 30, 2007. Factors contributing to this increase in our gross margin are our deliberate targeting of a larger profile customer, which resulted in (1) more efficient customer pricing; (2) a significant increase or growth in customer base; and (3) an increase in organic growth of our customer's data. In short, we have learned that our sales and marketing efforts are better expended targeting larger customers in the SMB and SME markets. We have learned how to sell our Digitiliti service to this larger profile customer, who has increased our revenue, proportionately reduced our costs of revenue and has allowed us to leverage our infrastructure and efficiently bill for our customer's data growth in our Fortress Storage Center vault.

Research and development expenses increased from \$24,000 to \$402,542 during the quarterly periods ended September 30, 2007, and 2008, respectively. This significant increase reflects our efforts in new product development as we learn from the successes of our digitiliti service. We are also in the process of developing enhanced storage service offerings that we can deploy through larger, more economical sales channels, thereby enabling faster growth.

Selling and marketing expenses increased to \$195,692 from \$152,081 for the quarterly periods ended September 30, 2008, and 2007, respectively, reflecting an increase of \$43,611. This decrease principally reflects our success in learning to market our digitiliti service to resellers who have the requisite expertise to produce immediate results. Again, we have not only learned to market our digitiliti service to larger profile customers, but also to larger profile and more technically proficient resellers, thereby resulting in increased sales with fewer (or more efficient) marketing expenditures.

General and administrative expenses increased by \$281,261 to \$1,122,346 compared to \$841,085 during the quarterly periods ended September 30, 2008, and 2007, respectively. This increase is attributable to consulting fees, stock-based compensation, legal and accounting expense associated with completing the reverse merger between us and Storage Elements, Inc., a Minnesota corporation (Storage and the Storage Merger), upgrading the financial information in preparation for Securities and Exchange Commission anticipated filings and the issuance of convertible debt with associated warrants.

Interest expense during the quarter ended September 30, 2008, increased by \$475,091 to \$643,294, compared to \$168,203 for the quarter ended September 30, 2007. The increase reflects interest expense associated with the convertible debt issued during the quarter ended September 30, 2007, versus interest expense associated with convertible debt issued during the quarter ended September 30, 2008, along with the related amortization of the deferred financing costs and discount of the associated warrants.

For the nine month periods ended September 30, 2008, and 2007

Our sales through September 30, 2008, increased \$1,341,399 to \$2,211,958 compared to \$870,559 through the nine months ended September 30, 2007. The increase in revenue is a direct result of an increase in customers under contract and the resulting terabytes of data added to our Fortress Storage Center, combined with the growth in existing customer data. Consistent with the pattern of growth as detailed above, our customer base grew from 243 as of September 30, 2007, to 720 as of September 30, 2008. The growth of customer contracts is a direct result of the heavy emphasis we placed on

marketing our digitiliti service. Our efforts included attending industry tradeshow throughout the country as well as revamping our website. We also concentrated significant resources refining our product presentation, product positioning and pricing models. Finally, we continued to enhance our network of resellers throughout the country by providing strong dealer support services and offering a compelling pricing program.

Our quarterly gross margin reflects an increase of \$1,457,660 with a gross margin of \$1,602,709 through September 30, 2008, versus 145,049 through September 30, 2007. Factors contributing to this increase in our gross margin are outlined above under the discussion of our Results of Operations for the three months ended September 30, 2008, and 2007.

Research and development expenses increased from \$24,784 to \$1,339,413 during the nine months ended September 30, 2007, and 2008, respectively. This significant increase reflects our efforts in new product development as we learn from the successes of our digitiliti service and our current process of developing enhanced storage service offerings that we can deploy through larger, more economical sales channels, thereby enabling faster growth.

Selling and marketing expenses decreased to \$520,815 from \$620,918 for the nine months ended September 30, 2008, and 2007, respectively, reflecting a decrease of \$100,103. This decrease principally reflects our success in learning to market our digitiliti service to resellers who have the requisite expertise to produce immediate results. Again, we have not only learned to market our digitiliti service to larger profile customers, but also to larger profile and more technically proficient resellers, thereby resulting in increased sales with fewer (or more efficient) marketing expenditures.

General and administrative expenses increased by \$1,033,913 to \$2,898,055 compared to \$1,864,142 during the nine months ended September 30, 2008, and 2007, respectively. This increase is attributable to consulting fees, stock-based compensation, legal and accounting expense associated with completing the Storage Merger, upgrading the financial information in preparation for Securities and Exchange Commission anticipated filings and the issuance of convertible debt with associated warrants.

Interest expense during the nine months ended September 30, 2008, increased by \$1,222,512 to \$1,506,018, compared to \$283,506 for the nine months ended September 30, 2007. The increase reflects interest expense associated with the convertible debt issued during the six months ended September 30, 2007, versus interest expense associated with convertible debt issued during the nine months ended September 30, 2008, together with the related amortization of the deferred financing costs and discount of the associated warrants.

Liquidity

Our liquidity is dependent, in the short term, on proceeds from newly issued debt and the sale of our common stock for cash. In the long term, we need to continue expanding our capacity of the Fortress Storage Center by investing in property and equipment and software licenses. During the year ended December 31, 2007, we received proceeds of \$3,149,550 and \$755,393, respectively, from the issuance of convertible debt securities and the sale of common stock.

For the nine month periods ended September 30, 2008, and 2007

During the nine months ended September 30, 2008, we received proceeds of \$2,505,382 from a note payable and the issuance of convertible debt securities, which funded our cash used in operations of \$1,477,597 and investments in property and equipment.

Net cash used by operating activities during the first nine months of 2008 was \$1,477,597 compared to \$1,431,658 during the third quarter of 2007. Net cash used by operating activities during the nine months ended September, 30 2008, was primarily impacted by:

.

Net loss of (\$5,463,041).

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Depreciation and amortization of \$801,449.

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Amortization of discount on convertible debt issued of \$675,520.

.

Increase in accounts receivable of \$367,900.

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Increase in accounts payable and accrued expenses of \$910,402.

Net cash used by operating activities during the nine months ended September, 30 2007, was primarily impacted by:

.

Net loss of (\$3,213,016).

.

Depreciation and amortization of \$564,782.

.

Increase in trade accounts payable and accrued expenses of \$243,514.

Net cash used by investing activities during the first nine months of 2008 was \$480,318, primarily related to the purchase of software licenses totaling \$78,868 and equipment of \$401,450. Net cash used by investing activities during the first nine months of 2007 was \$958,116 and was comprised of \$783,116 for equipment and software license purchases and \$175,000 for investment in Cyclone Holdings, Inc. (now the Registrant), which was acquired by Storage to complete the Storage Merger.

Net cash provided by financing activities during the first nine months of 2008 was \$1,732,321 primarily comprised of \$2,480,370 from the issuance of convertible debt and from a note payable. Offsetting these items were \$230,050 in payments of financing costs and \$533,011 in principal payments on capital leases. Net cash provided by financing activities during the first nine months of 2007 was \$2,382,002, primarily comprised of \$755,393 from the sale of common stock, \$2,298,550 from the sale of convertible securities and \$329,460. Offsetting these items were \$296,488 in principal payments on capital leases, \$229,855 in payments of financing costs.

At September 30, 2008, our cash balance was \$15,739 compared to \$180,898 at June 30, 2007.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

As a smaller reporting company, we are not required to provide disclosure under this Item 3.

Item 4T. Controls and Procedures.

Evaluation of disclosure controls and procedures

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control system is intended to provide reasonable assurance to our management and board of directors regarding the preparation and fair presentation of published financial statements and that we have controls and procedures designed to ensure that the information required to be disclosed by us in our reports that we will be required to file under the Exchange Act is accumulated and communicated to our management, including our principal executive and our principal financial officers or persons performing similar functions, as appropriate to allow timely decisions regarding financial disclosure.

Management's current assessment of the effectiveness of our internal controls is based principally on our financial reporting as of December 31, 2007, and 2006, and the quarterly periods ended September 30, June 30, 2008, and March 31, 2008. In making our assessment of internal control over financial reporting, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control Integrated Framework.

Accordingly, our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, as of the date of this Quarterly Report. Based on such evaluation of the above referenced periods, due to the material weaknesses in our internal controls over financial reporting further described below, our Chief Financial Officer concluded that such disclosure controls and procedures were not effective in providing reasonable assurance that information required to be disclosed by us in the reports we file under the Exchange Act were recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commissions rules, regulations and forms.

For the periods referenced above, management's assessment identified material deficiencies in our internal control over financial reporting. These deficiencies include lack of segregation of duties, lack of adequate documentation of our system of internal control, deficiencies in our information technology systems, limited capability to interpret and apply United States generally accepted accounting principles and lack of formal accounting policies and procedures and related documentation.

Management's efforts to resolve these internal control weaknesses started with the hiring of a full-time Controller on October 1, 2007. In April 2008, our Board of Directors approved this person's promotion to Chief Financial Officer.

Beginning in October 2007, management prepared a written review of every facet of our information processing system, like cash disbursements, sales and billing, cash receipts and other procedures. We continue to evaluate and address these weaknesses to ensure adherence to written policy, completeness of reporting, segregation of incompatible duties and compliance with generally accepted accounting principles; and we intend to continue to monitor and evaluate these and other factors affecting our internal controls.

It is management's intent to correct all identified material deficiencies in our internal controls as reported in previous periods. Until such time, our internal control over financial reporting may be subject to additional material weaknesses and deficiencies that we have not yet identified. Management has determined that these significant deficiencies, in the aggregate, constitute material weaknesses in the design and operation of our internal controls in effect prior to December 31, 2007, and 2006, and for the quarterly period ended September 30, 2008. We continue to address and evaluate these issues.

Our former auditors have advised us of certain other material weaknesses and significant deficiencies in our internal controls in connection with auditing our consolidated financial statements for the years ended December 31, 2007, and 2006, including, in summary: (i) lack of accounting expertise, with recommended additional training for our CFO; (ii) issues regarding reimbursement of unsubstantiated expenses; (iii) segregation of duties of accounting functions among various personnel; (iv) segregation of cash distribution responsibilities; (v) establishment of initial control over cash receipts; (vi) material weaknesses on preparation of our consolidated financial statements; and (vii) the establishment of an audit committee. We are also addressing these concerns.

Our current costs to remediate our material weaknesses in internal controls include the increase in salary of a full-time CFO at an annual cost of approximately \$4 0,000 more than our former part-time chief accounting officer, together with substantial time and expense of other employees involved in addressing these issues. Future costs will include fees and costs associated with attendance at seminars and other programs by our CFO and certain employees relative to recognizing and resolving these types of issues.

Changes in internal control over financial reporting

Except as indicated in the preceding paragraph about management's evaluation of disclosure controls and procedures, our management, with the participation of our chief executive officer and chief financial officer, has concluded there were no significant changes in our internal controls over financial reporting that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

None; not applicable.

Item 1A. Risk Factors.

Not required; however, various risk factors about us and our business prospects and products is contained in Item 1A of our Form 10 Registration Statement that was filed with the Securities and Exchange Commission on or about August 13, 2008, all of which are still applicable to us.

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

During the three months ended September 30, 2008, we issued 62,400 shares of our common stock for services provided in connection with the purchased software.

During the three months ended September 30, 2008, we issued 70,000 shares of common stock for services provided in connection with a public relations initiative.

During the three months ended September 30, 2008, we issued \$546,450 in convertible debt, along with 273,225 warrants with an exercise price of \$1.50 and 273,225 warrants with an exercise price of \$2.25.

We issued all of these securities to persons who were accredited investors as those terms are defined in Rule 501 of Regulation D of the Securities and Exchange Commission; and each such person had prior access to all material information about us. We believe that the offer and sale of these securities were exempt from the registration requirements of the Securities Act, pursuant to Sections 4(2) and 4(6) thereof, and Rule 506 of Regulation D of the Securities and Exchange Commission. Registration of sales to accredited investors are preempted from state regulation, though states may require the filing of notices, a fee and other administrative documentation like consents to service of process and the like.

Item 3. Defaults Upon Senior Securities.

None; not applicable.

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

None; not applicable.

Item 5. Other Information.

None; not applicable.

Item 6. Exhibits.

| Exhibit No. | Identification of Exhibit | |
|--------------------|---|----------------------------|
| 3.1 | Initial Certificate of Incorporation filed March 31, 2006. | Exhibit to our Form 10 |
| 3.2 | Bylaws. | Exhibit to our Form 10 |
| 3.3 | Certificate of Amendment regarding the name change to Digitiliti, inc. and the Recapitalization. | Exhibit to our Form 10 |
| 3.4 | Certificate Correction regarding the name change to Digitiliti, Inc. | Exhibit to our Form 10 |
| 3.5 | Amended and Restated Certificate of Incorporation filed May 13, 2008. | Exhibit to our Form 10 |
| 10.1 | Stock Purchase Agreement between Storage and our former principal shareholders under which Storage acquired a controlling interest in us. | Exhibit to our Form 10 |
| 10.2 | Agreement and Plan of Merger between us, Themescapes and Bulldog under which we became a holding company. | Exhibit to our Form 10 |
| 10.3 | Agreement and Plan of Merger, as amended, between us, Cyclone Acquisition and Storage under which Storage became our wholly-owned subsidiary. | Exhibit to our Form 10 |
| 10.4 | XO Communications Contract. | Exhibit to our Form 10 |
| 10.5 | FRM Associates Lease, as amended. | Exhibit to our Form 10 |
| 10.6 | EBC Minneapolis, Inc. Sublease Agreement. | Exhibit to our Form 10 |
| 10.7 | Upper Corner Venture, LLC Lease Agreement. | Exhibit to our Form 10 |
| 10.8 | M2 Consulting Agreement of May 2006, with Addendums. | Exhibit to our Form 10 |
| 10.9 | M2 Consulting Agreement of April 2007. | Exhibit to our Form 10 |
| 10.10 | 5X Partners Corporate Development Services Agreement with Addendums. | Exhibit to our Form 10 |
| 10.11 | StorageSwitch Consulting Services Agreement. | Exhibit to our Form 10 |
| 10.12 | StorageSwitch Non-Compete Agreement. | Exhibit to our Form 10 |
| 10.13 | StorageSwitch Technology Purchase Agreement. | Exhibit to our Form 10 |
| 10.14 | Vision to Practice, Inc. Development Services Agreement. | Exhibit to our Form 10 |
| 10.15 | Form of 12% Convertible Note. | Exhibit to our Form 10/A-2 |
| 10.16 | Form of A Warrant for 12% Convertible Note Offering. | Exhibit to our Form 10/A-2 |
| 10.17 | Form of B Warrant for 12% Convertible Note Offering. | Exhibit to our Form 10/A-2 |
| 10.18 | Letter Agreement with M2 of June, 2008. | Exhibit to our Form 10/A-2 |
| 16.1 | Letter of Auditors regarding termination. | Exhibit to our Form 10/A-2 |

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|------|--|------------------------|
| 21 | Subsidiaries. | Exhibit to our Form 10 |
| 31.1 | 302 Certification of CEO, Larry D. Ingwersen | |
| 31.2 | 302 Certification of CFO, William McDonald | |
| 32 | 906 Certification | |
| 99.1 | Digitiliti, Inc. Stock Option Plan. | Exhibit to our Form 10 |

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SIGNATURES

Pursuant to the requirements 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

Digitiliti, Inc.

Date: November 19, 2008

*By: /s/Daniel J. Herbeck
Daniel J. Herbeck, President, CEO and Director*

Date: November19, 2008

*By: /s/William McDonald
William McDonald, CFO/Treasurer*