VIRTRA SYSTEMS INC
Form 10KSB
April 17, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-KSB

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

For the Fiscal Year Ended December 31, 2006

or

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

For the transition period from _____________ to _____________

Commission File Number 000-28381

VIRTRA SYSTEMS, INC.

(Exact name of Registrant as specified in its Charter)

Texas	93-1207631
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
2500 City West Blvd, Suite 300, Houston, TX	77042
(Address of principal executive offices)	(Zip Code)

(817) 261-4269

(Registrant's telephone number, including area code)

Securities registered under Section 12(b) of the Exchange Act:

None

Securities registered under Section 12(g) of the Exchange Act:

Common Stock, par value $.005 per share

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. |__|

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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. |X| Yes |__| No

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. |X|

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

|__| Yes |X| No

The aggregate market value of the voting stock held by non-affiliates of Registrant at March 15, 2007 was approximately $3,878,901. The number of shares of Registrant's common stock outstanding on March 15, 2007 was 96,972,540. Revenue for the most recent fiscal year was $1,887,768.

Transitional Small Business Disclosure Format (Check one): |__| Yes; |X| No

Part I

Item 1. Description of Business

BUSINESS OVERVIEW

Our principal business began in 1993 with the organization of Ferris Productions, Inc. Ferris designed, developed, distributed, and operated virtual reality products for the entertainment, simulation, promotion, and education markets. Virtual reality is a generic term associated with computer systems that create a real-time visual/audio/haptic (touch and feel) experience. Virtual reality immerses participants into a three-dimensional real-time synthetic environment generated or controlled by one (or several) computer(s).

Since September, 2001 when Ferris Production, Inc. merged with GamCom, Inc. to ultimately become VirTra Systems, Inc., we have directed our efforts away from the historical areas of application in the entertainment/amusement arenas of business and toward the *immersive virtual reality*™ line of products that are computer based and that allow participants to experience, view and manipulate graphical representations of physical reality. Stimulating the senses of sight, sound, touch, and smell simultaneously, our virtual reality devices envelop the participant in dynamic filmed or computer-generated imagery, and allow the participant to interact with what he or she sees using simple controls and body motions. Virtual reality products have traditionally employed head-mounted displays that combine high-resolution miniature image source monitors, wide field-of-view optics, and tracking sensors in a unit small and light enough to be worn on the head. These products usually surround the participant with dynamic three-dimensional imagery, allowing the user to change perspective on the artificial scenes by simply moving his or her head. Virtual reality devices have in the past been used primarily in connection with electronic games, as, by surrounding the player with the sights, sounds, and smells he or she would experience in the real world, play is made far more realistic than it would be if merely presented in a two-dimensional flat screen display. Our emphasis is on the advertising/promotion, and training/simulation markets.

In 2003, we made the strategic decision to take our 360-degree core technology from headset-based systems to larger, more complex projection-based systems.

We currently manufacture, market, and sell our *immersive virtual reality* products in two distinct markets: training/simulation and advertising/promotion. Within the training and simulation market, we offer two different versions of our patent-pending IVR™ 360-degree high-definition firearms training simulators: the IVR HD™, launched in March of 2004, for use in marksmanship, conflict resolution, and situational awareness training of law enforcement and security officers, and the IVR 4G™, launched in December of 2004, for use in military firearms/marksmanship training, situational awareness, and fourth-generation squad-based training.

Within the advertising/promotion market, we market the patented Immersa-Dome® personal *immersive virtual reality* theater, featuring the sensations of sight, sound, touch, and smell, and our 3-D multisensory theater, a product offering customized three-dimensional projected content in high-definition, with multisensory effects, for multiple viewers.

We maintain our corporate office at 2500 City West Blvd., Suite 300, Houston, Texas 76042, and our telephone number is (832) 242-1100. We also maintain engineering, technical, and production offices, and a demonstration facility, at 1406 West 14th Street, Tempe, Arizona 85281, with a phone number of (480) 960-1488.

Entertainment/Amusement

The entertainment/amusement market was the original market for our products. Our *"immersive virtual reality™"* devices were designed to produce a highly-realistic experience at a significantly lower cost than traditional virtual reality technology. Within the entertainment/amusement market, we installed and operated virtual reality entertainment centers known as VR Zones in over a dozen theme parks and high-traffic visitor locations, such as:

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Six Flags,

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Paramount Parks,

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Busch Gardens, and

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Carnival Cruise Lines.

These VR Zones were equipped with systems we developed and manufactured, and were operated by our employees on a revenue-share basis with the theme park locations. We sold our VR Zones and effectively left this market in the spring of 2003, in order to more fully focus on the advertising/promotional and training/simulation markets.

Advertising/Promotion

We entered the advertising/promotion market, our second, with our 2000 “Drive With Confidence Tour™” for Buick, featuring a virtual reality “test-drive” of a Buick LeSabre with PGA professional Ben Crenshaw accompanying the participant. This project led us to additional projects within this market, such as:

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a virtual reality bi-plane experience for Red Baron® Pizza,

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a virtual reality ski jump promotional program for Chevrolet in conjunction with its *Olympic Torch City Celebration Tour™,”*

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an interactive promotional project for Shell Oil Product’s Pennzoil® division’s *“Vroom Tour*™”, which featured Jay Leno “inside” an automobile engine demonstrating how oil functions inside an automobile engine, and ended with the visitor driving Pennzoil’s Formula One car around the Las Vegas Motor Speedway at speeds in excess of 220 miles per hour,

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a 50-seat, 3-D immersive theater for Red Baron® Pizza's *"3-D Flying Adventure™,"* which featured special glasses, Dolby® 5.1 sound, and special effects that literally jump off the screen,

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a virtual reality recruitment tool for the United States Army, in which participants ride in an Army Black Hawk helicopter performing an exciting rescue mission, and

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a 3-D immersive theater project for Sea-Doo®, using our 3-D technology for 2-D to 3-D video conversion and 3-D computer animation, for 1) a motion simulator utilizing polarized glasses, 2) a theater-style presentation utilizing anaglyph (cyan-blue) glasses, and 3) a web-suitable version utilizing 3-D anaglyph glasses, all in connection with Bombardier's launch of its new 2004 Sea-Doo® 3D™ personal watercraft.

We made a strategic move from headset-based to projection-based technology in 2004, evidenced by the development and launch of our patented Immersa-Dome®, featuring a domed-shaped screen which surrounds the seated viewer and delivers a high-definition resolution virtual reality experience.

The May 3, 2004, launch of the Immersa-Dome product was rapidly followed by several new projects:

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a mobile promotional experience for Buick's new Terraza™ and LaCrosse™ vehicles, using four Immersa-Dome units installed in two of Buick's event-marketing trailers. This was our second collaboration with Buick's event marketing agency, Momentum Detroit,

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a sale of three Immersa-Domes to the United States Army Recruiting Command in Fort Knox, Kentucky, for installation in mobile recruiting trailers traveling the United States to major events, high schools, and universities in connection with the Army's recruiting efforts,

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the installation of three Immersa-Domes at the new Red Baron® Museum in Marshall, Minnesota, providing the visual experience of flying an acrobatic bi-plane with the Red Baron® Pizza Squadron™ in an 180-degree multisensory experience,

2005 advertising/promotion projects included projects for both new and returning customers. In addition, 2005 witnessed a new custom project that adapted our IVR™ product for use in the treatment of patients, and training of clinicians, for speech disorders. This speech disorder project represented the application of our *immersive virtual reality* technology into a new market medical treatment and training.

Returning customers during 2005 requested license renewals and/or upgrades of previous projects, including:

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the Schwan Food Company s renewal and upgrade of both its promotions for the Red Baron Pizza Squadron's 2005 air show season; renewal of the *Red Baron Flight Club*™ virtual reality experience, and integration of the Red Baron brand's *3-D Flying Adventure*™, a 3-D multisensory theater promotion, inside of a new, standard 18-wheel trailer, and

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Buick renewed and upgraded its Immersa-Dome® promotional experience for the 2006 Lucerne™ luxury sedan ,with new high-definition content featuring professional golfer Tiger Woods promoting Buick's new Lucerne automobile, which was installed into two themed trailers traveling throughout North America, stopping at Buick special events and selected PGA Tour events.

In addition, two new projects were received in 2005:

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An Immersa-Dome® promotional tour for Pfizer Pharmaceuticals trade show activities, featuring three specially themed Immersa-Domes delivering customized promotional content describing newly-developed drugs, and

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the sale of a specially-modified IVR 180 to Case Western Reserve University s speech pathology department, for researching the efficacy of virtual reality to treat patients for, and educate clinicians in, diagnoses of speech disorders.

In 2006, the Case Western Reserve University project has shown enormous success and as data is being gathered and analyzed more opportunities there appear possible, as well as expansion of the technology beyond this customer to orhers.

A civilian contractor for the United States Navy awarded us a significant job in 2006. For the Navy recruiting efforts, they acquired several of the company s Immersa-domes with indications of further orders in the future. We also enjoyed work from a third-party producer of customer 3-D hardware and content to their own high profile advertising clients.

Training/Simulation

Since introducing our IVR™ line of projection-based training simulators for judgmental use-of-force, situational awareness, combat-readiness, and tactical judgment objectives three years ago, we have advanced upon the technology and refined the applications.

The two IVR product lines provide the law enforcement, military, and security markets with 360-degree immersive training environments. Our IVR HD™ series, designed primarily for law enforcement objectives, was completed in January of 2004. Our military-oriented IVR 4G™ system, designed to train soldiers for “fourth generation” warfare, was debuted at the industry-leading I/ITSEC trade show in Orlando, Florida in December of that year. Fourth generation warfare, is characterized by transnational groups without territorially-based armies, engaging in highly irregular practices such as guerilla warfare, terrorist tactics, and low-intensity, close quarter conflict, enabling groups that are weaker militarily to defeat larger, stronger forces. Fourth-generation battlefields may include the whole of the enemy's society, where small, well-trained, highly maneuverable forces may tend to dominate.

In 2005, the installation base of our IVR HD and IVR 4G models grew both internationally and domestically, as we gained new military and law enforcement customers. We sold or installed IVR HD law enforcement simulators to law enforcement agencies in Washington County, Utah; Manistee, Michigan; Duluth, Georgia; and Charleston, South Carolina. In addition, our IVR 4G military version simulators were sold or installed, both domestically and abroad, at MacDill AFB, Florida: Fort Hood, Texas; and at two Mexican locations. We announced our initial sale in this market in September of 2003, and, as of March 15, 2006, we had sold to

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all of the armed services of the United States except the Coast Guard,

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a classified Department of Defense customer,

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the United States Marshall Service,

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the Department of Homeland Security,

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several domestic law enforcement agencies, and

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state police and security organizations in Mexico.

Our initial IVR series installation was accomplished in March of 2004 and we have follow up work there underway. Several serious inquiries from new customers, more than ever before, are being reviewed at year end

Virtual Reality Products

Our *"immersive virtual reality™"* products include:

Training/Simulation Products

The IVR HD™ and IVR 4G™ series, designed for law enforcement and military use, respectively, are projection-based, multi-screened, high-definition resolution, combat-readiness and judgmental use-of-force firearms training simulators. The IVR™ series simulators use company-produced high-definition filmed content as well as our Hybrid-CGI™ content. Our Hybrid-CGI software combines film content with computer-generated images, allowing users to create their own customized 360-degree training scenarios by combining "green-screen" video, panoramic photorealistic images, computer-generated images, and 3-D sound. Green-screen filming is the technique of filming actors and other visual elements in the foreground against an evenly-colored green background, and subsequently extracting the actors and other visual elements and placing them onto a new panoramic background specifically suited to the user s needs and locale.

The IVR systems use off-the-shelf computer equipment, extremely-accurate laser-based weapons tracking, 360-degree video and audio, and ultra-high resolution interactive graphics. The systems deliver both photorealistic and computer-generated imagery -based video for training scenarios. The systems support one to six users, and have the option to be reconfigured into a 20-lane, military-approved, virtual shooting range for realistic marksmanship training.

Trainees step into the simulator, and then interact with a training scenario selected by the instructor, using their weapon of choice. The training scenarios teach combat-readiness, situational awareness, fourth-generation warfare tactics, and judgmental use-of-force with both lethal and non-lethal weapons currently used by military, law enforcement, and security agencies.

The IVR 4G military series of simulator products are offered in four different configurations:

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the IVR 4G-base™ is a single-screen model, and its compact size offers portability and supports one to four trainees.

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the IVR 4G-180™ offers an 180-degree field-of-view for more realistic combat training and marksmanship. It supports one to four trainees.

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the IVR 4G-300™ delivers 300-degree field-of-view for more realistic combat scenarios and marksmanship training, and supports one to five trainees.

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the IVR 4G-360™ offers a 360-degree field-of-view for combat and marksmanship training, and supports one to six trainees.

The IVR HD law enforcement series is offered in four different configurations:

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the IVR HD-base™ is a single-screen model, offering portability, and supports one to four trainees.

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the IVR HD-180™ offers an 180-degree field-of-view for more realistic training and target tracking. It supports one to four trainees.

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the IVR HD-300™ delivers 300-degree use-of-force scenarios, and supports one to five trainees.

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the IVR-360™ HD offers 360-degree firearms training, and supports one to six trainees.

We also have developed and market proprietary training accessories for use with both our IVR product lines, as well as those manufactured by third-parties:

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the wireless Threat-Fire™ belt permits the simulator's instructor to deliver an electric "stun" to the trainee, simulating the sensation of being shot, thus enhancing the multi-directional experience of our IVR simulators by increasing the seriousness and stress of training scenarios.

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our Hybrid-CGI™ scenario creation software integrates "green-screen" video, panoramic photorealistic images, computer-generated images, and 3-D sound, decreasing both cost and time of scenario production. Our Hybrid-CGI software offers the end-user more custom scenario options than traditional scenario production methods and other forms of training software.

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a wireless/tetherless drop-in recoil conversion kit, which transforms a live weapon into an accurate and safe training weapon. It features 1) a laser-based tracking mechanism, 2) self-contained, tetherless pneumatic recoil, and 3) instructor-controlled weapon malfunction capability to simulate a jammed weapon in the field. The system provides no possibility of chambering a live bullet while in training mode.

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laser-based pneumatic recoil conversion kits for most military and law enforcement handguns, assault rifles, and shotguns.

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less-lethal, laser-based training tools, including Taser® and canister OC pepper spray.

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TMaR (Trainee Monitor and Recording) debriefing product, which records and plays back the trainee s actions in the simulator, allowing systematic review of the trainee s performance.

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wireless/tetherless handgun training conversion drop-in recoil kits, which transform a handgun into a safe training weapon, allowing modification of a trainee's sidearm for training in our IVR simulators.

Advertising/Promotional Products

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the Immersa-Dome® is a patented projection-based virtual reality system, which uses a domed-shaped screen to surround the viewer. The Immersa-Dome offers photorealistic environments with 180-degree field-of-view and high-definition resolution. The system is composed of the dome’s base, the viewer’s seat, and a separate projector/mirror stand.

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the 3-D Multisensory Theater™ is a portable-seat, high-capacity (50-100 viewers) 3-D theater with special effects packages, including fog, wind, and simulated lighting, among others. This theater system features 3-D, high-resolution imagery on a large projected screen. Participants wear polarized glasses, which facilitate 3-D depth in the screen images. This system also features time-triggered smells, wind simulation, and a Dolby® 5.1 sound system. The 3-D Multisensory Theater uses a silver screen and two projectors. Three-dimensional filming techniques are used and processed to finalize the 3-D experience. Computer-generated 3-D imagery is an alternative development method to 3-D filming.

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the 360-degree headset-based virtual reality system delivers photorealistic content. In addition, the user, while seated, is tracked in 360 degrees. The multisensory system incorporates off-the-shelf computer equipment, gyroscopic head-tracking, stereo sound, wind simulation, and smell. The system comes standard for one user.

Competition

Competition within each of our markets is intense.

There are several large competitors in the general field of high-tech simulation. For instance, the January 7, 2002 edition of Forbes magazine contains a feature story on L3 Communications, Inc., a company purportedly doing in excess of $5 billion in business with the United States government in this market. L3 has so far focused on other types of simulators (such as aircraft motion simulators) and to-date we have never directly competed against L3, and may never compete with them regarding our IVR simulators. Other companies have made essentially the same single-screen style simulator for the past 15 years or longer.

As our virtual reality experiences are usually custom applications, and we deal primarily with advertising agencies, or directly with the client, it is difficult to quantify the competition. Sometimes companies are able to penetrate one or two particular high-tech promotions. With over 13 years in the marketplace, we currently are not aware of any other virtual reality-based advertising/promotion company with products similar to ours.

Some general competitors within the virtual reality industry that promote substitute and similar technologies are as follows:

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Advanced Interactive Systems, Inc. (AIS)--has been a provider of interactive simulation systems designed to provide training for law enforcement, military, and security agencies since 1993. Its line of products uses primarily video production in judgmental training scenarios. AIS also markets to anti-terrorist and other special application training facilities for military and special operations groups. Its systems have historically used only single screen technology.

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Cubic Defense Applications performing in a wide range of industries, including military simulation, Cubic currently produces a product (EST-2000) which was developed several years ago as mainly a marksmanship training system, with limited immersive combat training capabilities. Due to its size and corporate strength, Cubic could become a formidable competitor if it chose to focus on firearms training.

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Firearms Training Systems, Inc. (FATS)--claims to have over 4,000 training systems installed worldwide by military, law enforcement, and commercial customers. FATS is a full service training/simulation company that also uses video scenarios with single-screen technology. FATS also produces other types of simulators and recoil weapons. AIS, Cubic and FATS products are similar in many respects, although FATS has been in the market longer.

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IES Interactive Training, Inc. (IES)--a supplier of basic simulation equipment to law enforcement. Having fielded several hundred single screen systems in the law enforcement marketplace, it is mainly focused on the law enforcement marketplace.

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Straylight--has focused on the use of virtual reality in the promotions and conventions market. .

Our recent patent applications may hamper or halt potential plans by our competitors to enter the multi-screen simulator industry to compete with our IVR simulator.

The above summaries of competition are by no means exhaustive, since these industries are fluid and, at times, rapidly expanding.

Marketing

Marketing within the training/simulation market is conducted primarily through trade shows, trade journal advertisements, search engine strategies, and one-on-one demonstrations. We recently completed and publicly unveiled the IVR HD™ series of law enforcement-focused advanced training simulators at the Trexpo West trade show in March of 2004, and we publicly unveiled the military-oriented IVR 4G™ fourth generation warfare simulators at the I/ITSEC trade show in December of 2004. We have demonstrated the IVR simulators to high-level officers in the United States military, the Department of Defense, as well as to municipal, state, and federal agencies both domestically and internationally.

Marketing within the advertising/promotional market is conducted primarily by web-based search engine strategies and by the face-to-face sales efforts of our vice-president of advertising and promotion. Our Immersa-Dome demonstration unit uses high-definition content from our projects for Pennzoil, Buick, Red Baron® Pizza, Chevrolet, and the U.S. Army. Marketing within this industry is conducted primarily by one-on-one appointments and demonstrations of our technology to agencies and qualified corporations. We also attend industry tradeshows to generate leads and to garner further market exposure.

With each additional sale, we have one more customer upon whom we can depend upon for a referral. The more systems that we get into circulation, the less difficult it is to demonstrate to a prospective customer that we have a viable product.

Employees

At December 31, 2006, we employed 16 people. None of our employees are members of a union, and we consider relations with our employees to be satisfactory.

Trademarks/Patents

We have obtained a patent for our Universe Control Board™, and various federal trademarks. We have also filed for federal registration of our “Immersive Virtual Reality™” and “IVR™” trademarks.

On December 20, 2005, we successfully registered our claim on the trademark Immersa-Dome® from the United States Patent and Trademark Office.

On March 15, 2004, we applied for a patent on our IVR™ series of advanced training simulators, seeking a patent for our “multiple screen simulation system and method for situational response training.”

On May 3, 2004, we announced that we had obtained an exclusive license to the patented technology behind the Immersa-Dome.

On December 3, 2004, in advance of industry demonstration at the industry-leading Interservice/Industry Training and Simulation Education Conference in Orlando, Florida, we submitted three separate provisional patent applications for innovations in the field of firearms training. These included: 1) the Threat-Fire™ Belt, 2) our Hybrid-CGI™ software, and 3) a "drop-in" kit and magazine for wireless recoil in real weapons.

First, the Threat-Fire Belt permits the simulator's instructor to deliver an electric "stun" to the trainee, simulating the sensation of being shot, thus enhancing the multi-directional experience associated with our IVR simulators.

Second, the Hybrid-CGI software integrates "green-screen" video, panoramic images, computer-generated images, and 3-D sound. Green-screen filming is the technique of filming actors and other visual elements in the foreground against an evenly-colored green background, and subsequently extracting the actors and other visual elements and placing them onto a new panoramic background specifically suited to the user s needs and locale. Hybrid-CGI software decreases both cost and time of scenario production, and provides more scenario options to the end user than traditional production methods.

Third, the "drop-in" kit and magazine is non-permanent, and delivers wireless recoil to a real weapon. The magazine is refillable, and the aiming laser features hyper-accurate collinear placement for both immersive combat training and marksmanship qualification. Use of un-tethered training weaponry is highly desirable in firearms simulators.

On November 22, 2005, the provisional patent applications filed in 2004 for the Threat-Fire™ belt and Hybrid-CGI™ software were upgraded to full patent applications, submitted to the United States Patent and Trademark Office, and are currently awaiting patent office action.

In December of 2005, we decided to not proceed with a full patent application of the provisional application originally filed on December 3, 2004, relating to the "drop-in" kit and magazine recoil design, due to significant design improvements incorporated since the preparation of the original provisional patent application.

There can be no assurance that patents or trademarks will issue on these applications, or that, if issued, they will be sufficiently broad to provide meaningful protection.

Item 2. Description of Property

Our executive offices are located in Houston, Texas, in leased space at 2500 City West Blvd. Our monthly rent is $2,300. There is no assurance that these offices will remain sufficient for our use indefinitely. We have no plans for expanding leased administrative space in 2007.

Our production offices are located in Tempe, Arizona, in leased space that costs $7,611 per month. In September of 2006, we sold the office building owned by Ferris Holdings, L.L.C. See Certain Relationships and Related Transactions. Ferris Holdings has charged us $7,772.00 per month for our office space since August of 2000. We had a 25 1/2-year lease with Ferris Holdings that has been canceled without penalty. From the proceeds of the building sale, we retired a significant amount of debt.

Item 3. Legal Proceedings

On May 13, 2004, suit was filed against us in the federal district court of South Carolina, in cause number 04CP402455, styled *Garland and Leota Slagle v. VirTra Systems, Inc.*, seeking payment of the principal sum of $90,000, plus accrued interest, in equipment leases allegedly entered into by the Slagles with the former Ferris Productions, Inc. in 2001. We have contested the allegations. In May of 2006, judgment was awarded to the plaintiff in the amount of $116,005. At present this liability remains unpaid and is accruing interest at the rate of 8% per annum.

On December 30, 2004, suit was filed against us in the federal district court of North Carolina, in cause number 4:04-CV-199-H2, styled *Edward and Linda Strickland v. VirTra Systems, Inc.*, seeking payment in the principal sum of $72,000, plus accrued interest, in equipment leases allegedly entered into by Mr. Strickland with the former Ferris

Productions, Inc. 2001. We contested the allegations. In February of 2006, we entered into an agreed judgment in the amount of $85,000, with a contractual provision in the judgment that there would be no collection activity on the judgment prior to February of 2007. On March 12, 2007 we received notice from counsel for the plaintiffs that they will within 30 days begin post-judgment discovery. The company believes that adequate accruals have been made on the books.

On August 28, 2006, Virtra Systems received notice from Jones & Cannon, P.C. of Arlington, Texas, notifying the company of a lawsuit filed in the 352nd Judicial District Court of Tarrant County, Texas for fees and other charges that Jones & Cannon alleges are owed to it, in the amount of $508,362.55. The suit is for fees and charges Jones & Cannon claims to have accrued during the time that Kelly Jones, its lead partner, served as CEO of Virtra Systems, Inc. The current management and board of directors disagree with the merits of this case and have contested the matter vigorously. On January 15, 2007 both parties agreed to a settlement of the claim.

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

In the fourth quarter of 2006, the matter of increasing the company s authorized common stock by 400,000,000 shares was put to a vote of the shareholders and successfully passed..

Part II

Item 5. Market for Registrant's Common Equity and Related Stockholder Matters

Market Information`

Our common stock is quoted under the symbol "VTSI" on the OTC Electronic Bulletin Board. The following table sets forth the high and low bid prices for shares of our common stock for the periods noted, as reported by the OTC Electronic Bulletin Board. Quotations reflect inter dealer prices, without retail markup, mark down, or commission, and may not represent actual transactions.

		BID PRICES	
YEAR	PERIOD	HIGH	LOW
2004			
	First Quarter	$0.35	0.20
	Second Quarter	0.43	0.24
	Third Quarter	0.42	0.28
	Fourth Quarter	0.46	0.28
2005			
	First Quarter	0.43	0.22
	Second Quarter	0.30	0.13
	Third Quarter	0.24	0.11
	Fourth Quarter	0.20	0.10

2006			
	First Quarter	0.15	0.09
	Second Quarter	0.10	0.03
	Third Quarter	0.08	0.02
	Fourth Quarter	0.09	0.03

As of March 15, 2006, the reported bid price for our common stock was $0.04 per share.

Shareholders

As of December 31, 2006, we had 96,972,540 shares of common stock outstanding, held by 203 shareholders of record.

Dividends

We have not paid cash dividends on our common stock in the past and we do not anticipate doing so in the foreseeable future.

Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion contains certain forward-looking statements that are subject to business and economic risks and uncertainties, and our actual results could differ materially from those forward-looking statements. The following discussion regarding our financial statements should be read in conjunction with the financial statements and notes to those financial statements.

Overview

Our principal business began in 1993 with the organization of Ferris Productions, Inc. Ferris designed, developed, distributed, and operated virtual reality products for the entertainment, simulation, promotion, and education markets. In September of 2001, Ferris merged into GameCom, Inc., a publicly held Texas company whose principal business at the time was the development and marketing of an internet-enabled video game system. We subsequently adopted our present name.

Prior to the merger of Ferris and GameCom, both companies had incurred substantial debt, much of which was eliminated in December of 2004 in a debt for equity conversion. However, there can be no assurances that we will be able to successfully implement our expansion plans. As we enter the training/simulation market, we face all of the risks, expenses, and difficulties frequently encountered in connection with the expansion and development of a new business, difficulties in maintaining delivery schedules if and when volume increases, the need to develop support arrangements for systems at widely-dispersed physical locations, and the need to control operating and general and administrative expenses.

Critical Accounting Policies

Use of Estimates

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

Revenue Recognition

Revenue from custom application contracts are recognized on a percentage-of-completion basis, measured by the percentage of costs incurred to date to total estimated costs for each contract. Contract costs include all direct material and labor costs, and those indirect costs related to contract performance, such as indirect labor, supplies, tools, repairs, and depreciation costs. General and administrative costs are charged to expense as incurred.

Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions, and estimated profitability may result in revisions to costs and income, and are recognized in the period in which the revisions are determined. An amount equal to contract costs attributable to claims is included in revenue when realization is probable and the amount can be reliably estimated.

Costs and estimated earnings in excess of billings on uncompleted contracts represent revenue recognized in excess of amounts billed. Billings in excess of costs and estimated earnings on uncompleted contracts represent amounts billed in excess of revenue recognized.

Stock-Based Compensation

We account for our stock compensation arrangements under the provisions of Accounting Principles Board (APB) No. 25 Accounting for Stock Issued to Employees. We provide disclosure in accordance with the disclosure-only provisions of Statement of Financial Accounting Standard (SFAS) No. 123R Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation-Transition and

Disclosure . Effective January 1, 2006, we adopted FAS 123R using the modified prospective transition method as defined. Under the modified prospective method we will record compensation cost prospectively for the unvested portion as of January 1, 2006, of previously issued and outstanding awards over the remaining vesting period of such awards.

Results of Operations

Fiscal year ended December 31, 2006 compared to fiscal year ended December 31, 2005.

Total revenue for the year ended December 31, 2005 was $1,887,768, 93% above 2005 revenues of $977,358. Both the training/simulation and advertising/promotion sectors showed healthy growth.

	2006	2005	%
Training/Simulation	$ 1,279,654	$ 714,435	79.1
Advertising/Promotion	$ 545,216	$ 167,969	224.5

Cost of sales and services rose only $65,946, or less than 10%, to $729,322, for the year ended December 31, 2006, from $663,376 for the year ended December 31, 2005. Component costs of the finished products were reduced through modifications to the software and optics employed in the IVR products.

General and administrative grew $670,106 to $2,807,575, or 31.3%. During 2006, the company s stock price significantly declined. We repay the principal amount on our convertible debentures by issuing stock to the lender. The lower stock price resulted in far more shares being converted in order to reduce the principal, with the result being that the company exhausted its authorized capital. Although we were successful in obtaining a vote of the shareholders to increase the authorized capital from 100,000,000 shares to 500,000,000 shares, there was nonetheless a period whereby we could not fulfill our contractual conversion commitments. Penalties from the lender totaled $601,239.

Other income and expense grew to $175,622 from a loss of $401,569 in 2005. The most significant changes from the prior year were in reduced interest expenses and a gain on the sale of real estate. Our interest expense and finance charges fell to $537,944 from $939,813 the prior year. Not only had we reduced the principal amount of our convertible debentures measurably (before the authorized capital was exhausted), the sale of the company s office building in Phoenix, AZ resulted in a gain of $521,305. Virtra Systems also recorded a $212,782 gain on the forgiveness of debt income from the real estate sale, although we had a gain the prior year of $516,220 from the exchange of certain notes payable and obligations under product financing agreements.

Liquidity and Plan of Operations

As of December 31, 2006, our liquidity position was extremely precarious. We had current liabilities of $4,392,855, including $454,980 in obligations remaining under the lease financing for the old Ferris Productions virtual reality systems, $3,233,438 in accounts payable and accrued liabilities, and short-term notes payable of $133,145. As of December 31, 2006, there was only $498.005 in current assets available to meet those liabilities.

We met our 2006 capital requirements primarily from private placement offerings of equity. During the year we sold 18,598,802 shares of common stock, and another 12,390,138 were issued upon conversion of our debentures.

For the year ended December 31, 2006, our net loss was $1,473,507. After taking into account the non-cash items included in that loss, our cash requirements for operations were approximately $1,100,000. In addition, we made capital expenditures of $11,865, and repaid notes and certain advances in the amount of $1,027,898. To cover these cash requirements, we issued common stock for net cash proceeds of $704,784 and sold real estate for $1,210,430.

The opinion of our independent auditor for the year ended December 31, 2006 expressed substantial doubt as to our ability to continue as a going concern. Although our revenues have begun to grow consistently and we approach a break-even point in terms of profitability, we will need substantial additional capital in order to build new systems and reduce our debt load. During 2005 we completed two private placements with Dutchess for $1,250,000 in convertible debentures and management believed that this equity line would allow us to continue our operations for

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at least the next 12 months and it did. During 2006, we did not borrow any more money except for comparatively minor working capital needs. All financings needed were funded through the sale of equity. During the year we also took bona fide steps to address the tax deficiency to the Internal Revenue Service.

Item 7. Financial Statements

VIRTRA SYSTEMS, INC.

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James B. McElravy, CPA, P.C.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of

VirTra Systems, Inc.

We have audited the accompanying balance sheet of VirTra Systems, Inc. (the Company) as of December 31, 2006, and the related statement of operation, stockholders deficit and cash flow for the year ended December 31, 2006. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of VirTra Systems, Inc. as of December 31, 2006, and the results of its operations and its cash flow for the year ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming the Company will continue as a going concern. As discussed in Note 2 to the financial statements, the Company has suffered recurring losses from operations and at December 31, 2006 is in a negative working capital position and a stockholders deficit position. These factors raise substantial doubt about the Company s ability to continue as a going concern. Management s plans in regard to these matters are also described in Note 2. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As discussed in Note 3 to the financial statements, in 2004 the Company changed its method of accounting for variable interest entities.

/s/ James B. McElravy, CPA, P.C.

Houston, Texas

March 29, 2007

HAM,

LANGSTON &

BREZINA, L.L.P.

Certified Public Accountants

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of

VirTra Systems, Inc.

We have audited the accompanying statement of operations, stockholders deficit and cash flows for the year ended December 31, 2005. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the results of operations and cash flows of the Company for the year ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming the Company will continue as a going concern. As discussed in Note 2 to the financial statements, the Company has suffered recurring losses from operations and at December 31, 2005 is in a negative working capital position and a stockholders deficit position. These factors raise substantial doubt about the Company s ability to continue as a going concern. Management s plans in regard to these matters are also described in Note 2. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Ham Langston & Brezina, L.L.P.

Houston, Texas

April 14, 2006

VIRTRA SYSTEMS, INC.

BALANCE SHEET

December 31, 2006

ASSETS

Current assets:	
Cash and cash equivalents	$ 91,221
Accounts receivable	406,784
Total current assets	498,005
Property and equipment, net	141,386
Capitalized development cost, net	88,074
Total assets	$ 727,465

LIABILITIES AND STOCKHOLDERS DEFICIT

Current liabilities:	
Notes payable	$133,145
Obligations under product financing arrangements	454,980
Convertible debentures, net of discount of $122,388	347,729
Accounts payable	848,390
Accrued liabilities	2,390,048
Advances held on deposit	39,625
Other current liabilities	71,750
Billings in excess of costs and estimated earnings on uncompleted contracts	24,946
Payable to related party	82,252
Total current liabilities	4,392,855
Redeemable common stock, 371,834 shares at $.005 par value	1,859
Total liabilities	4,394,714

Commitments and contingencies

Stockholders deficit:	
Common stock, $.005 par value, 500,000,000 shares authorized, 96,972,540, shares issued and outstanding	483,663
Common stock committed	150,000
Additional paid-in capital	10,921,467
Accumulated deficit	(15,222,379)
Total stockholders deficit	(3,667,249)
Total liabilities and stockholders deficit	$ 727,465

See accompanying notes to financial statements.

VIRTRA SYSTEMS, INC.

STATEMENTS OF OPERATIONS

for the years ended December 31, 2006 and 2005

	2006	2005
Revenue:		
Custom applications		
Training/simulation	$1,279,654	$714,435
Advertising/promotion	545,216	167,969
Other revenue	62,898	94,954
Total revenue	1,887,768	977,358
Cost of sales and services	729,322	663,376
Gross margin	1,158,446	313,982
Gain on legal settlement		230,000
General and administrative expenses	(2,807,575)	(2,137,469)
Loss from operations	(1,649,129)	(1,593,487)
Other income (expenses):		
Forgiveness of debt income	212,782	516,220
Interest income	72	66
Interest expense and finance charges	(527,944)	(939,813)
(Gain)/Loss on Sale of Assets	(521,305)	
Other income	(30,593)	21,958
Total other income (expenses)	175,622	(401,569)
Net income (loss) before accounting change	(1,473,507)	(1,995,056)
Cumulative effect of accounting change	-	-

Net income (loss)	($1,473,507)	($1,995,056)
Weighted average shares outstanding - basic	81,186,290	62,221,809
Weighted average shares outstanding diluted	81,186,290	62,221,809
Basic net income (loss) per share:		
Net income (loss) per share before accounting change	($0.02)	($0.03)
Cumulative effect of accounting change	-	-
Net income (loss) per share	($0.02)	($0.03)
Diluted net income (loss) per share:		

Net income (loss) per share before accounting change	($0.02)	($0.03)
Cumulative effect of accounting change	-	-
Net income (loss) per share	($0.02)	($0.03)

See accompanying notes to financial statements.

VIRTRA SYSTEMS, INC.

STATEMENTS OF CASH FLOWS

for the years ended December 31, 2006 and 2005

	2006	2005
Cash flows from operating activities:		
Net income (loss)	(1,473,507)	$(1,995,056)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	81,363	163,231
Forgiveness of debt income	212,782	(516,220)
Gain on sale of assets	(521,305)	(18,000)
Bad debt expense	56,910	175,926
Common stock and options issued for services	180,216	155,720
Gain on settlement of litigation	0	(230,000)
Amortization of debt discount and beneficial conversion	176,782	406,348
Changes in operating assets and liabilities:		
Accounts receivable and other	(207,814)	(175,474)
Billings in excess of costs and estimated earnings	(84,650)	(39,446)
Accounts payable	(384,389)	224,190
Accrued liabilities and other	1,341,957	373,722
Product finance obligations	(39,392)	55,974
Net cash used in operating activities	(661,047)	(1,419,085)
Cash flows from investing activities:		
Capital expenditures	(11,865)	(14,536)
Proceeds from sale of assets	105,747	18,000
Common stock redeemed	-	(173)
Net cash provided by (used in) investing activities	93,882	3,291
Cash flows from financing activities:		
Proceeds from issuance of notes payable and other advances	(130,067)	405,640
Proceeds from issuance of common stock	839,784	76,143

Payments on notes payable and other advances	(52,095)	(475,791)
Proceeds from convertible debentures	-	1,250,000
Net cash provided by financing activities	657,622	1,255,992
Increase (decrease) in cash and cash equivalents	90,457	(159,802)
Cash and cash equivalents, beginning of year	764	160,566
Cash and cash equivalents, end of year	91,221	$ 764
Supplemental disclosure of cash flow information:		
Cash paid for interest expense	$ 3,563	$ 90,743
Cash paid for income taxes	$ -	$ -
Non-cash investing and financing activity:		
Common stock issued upon conversion of debentures	$ 449,427	$ 475,954
Effect of beneficial conversion feature and debt discount		
on convertible debentures	$ -	$ 705,518

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Common stock issued as settlement of accounts payable	$ -	$ -
Addition to note payable for late payment penalty	$ -	$ -
Common stock issued in exchange for notes payable, obligations under product financing arrangements and accrued interest payable	$ -	$ 159,782
Cancellation of redeemable common stock	$ -	$ -

See accompanying notes to financial statements.

VIRTRA SYSTEMS, INC.

STATEMENTS OF STOCKHOLDERS DEFICIT

for the years ended December 31, 2006 and 2005

	Common Stock		Common Stock	Additional Paid-In	Accumulated	
	Shares	Amount	Committed	Capital	Deficit	Total
Balance at December 31, 2004	60,438,152	$302,191		$8,210,395	($11,753,816)	($3,241,230)
Common stock issued for services	394,334	1,971		113,498	-	115,469
Common stock issued for cash	246,352	1,232		74,911	-	76,143
Common stock issued upon conversion of obligations under financing Arrangements	393,400	1,967		157,815	-	159,782
Effect of beneficial conversion feature and warrants issued with convertible debentures	-	-		705,518	-	705,518
Stock warrants issued for services	-	-		40,251	-	40,251
Common stock issued upon conversion of debentures	4,511,362	22,557		453,397	-	475,954
Net loss	-	-	-	-	-1,995,056	-1,995,056
Balance at December 31, 2005	65,983,600	$329,918	$ -	$9,755,785	($13,748,872)	($3,663,169)
Common stock issued for services	604,320	3,022	-	27,194	-	30,216

Common stock issued for cash	17,454,541	87,273	-	617,511	-	704,784
Common stock committed for issuance	-	-	150,000	-	-	150,000
Common stock issued for debt reduction	3,000,000	15,000		120,000		135,000
Effect of beneficial conversion feature and warrants issued with convertible debentures	-	-	-	-	-	-
Stock warrants issued for services	-	-	-	-	-	-
Common stock issued upon conversion of debentures	9,690,138	48,451	-	400,976	-	449,427
Net loss	-	-	-	-	(1,473,507)	(1,473,507)

Balance at December 31, 2006	96,732,599	$483,663	$150,000	$10,921,467	($15,222,379)	($3,667,249)

See accompanying notes to financial statements.

VIRTRA SYSTEMS, INC.

NOTES TO FINANCIAL STATEMENTS

1.

Background and Summary of Significant Accounting Policies

Background

GameCom, Inc. (GameCom), a Texas corporation, was founded in 1996. Effective September 21, 2001 GameCom merged with Ferris Productions, Inc. (Ferris) (together the Company) and the Company changed its name to VirTra Systems, Inc. (VirTra). The Company is headquartered in Arlington, Texas, with a production facility located in Phoenix, Arizona. The Company develops, manufactures and operates technically advanced personal computer and non-personal computer based products including virtual reality (VR) products for the training/simulation and advertising/promotion markets.

Use of Estimates

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

Revenue Recognition

Revenue from custom application contracts are recognized on a percentage-of-completion basis, measured by the percentage of costs incurred to date to total estimated costs for each contract. Contract costs include all direct material and labor costs and those indirect costs related to contract performance, such as indirect labor, supplies, tools, repairs and depreciation costs. General and administrative costs are charged to expense as incurred.

Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions, and estimated profitability may result in revisions to costs and income and are recognized in the period in which the revisions are determined. An amount equal to contract costs attributable to claims is included in revenue when realization is probable and the amount can be reliably estimated.

Costs and estimated earnings in excess of billings on uncompleted contracts represent revenue recognized in excess of amounts billed. Billings in excess of costs and estimated earnings on uncompleted contracts represent amounts billed in excess of revenue recognized.

Concentrations of Credit Risk

Financial instruments which subject the Company to concentrations of credit risk include cash and cash equivalents and accounts receivable.

The Company maintains its cash in well known banks selected based upon management s assessment of the banks financial stability. Balances periodically exceed the $100,000 federal depository insurance limit; however, the Company has not experienced any losses on deposits.

Accounts receivable generally arise from sales of equipment and services to various companies throughout the world. Collateral is generally not required for credit granted. During the years ended December 31, 2006 and 2005 the Company had three customers representing 33% and 36% of its custom application revenue, respectively. Included in accounts receivable at December 31, 2006 is $222,630 or 55% due from these three customers.

Cash Equivalents

For purposes of reporting cash flows, the Company considers all short-term investments with an original maturity of three months or less to be cash equivalents.

Property and Equipment

Property and equipment are recorded at cost. Depreciation is provided on the straight-line method over the estimated useful lives of the assets, which range from three to seven years. Expenditures for major renewals and betterments that extend the original estimated economic useful lives of the applicable assets are capitalized. Expenditures for normal repairs and maintenance are charged to expense as incurred. The cost and related accumulated depreciation of assets sold or otherwise disposed of are removed from the accounts, and any gain or loss is included in operations.

Capitalized Development Costs

Capitalized development costs consist of direct costs incurred in developing proprietary technology exclusively used in its products and costs incurred in obtaining a patent on such technology. The intangible assets are being amortized on a straight-line basis over a five-year period. As of December 31, 2006, accumulated amortization of these intangible assets is $125,358. During the years ended December 31, 2006 and 2005, the Company recorded amortization expense of $59,950 and $65,408, respectively. During the year ended December 31, 2006 the Company did not capitalize any additional development costs.

Debt Issuance Costs

Debt issuance costs are deferred and recognized, using the interest method, over the term of the related debt.

Shipping and Delivery Costs

The cost of shipping and delivery is charged directly to cost of sales and service at the time of shipment.

Income Taxes

The Company uses the liability method of accounting for income taxes. Under this method, deferred income taxes are recorded to reflect the tax consequences on future years of temporary differences between the tax basis of assets and liabilities and their financial amounts at year-end. The Company provides a valuation allowance to reduce deferred tax assets to their net realizable value.

Income (Loss) Per Share

Basic income (loss) per share is computed on the basis of the weighted average number of shares of common stock outstanding during each period. Diluted income (loss) per share is calculated by adjusting the outstanding shares by common equivalent shares from common stock options and warrants.

Stock-Based Compensation

The Company accounts for its stock compensation arrangements under the provisions of Accounting Principles Board (APB) No. 25 Accounting for Stock Issued to Employees . The Company provides disclosure in accordance with the disclosure-only provisions of Statement of Financial Accounting Standard (SFAS) No. 123 Accounting for Stock-Based Compensation . Under APB 25, because the exercise price of the Company s employee stock options is greater than or equals the market price of the underlying stock on the date of grant, no compensation expense has been recognized.

Proforma information regarding net income and earnings per share is required by Statement 123, and has been determined as if the Company had accounted for its employee stock options under the fair value method of that Statement. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model, with the following weighted average assumptions for 2004: risk free interest rate of 4%; no dividend yield; weighted average volatility factor of the expected market price of the Company s common stock of 71%; and a weighted average expected life of the options and warrants of 1 to 5 years. For purposes of proforma disclosures, the estimated fair value of the options is included in expense at the date of issuance, as required by Statement 123. There were no stock options or warrants granted to employees during 2005. During 2006, stock options were granted to key employees. The Company s proforma information is as follows:

	2006	2005
Net income (loss) before accounting change as reported	$(1,473,507)	$(1,995,056)
Net income (loss) before accounting change proforma	$(1,473,507)	$(1,995,056)
Basic income (loss) per share-as reported	$ (0.02)	$ (0.03)
Basic income (loss) per share-proforma	$ (0.02)	$ (0.03)
Diluted income (loss) per share-as reported	$ (0.02)	$ (0.03)
Diluted income (loss) per share-proforma	$ (0.02)	$ (0.03)

The Black-Scholes option valuation model was developed for use in estimating fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company s employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

Impairment of Long-Lived Assets

In the event that facts and circumstances indicate that the carrying value of a long-lived asset, including associated intangibles, may be impaired, an evaluation of recoverability is performed by comparing the estimated future undiscounted cash flows associated with the asset or the asset s estimated fair value to the asset s carrying amount to determine if a write-down to market value or discounted cash flow is required.

Fair Value of Financial Instruments

The Company includes fair value information in the notes to financial statements when the fair value of its financial instruments is different from the book value. When the book value approximates fair value, no additional disclosure is made.

Reclassification

Certain amounts reported in the prior period financial statements have been reclassified to the current period presentation.

Recently Issued Accounting Pronouncements

In January 2003, the FASB issued Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities . In December 2003, the FASB issued a revision to FIN 46 (FIN 46R). FIN 46R clarifies the application of ARB No. 51, Consolidated Financial Statements , to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support provided by any parties, including the equity holders. FIN 46R requires the consolidation of these entities, known as variable interest entities, by the primary beneficiary of the entity. The primary beneficiary is the entity, if any, that will absorb a majority of the entity s expected losses, receive a majority of the entity s expected residual returns, or both. Among other changes, the revisions of FIN 46R (a) clarified some requirements of the original FIN 46, which had been issued in January 2003, (b) eased some implementation problems, and (c) added new scope exceptions. FIN 46R deferred the effective date of the Interpretation for public companies that are small business issuers to the end of the first reporting period ending after December 15, 2004, except that all public companies must, at a minimum, apply the unmodified provisions of the Interpretation to entities that were previously considered special-purpose entities in practice and under the FASB literature prior to the issuance of FIN 46R by the end of the first reporting period ending after December 15, 2003. FIN 46R requires entities to either (a) record the effects prospectively with a cumulative effect adjustment as of the date on which FIN 46R is first applied, or (b) restate previously issued financial statements for the years with a cumulative effect adjustment as of the beginning of the first year being restated. The Company did not have any special purpose entities but does have an entity that qualifies as a variable interest entity under FIN 46R (See Note 3).

In December 2004, FASB issued SFAS No. 123R, Share Based Payments . The statement requires public companies to measure the cost of employee services in exchange for an award of equity instruments to be based on the grant-date fair value of the award as determined by using an option-pricing model. This statement eliminates the alternative to use APB No. 25 s intrinsic value method of accounting that was provided in Statement No. 123 as originally issued. The statement also clarifies and expands Statement No. 123 s guidance in several areas, including measuring fair value, classifying an award as equity or as a liability, and attributing compensation cost to reporting periods. For entities that file as a small business issuer, the effective date of this statement is the beginning of the first interim or annual reporting period that begins after December 15, 2005. The Company adopted SFAS No. 123R effective January 1, 2006, using the modified prospective method. This method applies the fair value based method to new awards and to awards modified, repurchased or cancelled after the required effective date. Also, compensation cost for the portion of awards for which the requisite service has not been rendered that are outstanding as of the required effective date shall be recognized as the service is rendered on or after the required effective date. Any options issued subsequent to January 1, 2006 will be accounted for under SFAS No. 123R.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs . The new Statement amends ARB No. 43, Chapter 4, Inventory Pricing , to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. This Statement requires that those items be recognized as current period charges and requires that allocation of fixed production overhead to the cost of conversion be based on the normal capacity of the production facilities. This Statement is effective for fiscal years beginning after June 15, 2005. The adoption of this statement on January 1, 2006, did not have a material impact on the Company s financial condition or results of operations.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets - An Amendment of APB Opinion No. 29 . SFAS No. 153 amends APB Opinion No. 29 to eliminate the exception for exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. SFAS No. 153 is to be applied prospectively for nonmonetary exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of this statement on January 1, 2006, did not have a material impact on the Company s financial condition or results of operations.

In May 2005, the FASB issued SFAS no. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3 . In addition to replacing APB Opinion No. 20 and FASB Statement No. 3, it changes the requirements for the accounting for and reporting a change in accounting principle. This Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. This Statement is effective for fiscal years

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beginning after December 15, 2005. The adoption of this statement on January 1, 2006 did not have a material impact on the Company s financial position or results of operations.

2.

Going Concern Considerations

During the years ended December 31, 2006 and 2005, the Company has defaulted on its notes payable and obligations under product financing arrangements, has continued to accumulate payables to its vendors and has experienced negative financial results as follows:

	2006	2005
Net income (loss)	$(1,473,507)	$(1,995,056)
Negative cash flows from operations	$(661,047)	$(1,419,085)
Negative working capital	$(3,894,850)	$(4,743,755)
Accumulated deficit	$(15,222,379)	$(13,748,872)
Stockholders deficit	$(3,667,249)	$(3,663,169)

Management has developed specific current and long-term plans to address its viability as a going concern as follows:

The Company s anticipated entry into the training/simulation market was advanced by the aftermath of September 11, 2001. The Company is currently in advanced discussions with representatives of various government authorities regarding use of the Company s technology in detecting and mitigating the risk of similar problems in the future.

The Company is also attempting to raise funds through debt and/or equity offerings. If successful, these additional funds would be used to pay down debt and for working capital purposes.

In the long-term, the Company believes that cash flows from continued growth in its operations will provide the resources for continued operations.

There can be no assurance that the Company s debt reduction plans will be successful or that the Company will have the ability to implement its business plan and ultimately attain profitability. The Company s long-term viability as a going concern is dependent upon three key factors, as follows:

The Company s ability to obtain adequate sources of debt or equity funding to meet current commitments and fund the continuation of its business operations in the near term.

The ability of the Company to control costs and expand revenues from existing or new businesses.

The ability of the Company to ultimately achieve adequate profitability and cash flows from operations to sustain its operations.

3.

Accounting Change

On December 31, 2004, the Company adopted FASB Interpretation No. 46R (FIN 46R), Consolidation of Variable Interest Entities (Revised) . This accounting change added assets and liabilities to the balance sheet as of that date resulting from the consolidation of Ferris Holdings, L.L.C., which was previously not included in the financial statements. Ferris Holdings, L.L.C. is an entity 100% owned by an officer/director of the Company. This entity s only asset is the land and building in Phoenix, Arizona that is currently leased by the Company. Since the Company also guarantees performance on the entities debt related to this property, the Company has an implicit variable interest in this entity. This accounting change resulted in $827,263 of additional property and equipment, net of accumulated depreciation, a $67,885 reduction in note receivable from a related party, and $805,856 of additional notes payable, but did not require an adjustment to earnings and is not expected to affect future earnings or cash flows. The accounting change did result in a loss of $(46,478), which is reported as a Cumulative effect of accounting change in the accompanying statement of operations.

4.

Accounts Receivable

Accounts receivable consist primarily of amounts due from certain companies for the purchase of equipment and services. An allowance for doubtful accounts is provided, when appropriate, based on past experience and other factors which, in management s judgment, deserve current recognition in estimating probable bad debts. Such factors include circumstances with respect to specific accounts receivable, growth and composition of accounts receivable, the relationship of the allowance for doubtful accounts to accounts receivable and current economic conditions. As of December 31, 2005 all accounts receivable are considered collectible and the allowance for doubtful accounts is $0.

5.

Custom Application Contracts

Costs, estimated earnings and billings on uncompleted custom application contracts at December 31, 2006 are summarized below.

Costs incurred on uncompleted contracts	369,024
Estimated earnings	770,352
	1,139,376
Billings to date	1,164,222

	-
	($24,946)

These amounts are included in the accompanying balance sheet under the following captions:

Costs and estimated earnings in excess of billings on uncompleted contracts	
Billings in excess of costs and estimated earnings on uncompleted contracts	$ 24,946

6.

Property and Equipment

Property and equipment consisted of the following at December 31, 2006

:

Land	
Building	
Computer equipment	158,860
Office furniture and equipment	347,119
	505,979
Less: accumulated depreciation	(364,593)
Property and equipment, net	141,386

Depreciation expense for the years ended December 31, 2006 and 2005 was $53,806 and $97,823, respectively.

7.

Notes Payable

Notes payable consist of the following at December 31, 2006:

Note payable to a bank, non-interest bearing,, payable in one installment of $10,000 on February 28, 2007, one installment of $10,000 payable May 31, 2007, and one final installment of $110,000 payable in one installment on August 31, 2007.	$130,000
Note payable to insurance premium finance company bearing interest at a rate of 10.59% and payable in monthly installments of $806.91	$ 3,145
Total notes payable	$ 133,145

Certain notes payable to banks contain various financial and non-financial covenants, which require the Company, among other things, to maintain certain levels of stockholders equity and to comply with certain financial ratios. The Company was in violation of these covenants as of December 31, 2006 and the banks could demand full payment of all principal and interest.

8.

Obligations Under Product Financing Arrangements

In financing the production of its arcade equipment, the Company had entered into agreements whereby an entity or individual advanced funds to the Company to produce specific arcade equipment. Under this arrangement, the Company had agreed to make monthly payments for a specified amount for three years, with an automatic renewal for an additional three years unless cancelled in writing, from the origination date as specified in the agreement. In addition, the entity or individual advancing the funds had the right to exercise a buy-out whereby the Company has 180 days to repay the obligation upon exercise of the buy-out. Interest is payable monthly at an annual rate of approximately 16%.

In connection with these financing arrangements, the Company had incurred debt issuance costs of approximately 21% of the total obligation. These costs were amortized over a three year period using the interest method resulting in an effective annual interest rate of approximately 29% on these obligations.

As of December 31, 2006, the Company was in default on its remaining obligations under the product financing arrangements (See Note 9) totaling $454,980, which included accrued interest. The Company has not made any interest payments on these obligations since September 2001 and has received notices from various individuals and entities demanding buyouts of these obligations.

9.

Debt Exchange Agreement

During 2004, the Company presented an exchange offer to the holders of certain of its notes payable and obligations under product financing arrangements whereby the debt holders were allowed to convert the

principal and accrued interest related to its debt to common stock of the Company under one of three options. Under Option A, the debt holder could receive common stock equal to 0.6 shares per dollar of principal amount he or she was owed, and was not required to lock up any of the shares he or she receives in the exchange. Under Option B, each debt holder could receive common stock equal to 0.9 shares per dollar of principal amount he or she was owed, but could not sell any of the shares for a period of six months, after which the shares could be sold in six equal monthly installments. Under Option C, each debt holder could receive common stock equal to 1.2 shares per dollar of principal amount he or she was owed, but could not sell any of the shares for a period of one year, after which the shares could be sold in six equal monthly installments. During the years ended December 31, 2005 and 2004, the Company issued 393,400 and 5,303,258 shares of its common stock in exchange for the following: (i) $0 and $183,500 in principal and $0 and $49,069 of accrued interest, respectively on its notes payable (ii) $0 and $615,531 in principal and $0 and $155,475 of accrued interest, respectively on its notes payable to stockholders and (iii) $159,782 and $5,792,176 of principal and interest, respectively, outstanding on its obligations under product financing arrangements. As a result of this debt exchange, the Company recorded $221,720 of forgiveness of debt income in the statement of operations for the years ended December 31, 2005.

10.

Forgiveness of Debt

In addition to the forgiveness of debt income resulting from the Debt Exchange Agreement (See Note 9), the Company also wrote off various notes payable and certain other notes payable to stockholders that were settled through a lawsuit settlement. Included in forgiveness of debt income in the statement of operations for the year ended

The company was in default on its building and equipment debt to Arizona Business Bank. We sold the property in on September 15, 2006. Negotiations with the bank resulted in an income item of $212,782 for the year ending December 31, 2006.

11.

Accrued Liabilities

Included in accrued liabilities as of December 31, 2005 is as follows:

Accrued payroll tax, including penalties and interest	$ 769,213
Accrued property tax	18,252
Accrued interest payable	541,172
Deferred revenue	58,511
Accrued commissions payable	929
Customer deposits	39,625
Accrued law suit liabilities	620.802
Other	376,106
	$2,454,610

12. Convertible Debentures

During February 2005 and August 2005 the Company issued $750,000 and $500,000, respectively, in convertible debentures. The debentures bear interest at 8% per year payable in cash or registered common stock at the Company s option. The debentures mature in February and August 2008 and are convertible, at the option of the holder, to shares of the company s common stock at a conversion price per share equal to the lower of (i) 80% of the lowest closing bid price for the common stock for the fifteen days prior to the conversion date; or (ii) 125% of the volume weighted average price on the closing date.

In addition the Company issued to the holders of the convertible debentures warrants to purchase 750,000 and 500,000 shares of the Company s common stock (See Note 15). In accordance with generally accepted accounting principles, the Company allocates the proceeds received from debt or convertible debt with detachable warrants or shares of common stock using the relative fair value of the individual elements at the time of issuance. Using the Black-Scholes valuation model, the Company has determined the aggregate value of the 750,000 warrants to be $117,427 (approximately $0.16 per warrant) and the value of the 500,000 warrants to be $48,655 (approximately $0.10 per warrant). The amount allocated to the warrants as debt discount has been recognized as additional interest expense over the period from the date of issuance of the note to the earlier of the conversion date or the stated maturity date. During the year ended December 31, 2006, the Company recognized $94,945 in interest expense related to the accretion of the debt discount recorded on these convertible debentures. As of December 31, 2006, the remaining balance of the debt discount was $122,388.

In accordance with generally accepted accounting principles, in the event the conversion price on debentures is less than the Company s stock price on the date of issuance, the difference is considered to be a beneficial conversion feature and is amortized as interest expense over the period from the date of issuance to the earlier of the conversion date or the stated maturity date. The Company has calculated the aggregate beneficial conversion feature of these convertible debentures to be $398,677 on the $750,000 debentures and $140,760 on the $500,000 debentures. During the year ended December 31, 2006, the Company recognized $189,840 in interest expense related to the amortization of the beneficial conversion feature recorded on these convertible debentures. As of December 31, 2006 the remaining balance of the beneficial conversion feature was $132,314.

13.

<u>Income Taxes</u>

The Company has incurred losses since its inception and, therefore, has not been subject to federal income taxes. As of December 31, 2006, the Company had net operating loss (NOL) carryforwards for income tax purposes of approximately $12,848,500 which expire in various tax years through 2026. Under the provisions of Section 382 of the Internal Revenue Code the ownership change in the Company that resulted from the merger of the Company could severely limit the Company s ability to utilize its NOL carryforward to reduce future taxable income and related tax liabilities. Additionally, because United States tax laws limit the time during which NOL carryforwards may be applied against future taxable income, the Company may be unable to take full advantage of its NOL for federal income tax purposes should the Company generate taxable income.

14.

Redeemable Common Stock

In 1997 the Company entered into an agreement to redeem 1,505,399 shares of common stock from certain stockholders at par value of $.005 per share with the consideration for such redemption to be paid pro-rata to such stockholders by March 31, 1998. During 2000 the Company and stockholders released 727,108 shares of common stock from the redemption requirement and 287,531 shares were redeemed. During 2004 the Company released an additional 16,559 shares of common stock from the redemption requirement and 67,743 shares of common stock were redeemed. During 2005, the Company redeemed 34,624 shares of common stock. None were redeemed in 2006 As of December 31, 2006, 371,834 shares remain to be redeemed at the option of the Company.

15.

Stock Options and Warrants

The Company periodically issues incentive stock options to key employees, officers, directors and outside consultants to provide additional incentives to promote the success of the Company s business and to enhance the ability to attract and retain the services of qualified persons.

In September 2001 the Company s stockholders amended the 2000 Incentive Stock Option Plan (the Plan). The stockholders have authorized 6,000,000 shares for the Plan and options granted under the Plan may be either incentive stock options or non-statutory stock options subject to certain restrictions as specified in the Plan. During the years ended December 31, 2006 and 2005, no options have been granted to employees under this Plan. As of December 31, 2006, options to purchase 100,000 shares of common stock are outstanding under the Plan.

Effective September 1, 2003, the Company granted stock options to purchase 1,000,000 shares of common stock at $0.10 per share to an employee. Options to purchase 200,000 shares are considered vested and exercisable upon the employee generating $600,000 of revenue for the Company during the first year of employment. Options to purchase 300,000 shares are considered vested and exercisable upon the employee generating $1,200,000 of revenue for the Company during the second year of employment. Options to purchase 500,000 shares are considered vested and exercisable upon the employee generating $1,500,000 of revenue for the Company during the third year of employment. These options expire at the end of each respective year if the revenue amounts are not achieved. As of December 31, 2006 options to purchase 200,000 shares of common stock became vested and exercisable resulting in compensation expense of $4,000. As of December 31, 2006 and 2005 options to purchase 300,000 and 500,000 respectively shares of common stock expired as the revenue target was not met. These options expire five years from the date they become vested.

Effective November 1, 2004, the Company granted options to purchase 4,000,000 shares of common stock to its CEO. These options become vested and exercisable as follows: (i) 2,000,000 shares at an exercise price of $0.31 per share upon 85% conversion of debt to equity related to the Debt Exchange Agreement (See Note 9); (ii) 1,000,000 shares at an exercise price of $0.31 per share upon the Company s first profitable quarter; and (iii) 1,000,000 shares at an exercise price of $0.005 per share upon the Company achieving positive stockholders equity. As of December 31, 2004, options to purchase 3,000,000 shares of common stock at an exercise price of $0.31 per share, which approximated fair value at the grant date, became vested and exercisable. During the year ended no additional options became vested and exercisable. These options expire on October 31, 2009.

Effective November 1, 2004, the Company granted options to purchase 1,000,000 shares of common stock to its President with an exercise price of $0.31 per share, which approximated fair market value at the grant date. These options became vested and exercisable upon the Company s first profitable quarter. As of December 31, 2004, these options were fully vested and exercisable and expire on October 31, 2009.

In an employment agreement entereded into with Major General Perry Dalby (USA-ret.), the company on June 1, 2006 granted General Dalby options to purchase 1,000,000 shares of the company s common stock at a strike price of $0.035 per share. The Board of Directors also granted stock options on an additional 2,000,000 shares at $0.035 per share to be vested as follows: (i) 500,000 shares if the stock price averages $.10 per share for one quarter, (ii) 500,000 shares if the stock price averages $.25 or higher for one quarter, (iii) 500,000 shares if the stock price averages $.50

per share for one quarter and (iv) 500,000 shares if the stock price averages $1.00 or higher for one quarter.

A summary of the Company s stock option activity and related information for the years ended December 31, 2006 and 2005 follows:

	Number of Shares Under Options	Weighted-Average Exercise Price
Outstanding December 31, 2004	6,100,000	$0.22
Granted	-	-
Exercised	-	-
Forfeited/cancelled	-300,000	$0.10

Outstanding December 31, 2005	5,800,000	$0.23
Exercisable December 31, 2005	4,300,000	$0.30
Granted	3,000,000	$0.035
Exercised	-	-
Forfeited/cancelled		
Outstanding December 31, 2006	8,800,000	$0.16

Following is a summary of outstanding stock options at December 31, 2005:

Number of Shares	**Vested**	**Expiration Date**	**Weighted Average Exercise Price**
100,000	100,000	2012	$0.21
700,000	200,000	2009	$0.10
1,000,000	-	2009	$0.005
4,000,000	4,000,000	2009	$0.31
3,000,000	1,000,000	2010	$.035
8,800,000	5,300,000		

In July 2002, the Company entered into an agreement for up to a maximum $5,000,000 sale of its common stock to Dutchess Private Equities Fund, LP (Dutchess). Under this investment agreement the Company has the right to issue a put notice to Dutchess to purchase the Company s common stock. Put notices cannot be issued more frequently than every seven days. The required purchase price is equal to 92% of the average of the four lowest closing bid prices of the common stock during the five-day period immediately following the issuance of the put notice. Each individual put notice is subject to a maximum amount equal to 175% of the daily average volume of the common stock for the 40 trading days before the issuance of the put notice multiplied by the average of the closing bid prices of the common stock for the three trading days immediately preceding the put notice date. Regardless of the amount stated in a put notice, the maximum amount that Dutchess is required to purchase is the lesser of the amount stated in the put notice or an amount equal to 20% of the aggregate trading volume of the common stock during the five days immediately following the date of the put notice times 92% of the average of the four lowest closing bid prices of the common stock during this five-day period. During the year ended December 31, 2005 the Company received $76,142 of net proceeds from the issuance of 246,352 shares of its common stock related to this agreement.

In February 2005, the Company entered into a new investment agreement with Dutchess for up to a maximum $6,000,000 sale of its common stock. Under this investment agreement the Company has the right to issue a put notice to Dutchess to purchase the Company s common stock. Put notices cannot be issued more frequently than every seven days. The required purchase price is equal to 92% of the average of the four lowest closing bid prices of the common stock during the five-day period immediately following the issuance of the put notice. Each individual put notice is subject to a maximum amount equal to 175% of the daily average volume of the common stock for the 40 trading days before the issuance of the put notice multiplied by the average of the closing bid prices of the common stock for the three trading days immediately preceding the put notice date. Regardless of the amount stated in a put notice, the maximum amount that Dutchess is required to purchase is the lesser of the amount stated in the put notice or an amount equal to 20% of the aggregate trading volume of the common stock during the five days immediately following the date of the put notice times 92% of the average of the four lowest closing bid prices of the common stock during this five-day period. During the year ended December 31, 2005, no shares of common stock were issued under this agreement.

A summary of the Company s stock warrant activity and related information is as follows:

	Number of Shares	Weighted Average Exercise Price
Outstanding at December 31, 2004	996,703	$0.38
Granted	1,750,000	$0.29
Exercised	-	-
Forfeited	-	-
Outstanding at December 31, 2005	2,746,703	$0.29
Granted		
Exercised		
Forfeited		
Outstanding at December 31, 2006	2,746,703	$0.29

In connection with the issuance of Convertible Debentures in 2005 (see note 12) the Company issued stock warrants to purchase 500,000 shares of the Company s common stock at $0.33, 250,000 shares of the Company s common stock at the lowest market price five days prior to funding and 500,000 shares of the Company s common stock at $0.19 per share. These warrants are exercisable over a 5 year period.

During August of 2005, the Company issued stock warrants to a consultant to purchase 500,000 shares of the Company s common stock at prices ranging from $0.25 to $0.40 per share. These warrants vest upon grant and are exercisable over a three-year period. Using the Black-Scholes Option Pricing Model with the following assumptions: (i) volatility of 71%, and (ii) interest rate of 3.5%, the value of the warrants were estimated to be $40,251 which was recorded as selling, general and administrative expense in the statement of operations for the year ended December 31, 2005.

16.

<u>Net Income (Loss) Per Share</u>

Basic earnings per share is calculated using the weighted average shares of common stock outstanding during the periods. Diluted earnings per share is calculated using the weighted average number of common and potentially dilutive common shares outstanding during the period, using the as-if converted method for convertible preferred stock, convertible secured debentures and convertible secured promissory notes, and the treasury stock method for options and warrants.

For the year ended December 31, 2005 and 2006, all of the outstanding stock options and warrants were not included in the computation of diluted net income (loss) per share since such inclusion would be antidilutive.

The following table sets for the computation of basic and diluted net income (loss) per share for the years ended December 31, 2006 and 2005:

	2006	2005
Numerator:		
Net income (loss) before accounting change	($1,473,507)	($1,995,056)
Denominator:		
Denominator for basic calculation weighted average shares	81,186,290	62,221,809
Dilutive common stock equivalents:		
Stock options		-
Stock warrants		-
Denominator for diluted calculation weighted average shares	81,186,290	62,221,809
Net income (loss) per share:		
Basic net income (loss) per share	($0.02)	($0.03)
Diluted net income (loss) per share	($0.02)	($0.03)

17.

Commitments and Contingencies

Lease Obligations

The Company rents office space in Houston, Texas on a month-to-month basis at $2,139 per month and in Tempe at $7,611 per month. Both facilities are leased from third parties.

In prior years, the company leased office space in Arlington, Texas from the law firm of Jones & Cannon. No payments were made during the years ended December 31, 2006 and 2005. Included in accounts payable at December 31, 2005 is $75,750 owed to the officer and stockholder for this rent. Included in the statement of operations for the years ended December 31, 2005 is rent expense of $18,000.

These lease charges were a component of the lawsuit against us by Jones & Cannon. The company has reserved adequate amounts on its books for this liability.

Employment Contract

Effective September 1, 2003, the Company entered into a contract with an employee whereby the employee is to receive a base salary and a four percent cash commission on all sales originated by the employee. In addition, the employee is entitled to receive options to purchase 1,000,000 shares of the Company s common stock with an exercise price of $0.10 per share, if certain sales targets are achieved for each of the next three years. If the sales targets are not achieved, the stock options will not be exercisable. As of December 31, the sales target in the first year was achieved, therefore, options to purchase 200,000 shares of common stock became exercisable. During December 31, 2006 and 2005 the sales target in the second and third year was not achieved, therefore, options to purchase 300,000 and 500,000 respectively, shares of common stock were cancelled (See Note 15).

Litigation

The Company is involved in litigation related to its delinquent repayment of certain of its obligations under product financing arrangements, notes payable to stockholder and accounts payable to vendors. Management believes that such litigation will not have a material impact on the Company s financial position, results of operations or cash flows as the amounts owed to these individuals and entities have been accrued in the accompanying balance sheet.

The Company is currently a party to certain other litigation arising in the normal course of business. Management believes that such litigation will not have a material impact on the Company s financial position, results of operations or cash flows.

18.

Related Party Transactions

Included in other current liabilities on the balance sheet are $82,252 owed to an officer of the company for advances he has made to Virtra Systems over the years.

19.

Subsequent Events

On January 10, 2006 the Company entered into an agreement to merge with a newly-formed entity, Virtra Merger Corporation, which in anticipation of the merger, is to acquire Altatron International, Inc., Chrysalis Manufacturing Corporation and Dynalist Manufacturing. Upon completion of due diligence, the matter has been shelved indefinitely.

On September 19, 2006, we entered into a factoring arrangement intended to provide additional working capital through factoring of our accounts receivable. At the time, we were moving toward a merger with VirTra Merger Corporation, separate company that had been formed to acquire Chrysalis Manufacturing Corporation, (a/k/a Altatron EMS) and another company. Upon consummation of those acquisitions, VMC was to be acquired by VirTra Systems, Inc.

The lender did not regard either VirTra Systems, Inc. or VMC as sufficiently creditworthy to grant a credit line without guarantees. As a result, we entered into an arrangement whereby CapNet Securities Corporation would be the borrower under the factoring arrangement, would secure its borrowings by accounts receivable of VirTra Systems and VMC, and would relend the borrowed funds to us and to VMC. We, VMC and Daniel L. Ritz, Jr., , a principal of CapNet, jointly and severally guaranteed payment of amounts drawn under the credit arrangement up to $1,000,000.

We borrowed $100,000 under the arrangement described above, an amount which is still outstanding. We understand that VMC and/or another company associated with CapNet borrowed additional amounts under the arrangement, and that the total amount due the lender currently stands at approximately $500,000.

The expected merger with VMC did not occur. We do not intend to borrow any more money from Charter Capital/CapNet under the arrangement and VMC (now known as ComCon Manufacturing Services, Inc.) informs us that they also do not intend to borrow additional amounts under the arrangement. Charter Capital has been notified that the parties intend to discontinue the facility altogether..

Charter Capital has agreed in principle to a modification which would limit the amount of our guaranty to $200,000.

In addition to the $100,000 that the company owes under this arrangement, we also have unsecured advances $96,650 from other companies largely owned and/or controlled by Daniel L. Ritz, Jr. No further payments will be made on those advances until we have been released from our guaranty to Charter Capital.

VirTra Systems, Inc. has since formalized the credit arrangement directly with Charter Capital for repayment over 90 days, at which time the company will be unconditionally released from the guarantee. As of March 30, 2007, we are current with Charter Capital.

During the course of 2006, the prospectus covering the registration of shares for conversion by Dutchess Private Equities lapsed, unbeknown either to VirTra Systems or Dutchess. From July through October, Dutchess continued to convert and Virtra honored their conversions to common stock in an apparent violation of securities laws. However it was not Virtra, but a selling shareholder that was selling the unregistered stock. There is no way to know whom the end buyers were so no formal offer of recission, the normal remedy in such cases, can be made. However, certain shareholders who acquired this stock during that period could seek recission. The company s potential liability could be up to $250,000.

Item 8. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable.

Item 8A. Controls and Procedures.

Based upon an evaluation performed within 90 days of this report, our chief executive officer and chief financial officer has concluded that our disclosure controls and procedures are effective to ensure that material information relating to our company is made known to management, including the chief executive officer and chief financial officer, particularly during the period when our periodic reports are being prepared, and that our internal controls are effective to provide reasonable assurance that our financial statements are fairly presented in conformity with generally accepted accounting principles.

In accord with SEC requirements, the chief executive officer and chief financial officer notes that, since the date of his evaluation to the date of this annual report, there have been no significant changes in internal controls or in other factors that could significantly affect internal controls, including any corrective actions with regard to significant deficiencies and material weaknesses.

Item 8B.

Other Information.

N/A

PART III

Item 9. Directors, Executive Officers, Promoters and Control Persons; Compliance With Section 16(a) of the Exchange Act.

The following table sets forth the names and ages of our current directors and executive officers, the principal offices and positions held by each person, and the date such person became our director or executive officer.

Name	Age	Positions	Date became director or executive officer
Perry V. Dalby	63	chief executive officer and chairman of the board of directors	June 20, 2006
Bob Ferris	36	president and director	September 21, 2001
J. David Rogers	53	chief financial officer	February 1, 2007
H. Frank Stanley	43	director	July 28,2006
			November 29, 2006
Thomas Cloud	43	director	

The members of our board of directors are elected annually and hold office until their successors are elected and qualified. Our officers are chosen by and serve at the pleasure of its board of directors. Some of the officers and directors have positions of responsibility with other businesses and will devote only such time as they believe necessary on our business.

There are no family relationships between any of the directors and executive officers. There was no arrangement or understanding between any executive officer and any other person pursuant to which any person was selected as an executive officer.

We do not have a separate audit committee.

Major General Perry V. Dalby (retired), age 62, has served on our advisory board of directors since January of 2005. In December of 2000, General Dalby assumed command of the 75th Division (training support), and mobilized the division in support of the global war on terrorism in January, 2003. Previously, in 1983, General Dalby was assigned to the 75th Maneuver Area Command, and subsequently assumed command as chief of the Battle Simulation Center, Combat Arms Branch, and as the assistant deputy commander for the 75th Division (Exercise). General Dalby retired from the U.S. Army in May of 2004. General Dalby s 37 years of military service were highlighted by the Distinguished Service Medal, Legion of Merit, Distinguished Flying Cross, Bronze Star (two clusters), and the Purple Heart.

Bob Ferris became our president in September of 2001. He previously had been the president of the former Ferris Productions, Inc. since he founded that company in 1993. Mr. Ferris attended the United States Air Force Academy with a major in management. He received a degree in systems engineering from the University of Arizona.

J. David Rogers became our chief financial officer in February of 2007. Since 2005, he has served as vice-president of corporate finance for CapNet Securities Corporation, a Houston-based NASD broker/dealer and investment bank.. In October, 2005 he became Vice President of Corporate Finance at CapNet Securities. From January of 2004, Mr. Rogers previously served as an analyst for CapNet Securities, and, prior to that, for The Dorato Group, which was then an affiliated company of CapNet Securities. In July, 2002, he joined Institutional Capital Management, Inc. in its fixed income department. From 1998 through 2001, Mr. Rogers was with The Tribo Companies, Houston based group of independent oil and gas exploration and production companies. He was the assistant controller of Tri-Union Development Corporation and its subsidiary, and Controller of the other companies in the group. Mr. Rogers, 53, served earlier in his career in operating and staff management positions for divisions of Dresser Industries, NL Industries and The Hughes Tool Company. He holds bachelor of science and masters in business administration degrees from Southern Methodist University, and NASD licenses 7 (general securities), and 63.

H. Frank Stanley retired as a major in military intelligence from the U.S. Army after serving for over 20 years. His military experiences range from instruction and leadership in special operation tactics to weapons training. Stanley's military duties have taken him from service in the United States to Bosnia and Iraq. Most recently, he served in Baghdad, Iraq, as the Army's chief of intelligence leading the War Crimes Investigations Team, hunting Iraq's 52 most-wanted war criminals. Mr. Stanley is presently a real estate development executive with Cushman & Wakefield in Houston.

Thomas J. Cloud was appointed as a director on December 19, 2006. Mr. Cloud has served as President, CEO, and Director, of Supreme Holdings, Inc. since May of 2002. Supreme Holdings, Inc. provides professional business services and solutions primarily to small and medium-sized businesses. Its shares are traded on the NASDAQ Bulletin Board under the symbol SUHO. From 1997 to 2001, Mr. Cloud served as founder, President and CEO of Oxford Financial Group, a boutique stock brokerage firm with headquarters in Houston, Texas. He holds a BA in Public Speaking and Debate from South Texas State University.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16 of the Securities Exchange Act of 1934, as amended ("Section 16"), requires that reports of beneficial ownership of capital stock and changes in such ownership be filed with the Securities and Exchange Commission (the "SEC") by Section 16 "reporting persons," including directors, certain officers, holders of more than 10% of the outstanding common stock and certain trusts of which reporting persons are trustees. We are required to disclose in this annual report on Form 10-K each reporting person whom we know to have failed to file any required reports under Section 16 on a timely basis during the fiscal year ended December 31, 2005 or prior fiscal years.

Code of Ethics

We have not adopted a code of ethics for our principal executive officer and senior financial officers. The board of directors intends to hold these officers to the highest ethical standards in their conduct of our business, but it does not believe that for a small company like ours formal exhortations to that effect are effective or contribute to that objective. The board of directors also believes that publishing a laundry list of specific prohibitions would be counter-productive, as it would detract from the board of director's objective by encouraging the attitude that all conduct not specifically prohibited is permitted.

Significant Employees

In addition to the officers and directors identified above, the following employees play a significant role in our operations.

Tom Milks, age 44, serves as our vice-president of advertising and promotion sales. Previously, Mr. Milks ran the North American operations office of Virtuality, a virtual reality company. Before joining our company, he was the Western United States sales director for BitFlash, a graphic technology company, based in Ottawa, Ontario, Canada.

Steve Haag, age 46, serves as our vice-president of investor relations. Mr. Haag received his bachelors degree in psychology, with a minor in organizational behavior, from Webster University in 1993, and his masters degree in education from the University of Missouri-St. Louis in 1995. Before joining us, he was employed at Connect Computer Group, Inc., the firm which was largely responsible for the development of our kiosk and computer systems.

Matt Burlend, age 32, serves as vice-president of production and senior engineer. Prior to his employment with the former Ferris Productions, Mr. Burlend was employed from 1996 until 1999 at Panduit Corporation, a designer of automated production equipment, as a machine design engineer. Mr. Burlend holds a mechanical engineering degree from Olivet Nazarene University.

Item 10. Executive Compensation

Summary Compensation Table

This summary compensation table shows certain compensation information for services rendered in all capacities during each of the last two completed fiscal years.

SUMMARY COMPENSATION TABLE

Name and principal position	Year	Salary ($)	Bonus ($)	Stock Awards ($)	Option Awards ($)	Non-Equity Incentive Plan Compensation ($)	Nonqualified Deferred Compensation Earnings ($)	All Other Compensation ($)	Total ($)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
Perry V. Dalby, CEO	2006	87,500	-	-	5,000	-	-	-	92,500
	2005	-	-	-	-	-	-	-	-
L. Kelly Jones, former CEO	2006	60,000	-	-	-	-	-	-	60,000
	2005	180,000	-	-	-	-	-	-	180,000
J. David Rogers, CFO	2006	-	-	-	-	-	-	-	-
	2005	-	-	-	-	-	-	-	-
Robert L. Ferris, President	2006	80,000	-	-	-	-	-	-	80,000
	2005	120,000	-	-	-	-	-	-	120,000

We have an employment agreement with General Dalby which expires in June of 2008. Under that employment agreement General Dalby is entitled to a salary of $150,000 per year, and to receive compensation of $10,000 per quarter while a member of the Board of Directors. Both the salary and the compensation for serving as a director may be paid in stock, cash or stock options. In addition to the salary and director's fees provided for in the agreement, if we report a profitable year of at least $100,000 in net profit, the General is to receive 7.5% of net profit in the form of cash or stock. Further, he is entitled to stock options under which he may purchase up to 2,000,000 shares of our common stock at a price of $0.035 per share upon achievement of the following goals:

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500,000 shares if our stock price averages $.10 or higher for one quarter

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an additional 500,000 shares if the stock price averages $.25 or higher for one quarter

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an additional 500,000 shares if the stock price averages $.50 or higher for one quarter, and

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an additional 500,000 shares if the stock price averages $1 or higher for one quarter.

2000 Incentive Stock Option Plan

In February, 2000, the board of directors adopted, and a majority of the shareholders approved, our 2000 Incentive Stock Option Plan, subject to approval of shareholders at the next annual meeting. The purpose of the plan is to enable us to attract, retain and motivate key employees who are important to the success and growth of our business, and to create a long-term mutuality of interest between our shareholders and those key employees by granting them options to purchase our common stock. Options granted under the plan may be either incentive stock options or non-statutory options. The plan is to be administered either directly by the board, or by a committee consisting of two or more outside directors (the **"Committee"**). Under the plan, options may be granted to our key employees. The option price is to be fixed by the Committee at the time the option is granted. If the option is intended to be an incentive stock option, the purchase price is to be not less than 100% of the fair market value of the common stock at the time the option is granted, or, if the person to whom the option is granted is the owner of 10% or more of our common stock, 110% of such fair market value. The Committee is to specify when and on what terms the options granted to key employees are to become exercisable. However, no option may be exercisable after the expiration of ten years from the date of grant or five years from the date of grant in the case of incentive stock options granted to a holder of ten percent or more of our common stock. In the case of incentive stock options, the aggregate fair market value of the shares with respect to which the options are exercisable for the first time during any calendar year may not exceed

$100,000 unless this limitation has ceased to be in effect under Section 422 of the Internal Revenue code. If there is a change of control of our company, all outstanding options become immediately exercisable in full. In the event of an employee's death, or following the employee's retirement at or after age 65 or before age 65 with the consent of the Committee, outstanding options may be exercised for a period of one year from the applicable date of death or retirement. If the employee's employment is terminated for reasons other than death or retirement, the options remain exercisable for a period of three months after such termination unless termination was for cause, in which case all outstanding options are immediately canceled. 1,500,000 shares of common stock have been initially authorized for issuance under the plan. Under the plan, eligible individuals may, at the discretion of the Committee, be granted options to purchase shares of common stock. However, no eligible individuals may be granted options for more than 500,000 shares in any calendar year. The option price and number of shares covered by an option will be adjusted proportionately in the event of a stock split, stock dividend, etc., and the Committee is authorized to make other adjustments to take into consideration any other event which it determines to be appropriate to avoid distortion of the operation of the plan. In the event of a merger or consolidation, option holders will be entitled to acquire the number and class of shares of the surviving corporation which they would have been entitled to receive after the merger or consolidation if they had been the holders of the number of shares covered by the options. If we are not the surviving entity in a merger and consolidation, the Committee may in its discretion terminate all outstanding options, and in that event option holders will have 20 days from the time they received notice of termination to exercise all their outstanding options. The plan terminates ten years from its effective date unless terminated earlier by the board of directors or the shareholders. Proceeds of the sale of shares subject to options under the plan are to be added to our general funds and used for its general corporate purposes.

On September 21, 2001, our shareholders approved the 2000 Incentive Stock Option Plan, and increased the shares authorized for the plan from 1,500,000 to 6,000,000.

In May of 2002, options for 150,000 shares under the plan, at an option price of $0.21, were granted to our corporate secretary and our then-current vice-president of operations. The former vice-president of operations has exercised his options.

In February of 2005, options for 1,700,000 shares under the plan, at an option price of $0.30, were granted to our vice-president of production and senior engineer; our vice-president of advertising/promotion; our vice-president of investor relations; our director of training; our corporate secretary; our senior engineer; our senior graphics designer; our videographer; and our graphic artist.

The following table shows certain information concerning equity awards which were outstanding as of December 31, 2006.

OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END

	OPTION AWARDS					STOCK AWARDS			
Name	Number of Securities Underlying Unexercised Options	Number of Securities Underlying Unexercised Options	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options	Option Exercise Price	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested	Market Value of Shares or Units of Stock That Have Not Vested	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested
(a)	(#)	(#)	(#)	($)	(f)	(#)	($)	(#)	(#)
	Exercisable	Unexercisable	(d)	(e)		(g)	(h)	(i)	(j)
	(b)	(c)							
Perry V. Dalby, CEO	1,000,000	2,000,000		0.035	2011	-	-	-	-
Robert L. Ferris, President	2,000,000		-	0.310	2009	-		-	-
L. Kelly Jones, former CEO	3,000,000	1,000,000	-	0.310	2009			-	-

Compensation of Directors

Effective for a portion of the year 2006, members of the Board of Directors are paid $10,000 per quarter, payable in common stock of the company.

Name (a)	Fees Earned or Paid in Cash ($) (b)	Stock Awards ($) (c)	Option Awards ($) (d)	Non-Equity Incentive Plan Compensation ($) (e)	Non-Qualified Deferred Compensation Earnings ($) (f)	All Other Compensation ($) (g)	Total ($) (j)
Perry V. Dalby	7,500	20,000	-	-	-	-	27,500
Michael Kitchen		23,330	-	-	-	-	23,330
H. Frank Stanley		23,330	-	-	-	-	23,330
Thomas Cloud		3,333	-	-	-	-	3,333

General Dalby's cash compensation was for his period as an advisory director, and prior to his appointment as CEO.

Item 11. Security Ownership of Certain Beneficial Owners and Management

The following table shows, as of March 15, 2007, information about equity securities we believe to be owned of record or beneficially by

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each of our directors;

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each person who owns beneficially more than 5% of any class of our outstanding equity securities; and

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all of our directors and executive officers as a group.

Shareholder s Name and Address	Number of Shares Owned	Percent
L. Kelly Jones 440 North Center Arlington, Texas 76011	7,088,752 (5)	7.1% (1)
Bob Ferris 1941 South Brighton Circle Mesa, Arizona 85208	7,860,240 (2)	7.9% (1)
L. Andrew Wells 1011 Compass Cove Circle Spring, Texas 77379	5,530,120(4)	5.6% (1)
Perry V. Dalby 1400 N Loop 121 Belton, Texas 76513	4,000,000 (3)	4.0% (1)
all officers and directors as a group (4 persons)	11,860,240	11.5% (1)

* less than 1%.

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(1)

based on 96,972,540 shares outstanding, fully diluted to 105,772,540 if all options exercised

(2)

Includes options for 2,800,000 shares exercisable within sixty days

(3)

Includes options for 3,000,000 shares exercisable within sixty days

(4)

Includes 2,000,000 shares owed for consulting services rendered, but yet to be distributed

(5)

includes incentive conditional options to purchase 3,000,000 shares of our common stock for $930,000, which are exercisable within 60 days.

The beneficial owners of securities listed above have sole investment and voting power with respect to such shares. Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to securities. Shares of stock subject to options or warrants currently exercisable, or exercisable within 60 days, are deemed outstanding for purposes of computing the percentage of the person holding such options or warrants, but are not deemed outstanding for purposes of computing the percentage of any other person.

Item 12. Certain Relationships and Related Transactions

Mr. Ferris, our president, is the owner of Ferris Holdings, L.L.C., which was the landlord on the lease for our engineering, technical, and production facilities in Phoenix, Arizona. On December 31, 2004, we adopted FASB Interpretation No. 46R (FIN 46R), Consolidation of Variable Interest Entities (Revised) . This accounting change added assets and liabilities to the balance sheet as of that date resulting from the consolidation of Ferris Holdings, L.L.C., into our financial statements. Ferris Holdings, L.L.C. is an entity 100% owned by Mr. Ferris, and the entity s only asset is the land and building in Phoenix, Arizona, which we currently lease, Since we also guarantee the debt related to this property, we have an implicit variable interest in this entity. This accounting change resulted in $827,263 of additional property and equipment, net of accumulated depreciation, a $67,885 reduction in note receivable from a related party, and $805,856 of additional notes payable, but did not require an adjustment to earnings and is not expected to affect future earnings or cash flows. The accounting change did result in a loss of $(46,478), which is reported as a Cumulative effect of accounting change in the accompanying statement of operations. On September 15, 2006, the building was sold and Virtra was released from the lease without penalty. The company now leases space from an unrelated third party.

In December, 1997, we agreed to redeem at par value an aggregate of 1,505,399 shares of the common stock held by the ten former shareholders of First Brewery of Dallas, Inc., a company we acquired in April, 1997. The aggregate redemption price was $7,527.02. That redemption was to have occurred no later than March 31, 1998. However, we did not have sufficient funds to honor this commitment and are currently in default under the agreement as to a few of these shareholders. Mr. Jones and Ms. Biggs were among those whose shares were to have been redeemed. In February, 2000, we and Mr. Jones agreed that the shares that were to have been redeemed from Mr. Jones would not be redeemed. In September of 2004, we and Ms. Biggs agreed that the shares that were to have been redeemed from Ms. Biggs would not be redeemed. In February, 2002, we completed the redemption of 287,531 of these shares from one shareholder, and those shares when received were canceled. In December, 2004, and January, 2005, we completed the redemption of 67,743 and 34,624 of these shares from two shareholders. Demand has been made upon the remaining four shareholders for 371,834 shares.

During the period from July, 1997 through May, 1998 Mr. Jones, our chairman of the board and chief executive officer, lent us an aggregate of $90,000 for use as operating capital. Of this amount, $65,000 was subsequently eliminated when Mr. Jones accepted in full satisfaction of that debt certain equipment securing bank debt which Mr. Jones had guaranteed, leaving a balance of $25,000.00. This indebtedness was evidenced by an unsecured demand promissory note at an annual interest rate of 12 % per annum. During the period from November, 2000 through December, 2001, Mr. Jones lent us an aggregate of $81,000 for use as operating capital, for a total indebtedness of $106,000. This $81,000 indebtedness was evidenced by unsecured promissory notes without interest. All of this indebtedness was converted to 151,200 common shares, contractually locked up until as long as June of 2006, as part of our debt conversion plan approved on December 13, 2004.

Item 13. Exhibits

N/A

Item 14. Principal Accountant Fees and Services.

Audit fees.

The aggregate fees billed for each of the last two fiscal years for professional services rendered by our principal accountant for the audit of our annual financial statements and review of financial statements included in our Forms 10-QSB were $50,000 and $76,477 for each of the fiscal years ended December 31, 2005 and 2006, respectively.

Audit-Related Fees

N/A

Tax Fees

$3,000 per year.

All Other Fees

N/A

Pre-approval Policies and Procedures

All engagements of our auditors are approved by the board of directors before the accountant is engaged to render audit or non-audit services.

Signatures

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

VIRTRA SYSTEMS, INC.

(Registrant)

By:

/s/ Perry V. Dalby

Perry V. Dalby, chief executive officer

Dated April 15, 2006

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

Signature	Title	Date
/s/ Perry V. Dalby Perry V. Dalby	chief executive officer and director president and director	

/s/ Bob Ferris
Bob Ferris

/s/ J. David Rogers J. David Rogers	chief financial officer
/s/ H. Frank Stanley H. Frank Stanley	director
Thomas Cloud	director