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DALRADA FINANCIAL CORP  
Form 10KSB  
October 17, 2006

U.S. SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-KSB  
(Mark One)

ANNUAL REPORT PURSUANT SECTION 13 OR 15(D) OF THE  
SECURITIES EXCHANGE ACT OF 1934.

For the fiscal year ended June 30, 2006.

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 0-12641

DALRADA FINANCIAL CORPORATION  
(Name of small business issuer in its charter)

DELAWARE  
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13-0021693  
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(State or other jurisdiction of  
incorporation or organization)

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

9449 BALBOA AVENUE, SUITE 210  
SAN DIEGO, CA 92123  
(Address of principal executive offices)

Registrant's Telephone number, including area code: (858) 451-6120

Securities registered under 12(b) of the Exchange Act: None

Securities registered under Section 12(g) of the Act: Common Stock Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 Regulation S-B is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. Yes  No

The issuer had revenues of \$70,380,000 for the fiscal year ended June 30, 2006.

The aggregate market value of the voting stock held by non-affiliates on June 30, 2006 was approximately \$,3085,998 based on the average of the bid and asked prices of the issuer's common stock in the over-the-counter market on such date as reported by the OTC Bulletin Board. As of June 30, 2006 4,886,248 post split shares of the issuer's Common Stock were outstanding. As of September 15, 2006 4,886,248 post split shares of the issuer's Common Stock were outstanding.

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). (Check one): Yes [ ] No [X]

## DOCUMENTS INCORPORATED BY REFERENCE

None

TRANSITIONAL SMALL BUSINESS DISCLOSURE FORMAT: YES [ ] NO [X]

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PART 1.

## ITEM 1. DESCRIPTION OF BUSINESS

Dalrada Financial Corporation (OTCBB symbol: DFCO) ("DFCO" or the "Company") was incorporated in March 1982 under the laws of the State of California, and reincorporated in May 1983 under the laws of the State of Delaware. The Company's principal executive offices are located at 9949 Balboa Avenue, Suite 210, San Diego, CA 92123. The Company's main phone number is (858) 277-5300.

We provide financial services to small and medium-size business. Our clients rely on us to provide services that relieve them from many of the day-to-day tasks that negatively impact their core business operations, such as payroll processing, human resources support, workers' compensation insurance, safety programs, employee benefits, and other administrative services.

Our business is predominantly related to staffing - staff leasing, temporary staffing and co-employment. We provide core services as well as a wide selection of employee and employer benefits, which we present as the Benefits Bank(TM). These aftermarket products include health insurance, business insurance, 401k plans, 125 cafeteria plan, tool reimbursement, deferred compensation programs, voluntary benefits, debit cards, and discount programs for employees.

### FINANCIAL AND HUMAN RESOURCES SERVICES

We provide a variety of financial, staffing, professional employer organization outsourcing (PEO) and human resources services to small and medium-size businesses. These services allow our customers to outsource many human resources tasks, including payroll processing, workers' compensation insurance, employee benefits administration, risk management and human resource administration. These financial services relieve existing and potential customers of the burdens associated with personnel management and control.

As a human resource department and strategic business partner for our clients, our service offerings allow our clients to:

- o comply with ever evolving complex employment related regulatory and tax issues;
- o increase productivity by improving employee satisfaction and retention;
- o reduce payroll expenses with lower workers' compensation costs; and
- o focus on core business activities instead of human resource matters.

We also provide our products and services through our subsidiaries and divisions: SourceOne Group, Inc. ("SOG"), Heritage Staffing and The Solvis Group, Inc., ("Solvis"). Solvis operates several operating units, including CallCenterHR(TM), Solvis Financial Services, Solvis Medical Staffing and Solvis Home Health Care.

Our temporary staffing services include on-demand or short-term staffing assignments, long-term or indefinite-term contract staffing and on-site management. This segment of our business is primarily devoted to medical, light industrial, and call center staffing.

In a co-employment or PEO contract arrangement, we become a co-employer of the client's existing workforce and assume some or all of the client's human resource management responsibilities. Our product and services mix is similar, but the relationship with our PEO client is characterized by shared responsibility for employees.

### IMAGING PRODUCTS

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In January 2003, we completed the acquisition of a controlling interest in the shares of Quik Pix, Inc. ("QPI"), located in Anaheim, California. At the time of acquisition, QPI's principal business was providing products and services associated with visual marketing support. QPI revenues consist primarily of developing and mounting photographic and digital images for use in display advertising for tradeshows and customer building interiors. QPI also has a proprietary product PhotoMotion Images(TM), ("PhotoMotion") which is a patented color medium of multi-image transparencies. DFCO moved its ColorBlind(TM) software business into QPI. The business is in the process of being sold to another company, which will be concluded by the end of October 2006.

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In July 2005, QPI acquired The Solvis Group, Inc. ("Solvis") from DFCO and changed its name to The Solvis Group and its trading symbol to SLVG. Solvis currently trades on the Pink Sheets(R).

### MARKET OVERVIEW - FINANCIAL AND HUMAN RESOURCES SERVICES

The burdens placed on small and medium-sized employers by the complex legal and regulatory issues related to human resources management caused our industry segment to grow beginning in the 1980's. While various service providers have been available to assist these businesses with specific tasks, companies like ours emerged as providers of a more comprehensive range of services relating to the employer/employee relationship. We assume broad aspects of the employer/employee relationship for our clients. Because we provide employee-related services to a large number of employees, we provide economies of scale that provide our clients employment-related functions more efficiently, provide a greater variety of employee benefits, and devote more attention to human resources management.

We believe that the demand for our services is driven by (1) the trend by small and medium-sized businesses toward outsourcing management tasks outside of core competencies; (2) the difficulty of providing competitive health care and related benefits to attract and retain employees; (3) the increasing costs of health and workers' compensation insurance coverage and workplace safety programs; and (4) complex regulation of labor and employment issues and the related costs of compliance.

### MARKET OVERVIEW - IMAGING PRODUCTS

During FY 2006 we continued to operate a business unit, Quik Pix (a division of The Solvis Group) to market our proprietary imaging products and to provide photographic services to selected clientele.

ColorBlind software is a suite of software applications, which allow users to build color profiles of images in order to insure accurate output on digital devices such as printers, plotters, scanners, monitors, and cameras.

Photomotion is a patented process for adding multiple images to backlit static displays that appear to change as the viewer passes by the image. The PhotoMotion process uses existing original art to create an illusion of movement; and allows for separate and distinct image displays. It allows for three to five distinct images to be displayed within an existing light box. Images appear to change or "morph" as the viewer passes the display.

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We offer a spectrum of services allowing a client to produce color visuals (digital and photographic). We also offer a full range of color laboratory reproduction services.

The Company is in the process of selling this business unit to another company, with a planned closing of the transaction in October 2006.

### FINANCIAL AND HUMAN RESOURCE SERVICES

#### STRATEGIC OBJECTIVE

Our long-term strategic objective is to becoming a leading provider of human resource outsourcing services for small and medium-sized businesses. We differentiate our strategic position by offering a full spectrum of staffing services. The integrated nature of our platform assists our clients and customers in strengthening their organizational structure to meet their business objectives. Our operating and growth strategies are described below.

#### OPERATING STRATEGY

**SALES:** Our selling premise is that the aggregate cost providing human resources support in-house or purchasing separate services from multiple vendors is greater than the cost of purchasing from one independent source. We believe that we offer cost savings and managerial efficiencies to clients. Companies with multiple vendors often fail to realize the benefits and economies of scale of having a single, integrated source of human resource services.

We provide a broad range of human resource management tools and related financial services that meet critical personnel needs. Our solutions allow clients to maximize the value realized from integrating human resource needs by establishing a partnership with a single vendor.

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**OPERATIONAL EFFICIENCIES:** We recently reorganized our senior management into four regions in order to decentralize our management philosophy and structure to enhance our client contact and response. Our experienced senior managers possess the technical and management skills to be proactive in addressing the marketplace as well as being responsive to client needs. We believe that this investment in the re-organized structure and in the hiring of industry experienced senior managers will provide us with a platform to grow our business.

**WORKERS COMPENSATION AND RISK MANAGEMENT:** We have committed to minimize workers' compensation risk through disciplined underwriting processes. Our risk managers corroborate the underwriting data by assessing the candidate's operating culture, workplace safety standards and human resource administration philosophies, including compensation rates and benefit levels. If the client's safe-work culture or adherence to workplace safety procedures declines to unsatisfactory levels, we reserve the right to terminate the relationship under the terms of our contract.

We provide workers' compensation insurance through an independent carrier and coordinate rates, compliance, claims, safety programs, and medical review. We provide coverage through an A-rated national carrier and take responsibility for

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payment of premiums and the deposit of adequate reserves against claims.

### GROWTH STRATEGY

**EXPAND REGION AND BRANCH OFFICE OPERATIONS.** Our strategy is to increase penetration of our existing markets by enhancing our reputation and increasing brand awareness in the regions and cities in which we operate. We believe that there is substantial opportunity to further penetrate these territories by the effective use of insurance broker networks, referrals, and marketing efforts within the local business community.

**INCREASE VALUE-ADDED PRODUCTS AND SERVICES.** We believe that our partnership philosophy provides us with the opportunity to expand our staffing services and add on services. We will be able to continue our base level of service fees per client employee and to increase our business through products and programs such as employee benefits, which are expected to provide incremental profits and to improve client retention.

**INFORMATION SYSTEMS.** We have invested in new payroll processing systems, financial information systems and related process management systems during this past year. We intend to add a comprehensive human resource management system during the next year. The combination of these efforts are expected to provide us with a scalable platform to enable efficient growth. The systems will allow our customer service and human resource personnel to increase productivity while maintaining high levels of quality service.

**STRATEGIC ACQUISITION.** In May 2006 we acquired Strategic Staff Leasing, Inc., a Dallas, Texas-based provider of benefits and PEO services. In September 2006 we acquired All Staffing, Inc. - a PEO serving Pennsylvania, New Jersey and New York. All Staffing billed approximately \$100 million in non-GAAP gross revenues for 2005. We expect to continue to seek acquisitions that will effectively support our growth strategy.

### PRODUCTS AND SERVICES.

Our business provides a broad range of services associated with human resources management. These include benefits and payroll administration, health and workers' compensation insurance programs, voluntary benefits programs, personnel records management, employer liability management, employee recruiting and selection, performance management, and training and development services.

We perform a wide variety of processing and record keeping tasks, mostly related to payroll administration and government compliance. Specific examples include payroll processing, payroll tax deposits, quarterly payroll tax reporting, employee file maintenance, unemployment claims processing, workers' compensation claims management and reporting and safety programs.

We provide workers' compensation insurance through independent carriers and coordinate rates, compliance, claims, safety programs, and medical review. We provide coverage through an A-rated national carrier and take responsibility for payment of premiums and the deposit of adequate reserves against claims.

We sponsor benefit plans including individual and group health coverage, 401(k) and 125-Flex plans, and others. We are responsible for the costs and premiums associated with these plans, act as plan sponsor and administrator of the plans, negotiate the terms and costs of the plans, maintain the plans in accordance with applicable federal and state regulations, and serve as liaison for the delivery of such benefits to worksite employees.

We provide a variety of personnel management services, which provide our client companies access to resources normally found in the human resources departments of larger companies. Our client companies have access to a personnel guide, which sets forth a systematic approach to administering personnel policies and practices and is often customized to fit a client company's particular work culture/environment. We assume many employment-related responsibilities associated with administrative functions and benefit plans administration. Upon request, we can also provide our clients guidance on avoiding liability for discrimination, sexual harassment, and civil rights violations. We employ counsel specializing in employment law.

Our business represents a distribution channel for a wide variety of employer and employee benefit programs such as 401(k) plans, 125-Flex plans, legal services, tax consulting, payroll advances, and insurance programs. Our intention is to expand our business through offering a variety of financial services.

Our Company is growing rapidly, but profit margins are small. Consequently, profitability depends on (1) economies of scale leading to greater operating efficiencies; and (2) value-added services such as training, education, Internet support, and other services that may be used by employers and employees.

The income model for the service segment of our business generally revolves around fees charged for our services. While gross profit is low, gross revenues are generally substantial. To this end, the Company intends to pursue acquisitions of small firms and strategic alliances with similar companies as ours.

#### STAFFING SERVICES

Staffing services include on-demand or short-term staffing assignments, contract staffing, long-term or indefinite-term on-site management, and human resource administration:

Short-term staffing involves demands for employees caused by such factors as seasonality, fluctuations in customer demand, vacations, illnesses, parental leave and special projects.

Contract staffing refers to providing employees for our clients for a period of more than three months or an indefinite period.

We employ an experienced on site manager at a client's place of business under certain contractual arrangements. The manager is responsible for conducting all recruiting, screening, interviewing, testing, hiring and employee placement functions at the client's facility for a long-term or indefinite period.

We use a variety of methods to recruit our work force for staffing services. The employee application process may include an interview, skills assessment test, reference verification, and background checks. We use a pre-employment screening process to find and select applicants who are appropriately qualified for employment.

We have not experienced any material liability due to claims arising out of negligent acts or misconduct by our staffing services employees by staffing employees that are not under our direct control while working at a customer's business.

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### PEO SERVICES

In certain circumstances, we become a co-employer of the client's existing workforce in a PEO contract and assume responsibility for some or all of the human resource management responsibilities, including payroll and payroll taxes, employee benefits, health insurance, workers' compensation coverage, workplace safety programs, compliance with federal and state employment laws, labor and workplace regulatory requirements, and related administrative responsibilities. We have the right to hire and fire our worksite employees, while the client's management remains responsible for recruiting, work assignments, supervision and training.

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Prior to entering into a co-employer arrangement, we perform an analysis of the potential client's actual personnel and workers' compensation costs based on information provided. We recommend safety improvement procedures and equipment following a risk assessment. The potential client must agree to implement recommended changes as part of the co-employer arrangement.

Most service agreements provide for an initial term of one year with renewal provisions. Our agreements generally permit cancellation by either party upon 30 days' written notice. In addition, we may terminate the agreement at any time for specified reasons, including nonpayment or failure to comply with our workplace safety requests or as the result of worsening safety record or OSHA violations. The form of PEO services agreement also provides for indemnification of us by the client against losses arising out of any default by the client under the agreement, including failure to comply with any employment-related, health and safety, or immigration laws or regulations.

### IMAGING PRODUCTS AND SERVICES

During FY2006 we continued to provide imaging products and services through Quik Pix, a division of The Solvis Group. This business segment includes our proprietary ColorBlind color management software, our patented PhotoMotion Visual Images, and photographic services.

We are in the process of selling this business unit to another company with a planned closing of the transaction in October 2006.

### SALES AND MARKETING

Sales efforts are conducted by our regional and branch managers and by local sales representatives, often coupled with ties with insurance brokers. Our corporate office is responsible for product development, product management and the development of sales materials. Our sales activities are primarily focused on branch-level business relationships. Referrals by insurance brokers have been an important contributor in building our sales.

### COMPETITION

The financial and human resources services business is highly competitive, with over 800 firms operating in the U.S. There are several staffing services firms that operate on a nationwide basis with revenues and resources far greater than ours, such as Manpower, Inc and Kelly Services, Inc; in addition, we compete with local and regional staffing firms for customers and employees. The



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competitive factors that dominate the industry include price and quality placements of employees in a timely manner. We price our services competitively, provide premier customer service and manage the placement process.

Some large PEO companies are owned by insurance carriers and some are public companies whose shares trade on Nasdaq, including Administaff, Inc., Team Staff, Inc., Barrett Business Services, Gevity HR, Inc. and Staff Leasing, Inc. Competition includes staffing firms, payroll processors and financial services firms. As workers compensation insurance is often the key element in a client's decision to engage a PEO, competition among PEOs is often on the availability of cost competitive insurance. Our competitive position is enhanced by having a high deductible workers compensation plan with an A rated carrier. Our procedures to manage claims had resulted in a low claims loss experience in the last fiscal year.

The markets for our imaging products and services are also highly competitive and rapidly changing. Our ability to compete in our markets depends on a number of factors, including the success and timing of product and services introductions by us and our competitors, selling prices, performance, distribution, marketing ability, and customer support.

### WORKERS' COMPENSATION PROGRAM

Workers' compensation is a principal service we provide. We, as employer of record, are responsible for applicable statutory compliance for workers' compensation coverage. Our risk management activities are closely related to our underwriting approach.

INSURANCE FOR WORKERS' COMPENSATION. In April 2005, we obtained a high deductible policy with an A rated national carrier in order to manage our financial exposure from catastrophic injuries and fatalities. Regulations governing self-insured employers often require the employer to maintain surety deposits of government securities, letters of credit or other financial instruments to cover workers' claims in the event the employer is unable to pay for such claims.

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Our excess workers' compensation insurance annual policy provided coverage for single occurrences exceeding \$250,000 with an aggregate stop loss provision of \$4,000,000. We were required to post a \$2.625 million reserve with the carrier from which claims would be paid until all claims are settled. As of the end of the policy year, ending April 30, 2006, based upon an independent actuary report, we reserved \$615,000 in pending claims against the remaining collateral fund; producing an approximate \$1.8 million in excess reserves.

For the next policy year beginning May 2006, the carrier slightly raised our stop loss rates, but required us to deposit only \$1.6 million in the claims collateral fund as the result of our low claims experience in the prior year. However we are anticipating that, despite our risk management program and claims management program, we may not be able to duplicate the low claims experience of 2006 and may trend closer to traditional loss experiences of the general population.

CLAIMS MANAGEMENT . Our workers' compensation expense is tied directly to the incidence and severity of workplace injuries. We attempt to contain workers'

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compensation costs through an aggressive claims management process. We employ a managed-care system to minimize medical costs and income loss costs by assigning injured workers, as provided for in certain service agreements with our clients, to short-term assignments which are safe for the injured worker. We utilize TPAs for principal claims management expertise. Typical management procedures include performing thorough and prompt on-site investigations of claims filed by employees, working with physicians to encourage efficient medical management of cases, denying questionable claims and attempting to negotiate early settlements to eliminate future case development and costs.

**WORKERS' COMPENSATION INSURANCE COSTS** . The costs associated with our high deductible workers' compensation program include case reserves for reported claims, an additional expense provision for potential future increases in the cost of open injury claims, fees payable to our TPAs, administrative fees payable to state and federal workers' compensation regulatory agencies, premiums for excess workers' compensation insurance, and legal fees.

**WORKERS' COMPENSATION CLAIMS EXPERIENCE AND RESERVES:** We recognize our liability for the ultimate payment of incurred claims and claims adjustment expenses by accruing liabilities which represent estimates of future amounts necessary to pay claims and related expenses with respect to covered events that have occurred. When a claim involving a probable loss is reported, our TPA establishes a case reserve for the estimated amount of ultimate loss. The estimate reflects an informed judgment based on established case reserving practices and the experience and knowledge of the TPA regarding the nature and expected value of the claim, as well as the estimated expense of settling the claim, including legal and other fees and expenses of administering claims. The adequacy of such case reserves depends on the professional judgment of each TPA to properly and comprehensively evaluate the economic consequences of each claim. On an aggregate basis, we have established an additional reserve for both future adverse loss development in excess of initial case reserves on open claims.

As part of the case reserving process, historical data is reviewed and consideration is given to the anticipated effect of various factors, including known and anticipated legal developments, inflation and economic conditions. We have engaged an independent actuary to assist management in estimating the total future costs of claims, including potential future adverse loss development. We believe our total accrued workers' compensation claims liabilities at June 30, 2006, are adequate. It is possible, however, that our actual future workers' compensation obligations may exceed the amount of our accrued liabilities, with a corresponding negative effect on future earnings, due to such factors such as unanticipated adverse loss development of known claims, and to a much lesser extent, if any, of claims incurred but not reported.

### OPERATIONS

Our corporate headquarters facility in San Diego, California houses most of our administrative operations. Human resource services operations are conducted from the Company's headquarters offices and branch offices in Michigan (3), California (4), Colorado, Texas, and Pennsylvania (2). All of our offices are leased.

### INTELLECTUAL PROPERTY

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We have obtained U.S. registration for several of our trade names or trademarks, including ColorBlind, Photomotion Images, MedicalHR, CallCenterHR, SourceOne Group, and The Benefits Bank. These trade names are used to distinguish our products and services in the markets we serve.

If we fail to establish that we have not violated any asserted rights of others, we could be prohibited from marketing the associated product and/or services, and we could be liable for damages. We rely on a combination of trade secret, copyright and trademark protection, and non-disclosure agreements to protect our proprietary rights.

Software products related to our imaging operations are copyrighted. However, copyright protection does not prevent other companies from emulating the features and benefits provided by our software. We protect our software source code as trade secrets and make our proprietary source code available to OEM customers only under limited circumstances and specific security and confidentiality constraints. We hold the patent for Photomotion. These products exist in a rapidly changing business environment. Consequently, we believe the effectiveness of patents, trade secrets, and copyright protection is less important in influencing long term success than the experience of our employees and our contractual relationships. Due to lack of sales of the Photomotion, we have fully written-off the value of the related patent as of June 2005 year end.

### MANUFACTURING, PRODUCTION, AND SOURCES OF SUPPLY: - IMAGING PRODUCTS

We manufacture our software products and imaging products in-house and through selected outside vendors.

### RESEARCH AND DEVELOPMENT - IMAGING PRODUCTS

Some of our imaging products are characterized by rapidly evolving technology, frequent new product introductions, and significant price competition. We have entered into no formal projects in research and development for several years; however, we do make modifications to existing products on an as-needed basis to maintain their currency.

### GOVERNMENT REGULATION

While many states do not explicitly regulate companies like ours, over 20 states have passed laws that have licensing or registration requirements for professional employer organizations ("PEO"), which is a component of our business. Such laws vary from state to state, but generally provide for monitoring the fiscal responsibility of PEOs and, in some cases, codify and clarify the co-employment relationship for unemployment, workers' compensation, and other purposes under state law. We estimate that the annual cost of compliance with these regulations is approximately \$250,000.

### EMPLOYEES

Our Company (including subsidiaries, but not including employees pursuant to staffing and/or co-employer client contracts) employed a total of 75 individuals worldwide as of September 30, 2006. Of this number, 30 were involved in sales and marketing, 13 in corporate administration and finance, 40 were in human resources, payroll, and benefits administration, and 2 in technical support. There is no union representation for any of our employees.

### ITEM 2. DESCRIPTION OF PROPERTY

DFCO owns no real property. We lease or month-to-month rent all corporate and branch office facilities. At June 30, 2006, our leases had expiration dates ranging from less than one year to five years with total minimum payments

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through 2011 of approximately \$1.38 million.

### ITEM 3. LEGAL PROCEEDINGS

The Company and its SourceOne Group ("SOG") subsidiary have been sued by the Arena Football 2 Operating Company, LLC ("Arena") in Wayne County Circuit Court, Michigan. In April 2006, Dalrada and SourceOne Group, Inc. entered into a settlement with AF2 Operating Company, LLC and other parties involved in the matter of AF2 Operating Company, LLC v. SourceOne Group Inc., et al. The net result of the settlement was that Dalrada and SourceOne Group, Inc. are obligated to make a net settlement payment of \$ 202,500. In addition, the Company has filed claims against Arena and Arena's agent, Thilman and Filippini, based on, among other things, the representations made to SOG that led it to enter into the agreement with Arena. These claims are currently pending.

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The Company and SOG have been sued by Liberty Mutual Insurance Company ("Liberty") in the United States District Court for the Northern District of Illinois. The nature of the specific claims made by Liberty against the Company and SOG are that the Company and SOG were and are obligated to make additional premium payments to Liberty for workers' compensation insurance, which is related to the Arena litigation described above. The initial claim by Liberty was estimated by Liberty to be \$829 and is now claimed to exceed \$1,000. Management has vigorously contested the claims made by Liberty. The case remains in the discovery phase.

On April 25, 2006, a trial occurred in the matter of LM Insurance Corporation v. Brian Bonar pending in Superior Court of California for the County of San Diego. LM Insurance Corporation asserted that SourceOne Group, Inc. had entered into a policy for insurance coverage and that Brian Bonar had personally guaranteed the premium payments. The court found in favor of Brian Bonar.

On February 10, 2005, Berryman & Henigar Enterprises ("Plaintiff"), filed a complaint in the Superior Court of California, County of San Diego, Case No. GIC842610, against Warning Model Management, Inc. for breach of a promissory note issued pursuant to terms and conditions of a certain stock purchase and sale agreement dated September 9, 2004. The Company allegedly guaranteed payments on the underlying promissory note. Plaintiff seeks principal damages of \$750 in that regard. Warning Model Management, Inc. has taken the position that Plaintiff failed to disclose certain material information in the underlying transaction which thereby negates the promissory note. Warning Model Management, Inc. reached a settlement, effective as of September 30, 2005 with the Plaintiff, which requires defendants, collectively, to pay Plaintiff the aggregate sum of \$380. Defendants have made the initial two payments due under the settlement and the final payment in the sum of \$80 was paid in April 2006. Accordingly, the matter has been settled and all claims satisfied.

On March 17, 2005, Greenland Corporation ("Plaintiff"), filed an amended complaint in the Superior Court of California, County of San Diego, Case No. GIC842605, against the Company and multiple other individuals and entities resulting from a transaction as evidenced by the "Agreement to Acquire Shares" dated August 9, 2002, whereby the Company obtained a controlling equity interest in Plaintiff. Plaintiff contends that the Company engaged in various forms of wrongdoing including breach of fiduciary duty, conversion, conspiracy and aiding and abetting. The Company has filed a cross-complaint alleging various causes of

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action against Plaintiff and its officers, directors and/or managing agents including Thomas J. Beener, Gene Cross, George Godwin, and Edward Sano. The subject cross-complaint seeks pecuniary and punitive damages resulting from various fraudulent transactions as well as legal malpractice against Mr. Beener. In July 2006, the matter was settled with Dalrada paying \$150 thousand in legal fees incurred by Greenland.

On August 29, 2005, United Bank & Trust filed suit against the Company and other parties. The allegations of the lawsuit are that the Company guaranteed certain debt owed by InfoServices, Inc. and is liable in the amount of \$678. The case is in its early stages and discovery has not yet commenced. However, the Company intends to vigorously defend itself against the claims asserted.

Throughout fiscal 2004 and 2005, trade creditors have made claims and/or filed actions alleging the failure of the Company to pay its obligations to them in a total amount exceeding \$3,000. These actions are in various stages of litigation, with many resulting in judgments being entered against the Company. Several of those who have obtained judgments have filed judgment liens on the Company's assets. These claims range in value from less than \$1 to just over \$1,000, with the great majority being less than \$20.

On September 7, 2005, the arbitrator from the American Arbitration Association awarded to Accord Human Resources a judgment against Greenland Corporation and the Company as the guarantor, an amount equaling \$168. Legal counsel has estimated that the claim could amount to as much as \$214. The Company has reserved \$200 for the claim.

The Company was in a dispute with former creditors regarding the amount of debt converted into common stock. These creditors were seeking damages totaling \$316. The Company proposed a settlement in the amount of \$316, based on the advice of the Company's legal counsel. Consequently, \$316 was charged to operations in the accompanying financial statements for the three and six months ended December 31, 2005. The plaintiffs have accepted the settlement offer.

#### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITIES HOLDERS ANNUAL MEETING OF STOCKHOLDERS HELD ON MAY 25, 2006

At the Company's annual meeting of stockholders, held on May 25, 2006, the following proposals were voted upon and approved:

1. The election of five persons named in the accompanying Proxy Statement to serve as directors on the Company's board of directors (the "Board") and until their successors are duly elected and qualified;
2. To approve an amendment to the Certificate of Incorporation in order to effect a stock combination (reverse split) of the Common Stock in an exchange ratio of one newly issued share for each two hundred outstanding shares of Common Stock;
3. To ratify the appointment of Pohl, McNabola, Berg and Company, LLP, as the Company's independent auditors for the fiscal year ending June 30, 2006; and
4. To consider and transact such other business as may properly come before the Meeting or any adjournment(s) thereof.

The reverse split (Item 2 above) became effective as of September 15, 2006.

## PART II

## ITEM 5. MARKET FOR COMMON EQUITY AND RELATED SHAREHOLDER MATTERS

(a) Our common stock is quoted on the Over-the Counter Bulletin Board, also called the OTCBB, under the trading symbol "DFCO". The following table set forth the quarterly high and low bid prices per share for our common stock. The bid prices reflect inter-dealer prices, without retail markup, markdown, or commission and may not represent actual transactions.

|                          | Post Split |         |
|--------------------------|------------|---------|
|                          | High       | Low     |
|                          | ----       | ---     |
| Year ended June 30, 2005 |            |         |
| First quarter            | \$ 0.94    | \$ 0.46 |
| Second quarter           | 0.60       | 0.36    |
| Third quarter            | 0.76       | 0.40    |
| Fourth Quarter           | 1.26       | 0.42    |
| Year Ended June 30, 2006 |            |         |
| First quarter            | \$ 0.94    | \$ 0.46 |
| Second quarter           | 1.06       | 0.50    |
| Third quarter            | 1.98       | 0.70    |
| Fourth quarter           | 1.34       | 0.50    |

As of June 30, 2006, there were approximately 518 registered shareholders of DFCO's Common Stock and 997,175,961, (4,886,248 post split) issued and outstanding. The stock split was effective on September 15, 2006.

## TRANSFER AGENT AND REGISTRAR

DFCO's transfer agent is Atlas Stock Transfer, 5899 South State Street, Salt Lake City, Utah 54107, (801)266-7151.

## RECENT SALES OF UNREGISTERED SECURITIES

DFCO made the following sales of stock without registration using the exceptions available under the Securities Act of 1933, as amended, including unregistered sales made pursuant to Section 4(2) of the Securities Act of 1933, as follows:

## FISCAL YEAR 2005

Issuances are in pre-split shares.

On July 12, 2004, 38,000,000 shares (190,000 post split shares) were issued to the Longview Fund, LP as a partial conversion of a convertible debenture valued at \$175,560 of principal at \$0.00462 per share. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Longview Fund, LP was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On July 26, 2004, 450,000 shares (2,250 post split shares) were issued to

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Technipower, Inc, at \$.005 per share. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Technipower, Inc. was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On September 28, 2004 Allen, Sheridan and Temple were issued an aggregate of 1,500,000 shares (7,500 post split shares) at \$.0025 per share. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that the investors were sophisticated investors with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On September 28, 2004, 10,108,706 shares (50,544 post split shares) were issued to Bristol Investment Fund, Ltd. as a partial conversion of \$17,500 of principal and \$3,728.22 of interest at \$.0021 per share. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Bristol Investment Fund, Ltd. was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

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On October 19, 2004, David Whiteford , Michael Brann , and Jason Brann were issued 375,000, 576,950 and 576,950 shares (1,875, 2,885 and 2,885 post split shares respectively) of Dalrada common stock respectively valued at \$.00458 a shares for they service they performed in relation to the acquisition of Jackson Staffing. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that David Whiteford, Michael Brann and Jason Brann were sophisticated investors with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On October 19, 2004, Anne Woelk was issued 144,000 shares (720 post split shares) valued at \$.00500 a share for administrative services rendered. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Anne Woelk was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On October 25, 2004, Dominick Zack was issued 4,000,000 shares (20,000 post split shares) valued at \$.00500 a share for accounting services rendered in relation to the Jackson Staffing subsidiary. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Dominick Zack was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On October 25, 2004, Deborah McNeil was issued 1,000,000 shares (5,000 post split shares) valued at \$.00500 a share for accounting services rendered in relation to the Jackson Staffing subsidiary. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Deborah McNeil was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

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On December 3, 2004, 23,757,224 shares (118,786 post split shares) were issued to Bristol Investment Fund, Ltd. for conversion of \$29,000 of principal and \$6,635.84 of interest at \$0.00154 per share. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Bristol Investment Fund, Ltd., was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On December 13, 2004, 21,121,413 shares (105,607 post split shares) were issued to Stonestreet Limited Partnership at \$0.00151 per share for conversion of a convertible debenture valued at \$30,000 plus \$1893.56 in interest. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Stonestreet Limited Partnership was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On April 8, 2005, 46,852,670 shares (234,263 post split shares) were issued to Balmore S.A. at \$0.00181 per share for conversion of a convertible debenture valued at \$65,000 plus \$19,803.33 in interest. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Balmore S.A. was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On June 13, 2005, 6,000,000 shares ( 30,000 post split shares) were issued to John Capezzuto at \$0.005 per share. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that John Capezzuto was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On June 21, 2005, 525,000 shares ( 2,625 post split shares) were issued to Brian Bonar (CEO) at \$0.005 per share. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended.

### FISCAL YEAR 2006

Issuances are in pre-split shares.

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On July 12, 2005, 17,659,540 shares (88,298 post split shares) were issued to Bristol Investment Fund, Ltd. at \$0.001267 per share for conversion of a convertible debenture valued at \$22,374.67. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Bristol Investment Fund, Ltd was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On September 16, 2005, 5,000,000 shares (25,000 post split shares) were issued to Joseph Maleki at \$0.003 per share. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Joseph Maleki was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.



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On November 23, 2005, 33,698,362 shares (168,492 post split shares) were issued to Balmore S.A. at \$0.0017 per share for conversion of a convertible debenture valued at \$50,000 plus \$7,287.21 in interest. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Balmore S.A. was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On February 2, 2006, 10,000,000 shares (50,000 post split shares) were issued to Balmore S.A. at \$0.00236 per share for conversion of interest valued at \$23,660. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Balmore S.A. was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On February 2, 2006, 20,000,000 shares (100,000 post split shares) were issued to the Longview Fund at \$0.00226 per share for conversion of interest valued at \$45,200. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that the Longview Fund LP. was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On March 13, 2006, 51,178,167 shares (255,891 post split shares) were issued to Balmore S.A. at \$0.00226 per share for conversion of a convertible debenture valued at \$126,077 plus interest valued at \$2,662.58. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Balmore S.A. was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On March 13, 2006, 50,195,478 shares (250,978 post split shares) were issued to the Longview Fund LP. at \$0.00226 per share for conversion of a convertible debenture valued at \$112,226 plus interest valued at \$1,125.78. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that the Longview Fund LP. was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On March 13, 2006, 5,000,000 shares (25,000 post split shares) were issued to Naccarato & Associates at \$0.00226 per share. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Naccarato & Associates was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On March 13, 2006, 5,000,000 shares (25,000 post split shares) were issued to Grushko & Mittman PC at \$0.00226 per share. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Grushko & Mittman PC was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

On March 14, 2006, 50,000,000 shares (250,000 post split shares) were issued to Brian Bonar (CEO) at \$0.005 per share. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended.

On May 23, 2006, 25 shares (1 post split share) were issued to Mr. Kesselman at \$0.005 per share. These shares were issued pursuant to the exemption provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Mr. Kesselman was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

## ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

(in thousands, except share data)

The following discussion and analysis should be read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this Form 10-KSB. The statements contained in this Report on Form 10-KSB that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements regarding our expectations, hopes, intentions or strategies regarding the future. Forward-looking statements include statements regarding: future product or product development; future research and development spending and our product development strategies, and are generally identifiable by the use of the words "may", "should", "expect", "anticipate", "estimates", "believe", "intend", or "project" or the negative thereof or other variations thereon or comparable terminology. Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements (or industry results, performance or achievements) expressed or implied by these forward-looking statements to be materially different from those predicted. The factors that could affect our actual results include, but are not limited to, the following: general economic and business conditions, both nationally and in the regions in which we operate; competition; changes in business strategy or development plans; our inability to retain key employees; our inability to obtain sufficient financing to continue to expand operations; and changes in demand for products by our customers.

## OVERVIEW

We provide financial and human resource management services, including staffing services and PEO services. Staffing services revenues are generated primarily from short-term staffing, contract staffing, and on-site management. PEO service fees are generated from contractual agreements with clients under which we act as a co-employer of our client's workforce with responsibility for some or all of the client's human resource functions. We recognize revenues from our staffing services for all amounts invoiced, including direct payroll, employer payroll-related taxes, workers' compensation coverage and an administrative fee). PEO service fee revenues are recognized on a net basis in accordance with Emerging Issues Task Force No.99-19, "REPORTING REVENUES GROSS AS A PRINCIPAL VERSUS NET AS AN AGENT " ("EITF No.99-19"). Therefore PEO service fee revenues represent the gross margin generated from our PEO services after deducting the amounts invoiced to PEO customers for direct payroll expenses such as salaries, wages, health insurance and employee out-of-pocket expenses incurred incidental to employment. These amounts are also excluded from cost of revenues. PEO service fees also include amounts invoiced to our clients for employer payroll-related taxes and workers' compensation coverage.

Our business is conducted in California, Michigan, Colorado, Pennsylvania and Texas. In addition to seeking new markets, we expect to derive most of our revenues from our current markets for the near term. Any weakness in economic conditions or changes in the regulatory environments in these regions could have a material adverse effect on our financial results.

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Our services and products are marketed through our operating divisions and subsidiaries. PEO services are marketed by Dalrada Financial Services (formerly Strategic Staff Leasing), and All Staffing (acquired subsequent to year -end). Our staffing services revenues are obtained by: Heritage Staffing and our Solvis subsidiary (which includes CallCenterHR, Solvis Medical Staffing, and Solvis Home Health Care).

Our business continues to experience some liquidity problems. Accordingly, year-to-year comparisons may be of limited usefulness as our business continues to experience rapid growth.

Our current strategy is to expand our financial service business, including staff leasing, PEO services, and value added products and services to small and medium-size businesses.

To successfully execute our current strategy, we will need to improve our working capital position. The report of our independent auditors accompanying our June 30, 2006 financial statements included elsewhere in this Form 10KSB includes an explanatory paragraph indicating there is a substantial doubt about our ability to continue as a going concern, due primarily to a working capital deficiency and negative net worth, which is exacerbated by our losses in prior years. In addition, we are late in our filing of payroll tax returns for certain of our PEO divisions and are delinquent on the payment of payroll tax withholdings. We plan to overcome the circumstances that impact our ability to remain a going concern through a combination of achieving profitability and renegotiating existing obligations. In addition, we continue to work with the Internal Revenue Service and State taxing Authorities to reconcile and resolve all open accounts and issues.

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We have sought to reduce our debt through debt to equity conversions. In February 2006 we issued promissory notes for \$7,545,000, which consisted of a rolling over of approximate \$2,545,000 in existing debt and \$5,000,000 in cash. The proceeds were used primarily to pay off promissory notes, convertible note debt, factoring debt, and other debt and to establish collateral backed ACH credit lines.

There can be no assurance that we will be able to complete any additional debt or equity financings on favorable terms or at all, or that any such financings, if completed, will be adequate to meet our capital requirements. Any additional equity or convertible debt financings could result in substantial dilution to our shareholders. If adequate funds are not available, we may be required to delay, reduce or eliminate some or all of our planned activities, including any potential mergers or acquisitions. Our inability to fund our capital requirements would have a material adverse effect on the Company.

### SIGNIFICANT ACCOUNTING POLICIES AND ESTIMATES

Discussion and Analysis of Financial Condition and Results of Operations discuss our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. On an

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on-going basis, we evaluate our estimates and judgments, including those related to allowance for doubtful accounts, value of intangible assets and valuation of non-cash compensation. We base our estimates and judgments on historical experiences and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The most significant accounting estimates inherent in the preparation of our consolidated financial statements include estimates as to the appropriate carrying value of certain assets and liabilities which are not readily apparent from other sources, primarily allowance for doubtful accounts, estimated fair value of equity instruments used for compensation, estimated tax liabilities from PEO operations and estimated liabilities associated with worker's compensation liabilities. These accounting policies are described at relevant sections in this discussion and analysis and in the notes to the consolidated financial statements included elsewhere in this Form 10-KSB.

### REVENUE RECOGNITION

#### PEO SERVICE FEES AND WORKSITE EMPLOYEE PAYROLL COSTS

We recognize our revenues associated with our PEO business pursuant to EITF 99-19 "Reporting Revenue Gross as a Principal versus Net as an Agent." Our revenues are reported net of worksite employee payroll cost (net method). Pursuant to discussions with the Securities and Exchange Commission staff, we changed our presentation of revenues from the gross method to an approach that presents our revenues net of worksite employee payroll costs (net method) primarily because we are not generally responsible for the output and quality of work performed by the worksite employees.

In determining the pricing of the markup component of the gross billings, we take into consideration our estimates of the costs directly associated with our worksite employees, including payroll taxes, benefits and workers' compensation costs, plus an acceptable gross profit margin. As a result, our operating results are significantly impacted by our ability to accurately estimate, control and manage our direct costs relative to the revenues derived from the markup component of our gross billings.

Consistent with our revenue recognition policy, our direct costs do not include the payroll cost of our worksite employees. Our direct costs associated with our revenue generating activities are comprised of all other costs related to our worksite employees, such as the employer portion of payroll-related taxes, employee benefit plan premiums and workers' compensation insurance premiums.

#### TEMPORARY STAFFING

We record gross revenue for temporary staffing. We have concluded that gross reporting is appropriate because we (i) have the risk of identifying and hiring qualified employees, (ii) have the discretion to select the employees and establish their price and duties and (iii) bear the risk for services that are not fully paid for by customers. Temporary staffing revenues are recognized when the services are rendered by our temporary employees. Temporary employees placed by us are our legal employees while they are working on assignments. We pay all related costs of employment, including workers' compensation insurance, state and federal unemployment taxes, social security and certain fringe benefits. We assume the risk of acceptability of our employees to our customers.

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### WORKERS' COMPENSATION RESERVES

We are self-insured for workers' compensation coverage in a majority of our PEO and staffing employees up to \$250,000 per occurrence and up to an aggregate total of \$4 million for plan year 2006, ended April 30, 2006, and up to \$6 million for plan year ending April 30, 2007. Accruals for workers' compensation expense are made based upon our claims experience and a quarterly independent actuarial analysis, utilizing past experience, as well as claim cost development trends and current workers' compensation industry loss information. We believe the amount accrued is adequate to cover all known and unreported claims at June 30, 2006. However, if the actual costs of such claims and related expenses exceed the amount estimated, additional reserves may be required, which could have a material adverse effect on our operating results.

### ALLOWANCE FOR DOUBTFUL ACCOUNTS

We are required to make estimates of the collectibility of accounts receivables. Management analyzes historical bad debts, customer concentrations, customer creditworthiness, current economic trends and changes in the customers' payment tendencies when evaluating the adequacy of the allowance for doubtful accounts. If the financial condition of our customers deteriorates, resulting in an impairment of their ability to make payments, additional allowances may be required.

### INTANGIBLE ASSETS AND GOODWIL

We assess the recoverability of intangible assets and goodwill annually and whenever events or changes in circumstances indicate that the carrying value might be impaired. Factors that are considered include significant underperformance relative to expected historical or projected future operating results, significant negative industry trends and significant change in the manner of use of the acquired assets. Management's current assessment of the carrying value of intangible assets and goodwill indicates there was no impairment as of June 30, 2006. If these estimates or their related assumptions change in the future, we may be required to record impairment charges for these assets.

### SALES OF PRODUCTS

Revenue is recognized when earned. Our revenue recognition policies are in compliance with all applicable accounting regulations, including American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, Software Revenue Recognition, and SOP 98-9, Modification of SOP 97-2, Revenue from packaged product sales to and through distributors and resellers is recorded when related products are shipped. Maintenance and subscription revenue, if any, is recognized ratably over the contract period. When the revenue recognition criteria required for distributor and reseller arrangements are not met, revenue is recognized as payments are received. Provisions are recorded for returns and bad debts. Our software arrangements do not contain multiple elements, and we do not offer post contract support.

### RESULTS OF OPERATIONS (IN \$000)

YEAR ENDED JUNE 30, 2006 COMPARED TO YEAR ENDED JUNE 30, 2005

### REVENUES

Total revenues were \$70,380 and \$19,476 for the year ended June 30, 2006 and

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2005, respectively; an increase of \$50,904 (261%). The principal reason for the increase is due an overall increase in revenue in our staffing businesses.

Revenues of approximately \$1.3 million were not recorded as a result of a dispute with a customer. \$6.5 million of revenues were recorded as net fees only in accordance with EITF 99-19 GAAP requirements.

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### STAFFING

During fiscal 2005, certain staffing business units were renamed Solvis Group, Inc. Heritage Staff Leasing and Solvis revenues were \$68,226 and \$17,029 for the year ended June 30, 2006 and 2005, respectively; an increase of \$51,197 (300%). The principal reason for the increase is due to an increase in revenue from our staffing activities and our focus on this segment of our business - in California and in medical staffing.

Due to a dispute with a customer, we elected not to book approximately \$1.3 million in additional staffing revenues. However, costs associated with this activity have been included in our staffing cost of sales.

### PEO SERVICES

PEO revenues were \$1,382 and \$1,930 for the year ended June 30, 2006 and 2005, respectively; a decrease of \$548 (28%) due primarily to a decrease in our PEO customer base in California and our increased focus to expand our staffing business.

Under current GAAP rules, we are required to book PEO revenues on a net fee basis rather than as gross billed payrolls, which were approximately \$6.5 million in the fiscal year.

### PRODUCTS AND MANGEMENT FEES

Sales of products and software were generated from sales of imaging products in Solvis (imaging unit) and from management fees charged to a related party. Products revenues were \$772 and \$517 for the year ended June 30, 2006 and 2005, respectively; an increase of \$255 (49%). The increase is principally due to the recognition of a full year of management fees charged to a related party for the outsourcing of its human resources administration and payroll processing.

### COST OF PRODUCTS SOLD

Costs of staffing for the year ended June 30, 2006 and 2005 was \$62,897 (92% of temporary staffing revenue) and \$15,010 (88% of temporary staffing revenue), respectively. The decrease in gross profit is due primarily to the dramatic increase in low margin staffing business and our election to provide these services with more aggressive pricing in order to achieve greater market penetration.

Cost of PEO services for the year ended June 30, 2006 and 2005 was \$998 (72% of PEO revenues) and \$1,424 (74% of PEO revenues), respectively. The increase in gross profit is due primarily to lower workers' compensation costs.

Cost of products and software for the year ended June 30, 2006 and 2005 was \$34

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(4% of product revenue) and \$96 (19% of product revenue), respectively. The increase in gross profit was due to the significant growth in management fees.

### OPERATING EXPENSES

Operating expenses for the year ended June 30, 2006 and 2005 were \$11,190 and \$6,750 and, respectively; an increase of \$4,440 (66%). The increase is due to expenditures associated with building our business infrastructure (systems and staff) to accommodate our anticipated revenue growth, which was 261% greater than our prior fiscal year. Additionally we adjusted our accounting estimates, including legal and bad debt contingencies and other re-classifications, of approximately \$3.2 million.

During the year ended June 30, 2005, we determined that the cost of our PhotoMotion patent was not recoverable and took a write-off related to the patent of \$1,348.

### OTHER INCOME AND EXPENSE

Interest expense and financing costs for the year ended June 30, 2006 and 2005 was \$2,697 and \$1709 respectively; an increase of 988 (58%). The increase was principally due to the increase in the factoring of accounts receivable, (associated with the revenue growth primarily for staffing), the increase in debt associated with the February 2006 refinancing and the payoff of accrued interest as part of the refinancing. See Note 8 of the attached financial statements for further explanation of the refinancing and related derivative costs.

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Also associated with the February refinancing of debt was the loss on settlement of accrued interest, penalties and debt amounting to \$908. There was no loss on settlements in 2005.

### GAIN ON EXTINGUISHMENT OF DEBT

During the year ended June 30, 2006 and 2005, the Company recognized a gain on settlement of debt of \$8,546 and \$829, respectively. For the year ended June 30, 2006, the recognized a gain of \$4,120 related to the settlement of two notes payable to banks. (See Note 6 in attached financial statements) and a gain of \$2,140 related to the settlement of notes payable and accrued interest with a former director (See Note 9 in attached financial statements). The remaining gain of \$2,286 for the year ended June 30, 2006 and the gain of \$829 for the year ended June 30, 2005 resulted primarily from the write off of stale accounts payable and judgments. The Company, based upon an opinion provided by independent legal counsel, has been released as the obligator of these liabilities. Accordingly, management has elected to adjust its accounts payable and to classify such adjustments as settlement of debt.

### GAIN FROM RECONCILIATION OF PAYROLL TAX LIABILITES TO TAXING AUTHORITIES

For the years ended June 30, 2006 and 2005, we recorded as other income an adjustment of accrued PEO payroll taxes payable of \$1924 and \$1,895, respectively, resulting from reconciliations of certain liabilities with the Internal Revenue Service and certain State taxing authorities of amounts due for delinquent payment of payroll tax liabilities. We continually update our

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estimate of the amount due related to delinquent payroll taxes and penalties as we receive correspondence or settlement agreements with the Internal Revenue Service and State taxing authorities; accordingly we recognized penalties and interest as of June 30, 2006 and 2005 \$1,101 and \$1,312, respectively.

### CHANGES IN DERIVATIVES AND WARRANTY LIABILITIES

For the year ended June 30, 2006:

|          |   |
|----------|---|
| \$ 754   | income, decrease in value of warrant liability    |
| \$,1,234 | income, decrease in value of derivative liability |
| -----    |   |
| \$ 1,988 | other income related to convertible debt          |

For the year ended June 30, 2006, the Company recorded \$884 of interest expense related to the accretion of debt related to the convertible financing.

For the year ended June 30, 2006:

|        |  |
|--------|--|
| \$ 884 | of interest expense related to accretion of convertible debt |
| -----  |  |
| \$ 884 | of interest expense related to convertible debt              |

The balance of the carrying value of the convertible debt as of June 30, 2006 is:

|          |   |
|----------|---|
| \$ 1,605 | original carrying value on convertible debt |
| \$ (228) | converted to equity                         |
| 884      | accretion of convertible debt               |
| -----    |   |
| \$ 2,261 | June 30, 2006 carrying value of debt        |

The balance of the carrying value of the derivative liability as of June 30, 2006 is:

|           |   |
|-----------|---|
| \$ 2,717  | original value of derivative liability            |
| \$(1,234) | income, decrease in value of derivative liability |
| -----     |   |
| \$ 1,483  | June 30, 2006 value of derivative liability       |

The balance of the carrying value of the warrant liability as of June 30, 2006 is:

|          |  |
|----------|--|
| \$ 3,892 | original carrying value of warrant liability   |
| \$ (754) | income, decrease in value of warrant liability |
| -----    |  |
| \$ 3,138 | June 30, 2006 value of warrant liability       |

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During the year ended June 30, 2006, the Company discussed with the lead investor the refinancing of certain convertible notes, including disputed amounts for accrued interest, penalties and note balances. As part of the funding described above we recognized an additional settlement of accrued interest, penalties and balances for \$908. Please refer to Note 8 in the



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attached financial statements for additional detail.

### LIQUIDITY AND CAPITAL RESOURCES

Historically, we have financed our operations primarily through cash generated from operations, debt financing, and the sale of equity securities. Additionally, in order to facilitate our growth and future liquidity, we have made some strategic acquisitions.

As a result of some of our financing activities, there has been a significant increase in the number of issued and outstanding shares. During the year ended June 30, 2006 and the year ended June 30, 2005, we issued an additional 1,241,283 and 914,450 post split shares, respectively. These shares of common stock were issued primarily for corporate expenses in lieu of cash, for acquisition of businesses, for the conversion of convertible debentures and other debt, and for the exercise of warrants.

As of June 30, 2006, we had negative working capital of \$24,916, an increase in working capital of \$1,864 since June 30, 2005.

The Company is late on filing payroll tax returns and owes approximately \$18.5 million in payroll taxes. Net cash provided by operating activities was \$2,148 for the year ended June 30, 2006 as compared to net cash used in activities of \$4,351 for the prior-year period; an increase of \$6,499. The principal reasons are the increase of \$2,158 improvement in working capital (current assets less current liabilities) as the result of cost containment programs and the payoff of certain liabilities as part of the refinancing of February 2006. Also contributing was the payment of the worker's compensation premium and the worker's compensation deposit paid during the year ended June 30, 2005, which was absorbed during fiscal 2006 with the significant year to year growth.

Cash provided by financing activities was \$1,039 for the year ended June 30, 2006 as compared to \$4,482 for the year ended June 30, 2005, a decrease of \$3,443 from the prior-year period. The primary reason for the decrease was the net effect of the February 2006 refinancing and payoff of certain liabilities as compared to increases in notes payable associated with new workers' compensation policies obtain in FY 2005.

We have no material commitments for capital expenditures. Our 5% convertible preferred stock (which ranks prior to our common stock), carries cumulative dividends, when and as declared, at an annual rate of \$50 per share. The aggregate amount of such dividends in arrears at June 30, 2006, was approximately \$474.

Our capital requirements depend on numerous factors, including market acceptance of our products and services, the resources we devote to marketing and selling our products and services, and other factors. The report of our independent auditors accompanying our June 30, 2006 financial statements includes an explanatory paragraph indicating there is a substantial doubt about our ability to continue as a going concern, due primarily to the deficit in our working capital and net worth.

### CONTINGENT LIABILITY

The Company accrues and discloses contingent liabilities in its consolidated financial statements in accordance with Statement of Financial Accounting Standards ("SFAS") No. 5, Accounting for Contingencies. SFAS No. 5 requires accrual of contingent liabilities that are considered probable to occur and that can be reasonably estimated. For contingent liabilities that are considered reasonably possible to occur, financial statement disclosure is required, including the range of possible loss if it can be reasonably determined. The Company has disclosed in its audited financial statements several issues that it

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believes are reasonably possible to occur, although it cannot determine the range of possible loss in all cases. As these issues develop, the Company will continue to evaluate the probability of future loss and the potential range of such losses. If such evaluation were to determine that a loss was probable and the loss could be reasonably estimated, the Company would be required to accrue its estimated loss, which would reduce net income in the period that such determination was made. During the fiscal year ended June 30, 2006, the Company recorded \$530,000 in loss reserves , as opposed FY 2005 in which the Company recorded approximately \$463,000 in loss reserves.

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### OFF-BALANCE ARRANGEMENTS

There are no off balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors, except for the following.. As of September 8, 2004, Warning Management Services, Inc. ("Warning") purchased all of the issued and outstanding shares of Employment Systems, Inc. ("ESI") for \$1,500. The purchase was \$750 cash paid at the closing and a \$750 note payable. In connection with this transaction, the Company agreed to be a guarantor of the \$750 note payable. Our CEO, Brian Bonar, is also the CEO of Warning. As inducement to enter into this guarantee, we were given a non-cancelable 2-year payroll processing contract with ESI. Currently the \$750 note payable is in dispute. Warning is claiming that certain representations made by ESI were not correct and is proposing that the purchase price be reduced, thus reducing the \$750 note payable to \$258. Management has evaluated this contingent liability and has determined that no loss is anticipated as a result of this guarantee.

Warning Model Management, Inc. reached a settlement with Berryman & Henigar Enterprises, subsequent to June 30, 2006, to pay the aggregate sum of \$380, which has been paid in full. Accordingly, Dalrada's guarantee of this indebtedness is no longer applicable.

### ITEM 7. FINANCIAL STATEMENTS

The report of our independent auditors and our financial statements are set forth in this report beginning on Page F-1.

### ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

### ITEM 8A. CONTROLS AND PROCEDURES.

(a) Our Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15 and 15d-15 under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the period ended June 30, 2006, covered by this annual report (the "Evaluation Date"), and based on such evaluation, such officers have concluded, as of the Evaluation Date, that our disclosure controls and procedures were effective in ensuring that all information required to be disclosed in reports that we file or submit under the Exchange Act is recorded,

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processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms.

However, there were some material weaknesses in internal control over financial reporting resulting from the Chief Executive Officer and Chief Financial Officer's evaluation, which are described below. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures. Even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives.

(b) EXCEPT AS DESCRIBED BELOW, DURING OUR FOURTH QUARTER OF FISCAL 2006, there were no changes made in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Attached as Exhibits 31.1 and 31.2 to this annual report are certifications of the Chief Executive Officer AND CHIEF FINANCIAL OFFICER required in accordance with Rule 13a-14(a) of the Exchange Act. This portion of the Company's annual report includes the information concerning the controls evaluation referred to in the certifications and should be read in conjunction with the certifications for a more complete understanding of the topics presented.

In conjunction with their audit of our fiscal year 2005 consolidated financial statements, PMB & Co., LLP (PMB), the Company's independent registered public accounting firm, identified and orally reported to management and the Audit Committee the material weaknesses under standards established by the Public Company Accounting Oversight Board (PCAOB). A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is a more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

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The material weaknesses were identified as:

Planning and implementation of the Company's Accounting System; (2) Financial Statement closing process; (3) Ineffective Information Technology control environment, including the design of the Company's information security and data protection controls; (4) Untimely detection and assessment of impairment of intangible assets (i.e., patents where indicators of impairment are present; (5) Inadequate review of the valuation of certain payroll tax liabilities that resulted in post-closing journal entries to properly reflect the Company's payroll tax liabilities; (6) Proper recording of conversion of debt into shares of common stock, including the ability of certain managers to record journal entries without adequate review or supporting documentation and an inability by management to adequately review the issuance of common stock; and, (7) Lack of the necessary depth of personnel with sufficient technical accounting experience with U.S. GAAP to perform an adequate and effective secondary review of technical accounting matters

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In conjunction with their audit of our fiscal year 2006 consolidated financial statements, PMB & Co., LLP (PMB), the Company's independent registered public accounting firm, identified and orally reported to management and the Audit Committee the material weaknesses under standards established by the Public Company Accounting Oversight Board (PCAOB). A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is a more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

The material weaknesses were identified as:

(1) Planning and implementation of the Company's Accounting System; (2) Financial Statement closing process; (3) Ineffective Information Technology control environment, including the design of the Company's information security and data protection controls; (4) Proper recording of journal entries without adequate review or supporting documentation; (5) Lack of the necessary depth of personnel with sufficient technical accounting experience with U.S. GAAP to perform an adequate and effective secondary review of technical accounting matters; Lack of formal review process of expense reimbursements made to senior management. The Company will continue to evaluate the material weaknesses and will take all necessary action to correct the internal control deficiencies identified. The Company will also further develop and enhance its internal control policies, procedures, systems and staff to allow it to mitigate the risk that material accounting errors might go undetected and be included in its consolidated financial statements.

The Company contemplates undertaking a thorough review of its internal controls as part of the Company's preparation for compliance with the requirements under Section 404 of the Sarbanes-Oxley Act of 2002 and the Company is using this review to further assist in identifying and correcting control deficiencies. At this time, the Company has not completed its review of the existing controls and their effectiveness. Unless and until the material weaknesses described above, or any identified during this review, are completely remedied, evaluated and tested, there can be no assurances that the Company will be able to assert that its internal control over financial reporting is effective, pursuant to the rules adopted by the SEC under Section 404, when those rules take effect.

ITEM 8B.

None

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### PART III

#### ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(A) OF THE EXCHANGE ACT

The directors and executive officers of the Company, their ages and positions with the Company as of June 30, 2006 are as follows:

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| NAME               | AGE | SINCE | DIRECTOR/TITLE   |
|--------------------|-----|-------|--|
| -----              |     |       |  |
| Brian Bonar        | 59  | 1995  | Director and Chief Executive Officer   |
| Richard H. Green   | 70  | 2000  | Director   |
| Robert A. Dietrich | 60  | 2000  | Acting Chief Accounting Officer<br>4/16/06 to 9/30/06                                  |
| Eric W. Gaer       | 58  | 2000  | Director; Vice President   |
| David Lieberman    | 61  | 2006  | Director; Chief Financial officer and<br>Chief Operations Officer effective<br>10/1/06 |
| Stanley Hirschman  | 61  | 2006  | Director   |

BRIAN BONAR has served as a director of the Company since August 1995 and became the Company's Chairman of the Board in December 1999. From August 1992 through April 1994, Mr. Bonar served as the Company's Director of Technology Sales and from April 1994 through September 1994 as the Company's Vice President, Sales and Marketing. In September 1994, Mr. Bonar became the Company's Executive Vice President and, in July 1997, was appointed as the Company's President and Chief Operating Officer. In April 1998 Mr. Bonar assumed the post of CEO. From 1991 to 1992, Mr. Bonar was Vice President of Worldwide Sales and Marketing for Bezier Systems, Inc., a San Jose, California-based manufacturer and marketer of laser printers. From 1990 to 1991, he was Worldwide Sales Manager for Adaptec, Inc., a San Jose-based laser printer controller developer. From 1988 to 1990, Mr. Bonar was Vice President of Sales and Marketing for Rastek Corporation, a laser printer controller developed located in Huntsville, Alabama. From 1984 to 1988, Mr. Bonar was employed as Executive Director of Engineering at QMS, Inc., an Alabama-based developer and manufacturer of high-performance color and monochrome printing solutions. Prior to these positions, Mr. Bonar was employed by IBM, U.K. Ltd. for approximately 17 years.

DR. RICHARD H. GREEN has served as a director since September 2000. He is currently the President of International Power & Environmental Company (IPEC), a consulting company located in San Diego, California. From 1993 through 1995, he served as Deputy Secretary of the State of California Environmental Protection Agency (Cal/EPA). From 1988 through 1993 Dr. Green served as Manager of Program Engineering and Review Office in the Office of Technology and Applications at the Jet Propulsion Laboratory (JPL) in Pasadena, California, where he had held various management positions since 1967. From 1965 through 1967, Dr. Green served as Senior Engineer for The Boeing Company, Space Division. From 1983 through 1985, Dr. Green held the Corwin D. Denny Chair as Professor of Energy and Director of the Energy Institute at the University of LaVerne, and from 1961 through 1964 served as Assistant Professor of Civil Engineering (Environmental Sciences) at Washington State University. Dr. Green currently is a member of the Governing Board of Pasadena City College. Dr. Green completed his bachelor's degree at Whitman College in 1958, his Master of Science at Washington State University in 1961, and his Ph.D. at Washington State University, under a United States Public Health Services Career Development Award, in 1965.

ROBERT A. DIETRICH had served as a director of the Company since January 200. He resigned as a director as of March 1, 2006 and was appointed acting Chief Accounting Officer as of April 16, 2006. For a period of time during 2002 he served as Chief Accounting Officer and President of Source One Group. He is currently the Chief Financial Officer of The Solvis Group, Inc. an 85% owned subsidiary of the Company. He has served as Director, COO and CFO of Security First International Holdings, Inc. ("SFNH:PK"). During 2004 and 2005 he was President and CEO of Energy Transfer Corporation, a privately held bio-energy company. In 2003 and 2004 he was Founder and Chief Financial Officer of Modofood USA, Inc., a privately held food technology enterprise. In 1998 he helped found Cyber Air Communications, Inc. in which he served as a Director and President until 2002. Mr. Dietrich has been performing investment banking and consulting

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services for clients since 1990. Prior to that he has served as CEO, COO or CFO of privately held middle market companies. He is an accounting graduate from Notre Dame and possesses an MBA from U. of Detroit. He possesses a CPA certificate from Illinois (inactive).

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ERIC W. GAER has served as a director since marhc 2000 and since the fall of 2005 and Vice President - Marketing and Investor Relatioins. Since 1998, Mr. Gaer has been the President and CEO of Arroyo Development Corporation, a privately-held, San Diego-based management consulting company, which also holds California real estate and insurance broker licenses. From 1996 to 1998, he was Chairman and CEO of Greenland Corporation, a publicly-held high technology company in San Diego, California. In 1995, he was CEO of Ariel Systems, Inc., a privately-held engineering development company in Vista, California. Over the past 30 years, Mr. Gaer has served in executive management positions at a variety of technology companies, including Imaging Technologies, Daybreak Technologies, Venture Software, and Merisel. In 1970, he received a Bachelor's Degree in mass communications from California State University, Northridge.

DAVID LIEBERMAN has been the Chief Financial Officer for John Goyak & Associates, Inc., an aerospace consulting firm located in Las Vegas, NV since 2003. Previously, Mr. Lieberman was the President of Lieberman Associates from 2000 to 2003 where he acted as the Chief Financial Officer for various public and non-public companies located in NV and CA. Mr. Lieberman has over thirty years of financial experience beginning with five years as an accountant with Price Waterhouse from 1967 through 1972

STANLEY HIRSCHMAN has been President of CPointe Associates, a Plano, Texas based executive management and consulting firm since 1997. CPointe specializes in business solutions for companies with emerging technologies and is well-versed in the challenges of regulated corporate governance. He is also Chairman of the Board of Bravo Foods International, a director of Bronco Energy Fund, Energy & Engine Technology, GoldSpring, and 5 G Wireless Corporation and is a former chairman of Mustang Software, Inc. While at Mustang, Mr. Hirschman took a hands-on role in the planning and execution of the strategic initiative to increase shareholder value resulting in the successful acquisition of the company by Quintus Corporation. Prior to establishing CPointe Associates, he was Vice President Operations, Software Etc., Inc., a 396 retail store software chain, from 1989 until 1996. He also held senior executive management positions with T.J. Maxx, Gap Stores and Banana Republic. Stan is a member of the National Association of Corporate Directors and participates regularly in the KMPG Audit Committee Roundtable. He is active in community affairs and serves on the Advisory Board of the Salvation Army Adult Rehabilitation Centers.

### AUDIT COMMITTEE FINANCIAL EXPERT

The Audit Committee of the Board of Directors consists of Mr. Dietrich (until February 2006 ), Dr. Green and Stanley Hirschman (as of February 2006) all of whom are independent and qualify as financial experts under SEC regulations.

### COMPLIANCE WITH SECTION 16 OF THE SECURITIES EXCHANGE ACT OF 1934

Section 16(a) of the Securities Exchange Act of 1934 requires DFCO's directors and executive officers, and persons who own more than 10% of a registered class of DFCO's equity securities to file with the Securities and Exchange Commission

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initial reports of ownership and reports of changes in ownership of Common Stock and other DFCO equity securities. Officers, directors and greater than 10% shareholders are required by SEC regulations to furnish DFCO with copies of all Section 16(a) forms they file.

To DFCO's knowledge, based solely on its review of the copies of such reports furnished to the company and written representations that no other reports were required during the fiscal year ended June 30, 2006, all Section 16(a) filing requirements applicable to its officers, directors and greater than 10% beneficial owners were complied with.

### BUSINESS ETHICS CONFLICTS OF INTERESTS POLICY

The Company has adopted a Policy Statement on Business Ethics and Conflicts of Interest, which was approved by the Board of Directors, applicable to all employees, which is attached as exhibit 33.1 to this report.

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### ITEM 10. EXECUTIVE COMPENSATION

| Payouts<br>-----                | Annual Compensation<br>----- |           |       |                                 |                                    | Long-Term<br>-----                                   |
|---------------------------------|------------------------------|-----------|-------|---------------------------------|------------------------------------|--|
| (a)                             | (b)                          | (c)       | (d)   | (e)                             | (f)                                | (g)  |
|                                 | Year                         | Salary    | Bonus | Other<br>Annual<br>Comp (\$)(4) | Restricted<br>Stock<br>Awards (\$) | Securities<br>Underlying<br>Options/<br>(SAR) (#)(5) |
|                                 | -----                        | -----     | ----- | -----                           | -----                              | -----  |
| Brian Bonar,<br>Chairman/CEO    | 2006                         | \$588 (3) | 183   | 91                              | \$252                              |  |
|                                 | 2005                         | \$282     | (4)   | 0                               |                                    |  |
|                                 | 2004                         | \$157     | 0     | \$150                           |                                    | 35,000 (5)   |
| Robert A. Dietrich,             | 2006                         | \$75      |       |                                 |                                    |  |
| James R. Downey,<br>COO/CAO (1) | 2004                         | \$100     |       | \$20                            |                                    |  |
| Randall Jones (2)               | 2006                         |           |       |                                 |                                    |  |
|                                 | 2005                         | \$120     | \$40  |                                 |                                    |  |

- (1) Mr. Downey joined the Company effective January 6, 2003 and resigned effective January 1, 2004
- (2) Mr. Jones resigned as Chief Operating Officer effective April 15, 2006.
- (3) Mr. Bonar received salary compensation during FY2006 not paid in 2003-(\$63), 2004-(\$129) and 2005-(\$30).
- (4) Mr. Bonar received bonus compensation during 2006 not paid in 2004-(\$5) and 2005-(\$37).
- (5) Post split

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The following table provides information on Options/SARs granted in the 2006 Fiscal Year to the Named Officers.

| Name        | Number of Securities Underlying Options/SARs Granted (#) | Percent of Total Options/SARs Granted to Employees in Fiscal Year | Exercise or Base Price (\$/Share) | Expiration Date | Potent<br>Valu<br>Ann<br>St<br>Appr<br>Opt<br>5% (\$ |
|-------------|--|---|-----------------------------------|-----------------|--|
| Brian Bonar | 0  | 0%  |                                   |                 |  |

### AGGREGATED OPTION/SAR EXERCISES IN LAST FISCAL YEAR AND FY-END OPTION/SAR VALUES

The following table provides information on option exercises in the 2006 Fiscal Year by the Named Officers and the value of such Named Officers' unexercised options at June 30, 2006. Warrants to purchase Common Stock are included as options. No stock appreciation rights were held by them at the end of the 2006 Fiscal Year.

| Name        | Shares                   | Value Realized (\$) | Number of Securities Underlying Unexercised Options/SAR's at FY-end (#) |               | Valu<br>In-the<br>At Fisco |
|-------------|--------------------------|---------------------|---|---------------|----------------------------|
|             | Acquired on Exercise (#) |                     | EXERCISABLE   | UNEXERCISABLE | EXERCISA                   |
| Brian Bonar | --                       |                     | --  | --            |                            |

### COMPENSATION OF DIRECTORS

Each member of the Board of Directors of the Company receives a fee of \$500 from the Company for each meeting attended.

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### EMPLOYMENT CONTRACTS, TERMINATION OF EMPLOYMENT, AND CHANGE-IN-CONTROL ARRANGEMENTS

The Company entered into five year employment agreement with Brian Bonar, Chief Executive Officer, on January 1, 2006. Under the terms of the Agreement, Mr. Bonar shall earn \$393,000 per annum in initial salary, subject to annual increases of up to ten (10) percent, based upon performance criteria. Mr. Bonar shall be eligible to earn quarterly bonus of \$47,000 based upon the Company



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achieving a net profit for that quarter. Mr. Bonar shall be issued common stock of DFCO sufficient to provide a ten (10) percent ownership position post reverse split, which shares be maintained for a period of two years.

### COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

The Compensation Committee, during fiscal 2006, consisted of Messrs. Gaer and Green. Mr. Green was not an officer or employee of the Company at any time during the 2006 Fiscal Year; but was engaged as a consultant during the year. Mr. Gaer is currently employed as a Vice President of the Company and has resigned from the Committee..

### AUDIT COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

The Audit Committee currently consists of Messrs. Green and Hirschman. Neither of these individuals was an officer or employee of the Company at any time during the 2006 Fiscal Year. Mr. Green was a paid consultant to the Company during the year.

### ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth certain information known to DFCO with respect to the beneficial ownership of DFCO's common stock as of June 30, 2006 by (i) each person who is known by the Company to own beneficially more than 5% of the Company's common stock, (ii) each of DFCO's directors and executive officers, and (iii) all officers and directors of DFCO as a group. Except as otherwise listed below, the address of each person is c/o Dalrada Financial Corporation., 9449 Balboa Avenue, Suite 210, San Diego, CA 92123

| NAME AND ADDRESS OF BENEFICIAL OWNER (1)<br>-----   | SHARES BENEFICIALLY<br>OWNED<br>-----<br>Post Split | PERCENT |
|---|---|---------|
| Longview Fund, LP (3)<br>600 Montgomery Street 44th floor<br>San Francisco, CA 94111              | 9,969,775 (14)                                      |         |
| Longview Equity Fund, LP (4)<br>600 Montgomery Street 44th floor<br>San Francisco, CA 94111       | 2,663,584 (15)                                      |         |
| Longview Int'l Equity Fund, LP (5)<br>600 Montgomery Street 44th floor<br>San Francisco, CA 94111 | 1,311,915 (16)                                      |         |
| Alpha Capital Aktiengesellschaft (6)<br>Pradafant<br>9490 Furstentums<br>Vaduz, Liechtenstein     | 1,596,430 (17)                                      |         |
| Baltimore S.A. (7)<br>P.O. Box 146, Road Town<br>Tortola, BVI                                     | 3,231,478 (18)                                      |         |
| Howard Schraub (8)<br>c/o Howard Associates, Inc.<br>525 East 72nd Street<br>New York, NY 10021   | 795,100 (19)  |         |
| Directors and Officers  |   |         |

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|  |           |         |
|--|-----------|---------|
| Brian Bonar  | (9)       | 450,000 |
| Robert A. Dietrich   | (10) (20) | 119,375 |
| Stephen J. Fryer   | (11) (21) | 94,375  |
| Eric W. Gaer   | (12)      | 121,425 |
| Richard Green  | (13)      | 129,375 |
| All current directors and executive officers<br>(Group of 5) |           | 914,605 |

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(1) 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 common stock subject to options or warrants currently exercisable or convertible, or exercisable or convertible within 60 days of August 31, 2005 are deemed outstanding for computing the percentage of the person holding such option or warrant but are not deemed outstanding for computing the percentage of any other person. Except as pursuant to applicable community property laws, the persons named in the table have sole voting and investment power with respect to all shares of common stock beneficially owned.

(2) Percentage based on 4,886,248 post split shares of common stock outstanding as of June 30, 2006, plus shares underlying each shareholder's convertible note and warrants.

(3) Longview Fund, LP is a private investment fund that is in the business of investing publicly-traded securities for their own accounts and is structured as a limited liability company whose members are the investors in the fund. The General Partner of the fund is Viking Asset Management, LLC, a California limited liability company which manages the operations of the fund. Peter T. Benz is the managing member of Viking Asset Management, LLC. As the control person of the shares owned by Longview Fund, LP, Mr. Benz may be viewed as the beneficial owner of such shares pursuant to Rule 13d-3 under the Securities Exchange Act of 1934.

(4) Longview Equity Fund, LP is a private investment fund that is in the business of investing publicly-traded securities for their own accounts and is structured as a limited liability company whose members are the investors in the fund. The General Partner of the fund is Viking Asset Management, LLC, a California limited liability company which manages the operations of the fund. Peter T. Benz is the managing member of Viking Asset Management, LLC. As the control person of the shares owned by Longview Equity Fund, LP, Wayne Coleson may be viewed as the beneficial owner of such shares pursuant to Rule 13d-3 under the Securities Exchange Act of 1934.

(5) Longview International Equity Fund, LP is a private investment fund that is in the business of investing publicly-traded securities for their own accounts and is structured as a limited liability company whose members are the investors in the fund. The General Partner of the fund is Viking Asset Management, LLC, a California limited liability company which manages the operations of the fund. Peter T. Benz is the managing member of Viking Asset Management, LLC. As the control person of the shares owned by Longview International Equity Fund, LP,

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Wayne Coleson may be viewed as the beneficial owner of such shares pursuant to Rule 13d-3 under the Securities Exchange Act of 1934.

(6) Alpha Capital Aktiengesellschaft: In accordance with Rule 13d-3 under the Securities Exchange Act of 1934, Konard Ackerman may be deemed the control person of the shares owned by such entity. ALPHA Capital AG is a private investment fund that is owned by all its investors and managed by Mr. Ackerman. Mr. Ackerman disclaims beneficial ownership of the shares of common stock being registered hereto.

(7) Balmore S.A.: In accordance with Rule 13d-3 under the Securities Exchange Act of 1934, F. Morax may be deemed the control person of the shares owned by such entity. Balmore S.A. is a private investment fund that is owned by all its investors and managed by Mr. Morax. Mr. Morax disclaims beneficial ownership of the shares of common stock being registered hereto.

(8) Howard Schraub is an individual.

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(9) Includes 95,038 post split shares issuable upon exercise of warrants that are currently exercisable or will become exercisable within 60 days after June 30, 2006.

(10) Includes 56,923 post split shares issuable upon exercise of warrants that are currently exercisable or will become exercisable within 60 days after June 30, 2006.

(11) Includes 37,266 post split shares issuable upon exercise of warrants that are currently exercisable or will become exercisable within 60 days after June 30, 2006.

(12) Includes 49,680 post split shares issuable upon exercise of warrants that are currently exercisable or will become exercisable within 60 days after June 30, 2006.

(13) Includes 9,969,500 49,848 post split shares issuable upon exercise of warrants that are currently exercisable or will become exercisable within 60 days after June 30, 2006.

(14) Concerning Longview Fund, LP: Assuming \$3,761,707 of Convertible Debentures converted at \$0.00285 plus 3,370,288 post split warrants.

(15) Concerning Longview Equity Fund, LP: Assuming \$1,005,000 of Convertible Debentures converted at \$0.00285 plus 900,427 post split warrants.

(16) Concerning Longview International Equity Fund, LP: Assuming \$495,000 of Convertible Debentures converted at \$0.00285 plus 443,494 post split warrants.

(17) Concerning Alpha Capital Aktiengesellschaft: Assuming \$602,425 of Convertible Debentures converted at \$0.00285 plus 539,742 post split warrants.

(18) Concerning Balmore S.A.: Assuming \$1,380,969 of Convertible Debentures converted at \$0.00285 and \$119,737 converted at \$0.00226 plus 247,453,268 1,237,266 post split warrants.

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(19) Concerning Howard Schraub: Assuming \$300,000 of Convertible Debentures converted at \$0.00285 plus 268,784 post split warrants.

(20) Robert A. Dietrich resigned as a Director effective March 1, 2006 for personal reasons.

(21) Stephen J. Fryer resigned as a Director effective March 1, 2006 for personal reasons.

### ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

#### TRANSACTIONS WITH OFFICERS AND KEY EXECUTIVES

During the year ended June 30, 2005, the Company issued 36,361 post split shares of common stock to the Company's CEO as payment for accrued expenses and a note payable in the aggregate amount of \$109.

During the year ended June 30, 2006, Mr. Bonar was issued 250,000 post split shares pursuant to his employment agreement with the Company in the aggregate amount of \$250,000.

#### TRANSACTIONS WITH A RELATED PARTY

In April 2004, the Company had a PEO services client whose Chairman of the Board is the Company's current CEO and Chairman. The Company received fees of \$520 and \$390 during the years ended June 30, 2006 and 2005, respectively. The transaction is at fair value.

#### WARNING MANAGEMENT SERVICES, INC.

The Company's CEO and Chairman, Mr. Brian Bonar, is also the CEO and Chairman of Warning Management Services, Inc. Warning a public company, located in Southern California. Warning's operations consist of a modeling agency and providing temporary staffing services to government agencies and private companies.

Warning leases offices to the Company, on a month-to-month basis and charges the Company \$4680 per month rent.

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#### PEO SERVICES AGREEMENT WITH WARNING PROVIDES FOR A FEE AT PREVAILING MARKET RATE

In April 2004, the Company entered into an Agreement to provide PEO services for Warning. The Company receives from Warning a monthly administrative fee. During the years ended June 30, 2006 and 2005, the Company has invoiced Warning \$87 for management services and \$7 for management services, respectively.

### ITEM 13. EXHIBITS, LIST AND REPORTS IN FORM 8-K

| Number | Exhibits   |
|--------|--|
| 3(a)   | Certificate of Incorporation of the Company, as amended, and currently in effect. See also below (Incorporated by reference to Exhibit 3(a) to 1988 Form 10-K) * |
| 3(b)   | Certificate of Amendment of Certificate of Incorporation of the  |

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Company, filed February 8, 1995, as amended, and currently in effect (Incorporated by reference to Exhibit 3(b) to 1995 Form 10-K) \*

- 3(c) Certificate of Amendment of Certificate of Incorporation of the Company, filed May 23, 1997, as amended, and currently in effect (Incorporated by reference to 1997 Form 10-K) \*
- 3(d) Certificate of Amendment of Certificate of Incorporation, filed January 12, 1999, as amended and currently in effect (Incorporated by reference to Form 10-Q for the period ended December 31, 1998) \*
- 3(e) Certificate Eliminating Reference to Certain Series of Shares of Stock from the Certificate of Incorporation, filed January 12, 1999, as amended and currently in effect (Incorporated by reference to Form 10-Q for the period ended December 31, 1998)\*
- 3(f) By-Laws of the Company, as amended, and currently in effect (Incorporated by reference to Exhibit 3(b) to 1987 Form 10-K) \*
- 3(g) Certificate of Amendment of Certificate of Incorporation, filed May 12, 2000, as amended and currently in effect (Incorporated by reference to Exhibit 3(g) to 2001 Form 10-K) \*
- 4(a) Amended Certificate of Designation of Imaging Technologies Corporation with respect to the 5% Convertible Preferred Stock (Incorporated by reference to Exhibit 4(d) to 1987 Form 10-K) \*
- 4(b) Amended Certificate of Designation of Imaging Technologies Corporation with respect to the 5% Series B Convertible Preferred Stock (Incorporated by reference to Exhibit 4(b) to 1988 Form 10-K) \*
- 4(c) Certificate of Designations, Preferences and Rights of Series C Convertible Preferred Stock of Imaging Technologies Corporation (Incorporated by reference to Exhibit 4(c) to 1998 Form 10-K) \*
- 4(d) Certificate of Designation, Powers, Preferences and Rights of the Series of Preferred Stock to be Designated Series D Convertible Preferred Stock, filed January 13, 1999 (Incorporated by reference to Form 10-Q for the period ended December 31, 1998)\*
- 4(e) Certificate of Designation, Powers, Preferences and Rights of the Series of Preferred Stock to be Designated Series E Convertible Preferred Stock, filed January 28, 1999 (Incorporated by reference to Form 10-Q for the period ended December 31, 1998)\*
- 10(a) Private Equity Line of Credit Agreement by and among certain investors and the Company (Incorporated by reference to Form 8-K, filed July 26, 2000) \*
- 10(b) Convertible Note Purchase Agreement dated December 12, 2000 between the Company and Amro International, S.A., Balmore Funds, S.A., and Celeste Trust Reg. (Incorporated by reference to Form 8-K, filed January 19, 2001. \*

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- 10(g) Share Purchase Agreement, dated December 1, 2000, between ITEC and EduAdvantage.com, Inc. (Incorporated by reference to Form 10-Q for the period ended September 30, 2000) \*
- 10(h) Convertible Promissory Note dated September 21, 2001 between the Company and Stonestreet Limited Partnership. (Incorporated by reference to Exhibit 10(u) of 2001 Form 10-K) \*
- 10(i) Convertible Note Purchase Agreement dated September 21, 2001 between the Company and Stonestreet Limited Partnership. (Incorporated by reference to Exhibit 10(v) of 2001 Form 10-K) \*
- 10(j) Registration Rights Agreement dated September 21, 2001 between the Company and Stonestreet Limited Partnership. (Incorporated by reference to Exhibit 10(w) of 2001 Form 10-K) \*
- 10(k) Form of Warrant to Purchase 11,278,195 Shares of Common Stock of ITEC, dated September 21, 2001, between ITEC and Stonestreet Limited Partnership. (Incorporated by reference to Exhibit 10(x) of 2001 Form 10-K) \*
- 10(l) Asset Purchase Agreement, dated October 25, 2001, among the Company and Lisa Lavin, Gary J. Lavin, and Roland A. Fernando. (Incorporated by reference to Exhibit 10(a) to September 2001 Form 10-Q) \*
- 10(m) Audited Financial Statements of SourceOne Group, LLC. (Incorporated by reference to Form 8-K filed on January 25, 2002) \*
- 10(n) Secured Convertible Debenture issued by the Company to Bristol Investment Fund, Ltd., dated January 22, 2002. (Incorporated by reference to Exhibit 10(a) of December 2001 Form 10-Q) \*
- 10(o) Securities Purchase Agreement between the Company and Bristol Investment Fund, Ltd., dated January 22, 2002. (Incorporated by reference to Exhibit 10(b) of December 2001 Form 10-Q) \*
- 10(p) Registration Rights Agreement between the Company and Bristol Investment Fund, Ltd., dated January 22, 2002. (Incorporated by reference to Exhibit 10(c) of December 2001 Form 10-Q) \*
- 10(q) Transaction Fee Agreement between the Company and Alexander Dunham Securities, Inc., dated January 22, 2002. (Incorporated by reference to Exhibit 10(d) of December 2001 Form 10-Q) \*
- 10(r) Stock Purchase Warrant issued to Alexander Dunham Securities, Inc., dated January 22, 2002. (Incorporated by reference to Exhibit 10(e) of December 2001 Form 10-Q) \*
- 10(s) Stock Purchase Warrant issued to Bristol Investment Fund, Ltd., dated January 22, 2002. (Incorporated by reference to Exhibit 10(f) of December 2001 Form 10-Q) \*
- 10(t) Security Agreement between the Company and Bristol Investment Fund, Ltd., dated January 22, 2002. (Incorporated by reference to Exhibit 10(g) of December 2001 Form 10-Q) \*
- 10(u) Convertible Promissory Note between the Company and Stonestreet Limited Partnership, dated November 7, 2001. (Incorporated by reference to Exhibit 10(h) of December 2001 Form 10-Q) \*

- 10(v) Convertible Note Purchase Agreement between the Company and Stonestreet Partnership, dated November 7, 2001. (Incorporated by reference to Exhibit 10(i) of December 2001 Form 10-Q) \*
- 10(w) Registration Rights Agreement between the Company and Stonestreet Limited Partnership, dated November 7, 2001. (Incorporated by reference to Exhibit 10(j) of December 2001 Form 10-Q) \*
- 10(x) Stock Purchase Warrant issued to Stonestreet Limited Partnership, dated November 7, 2001 . (Incorporated by reference to Exhibit 10(k) of December 2001 Form 10-Q) \*
- 10(y) Acquisition Agreement between the Company and Dream Canvas, Inc., dated May 17, 2002; subject to completion of its terms. (Incorporated by reference to Exhibit 10(y) of Form 10-K filed November 18, 2002.) \*
- 10(z) Closing Agreement between the Company and Quik Pix, Inc., dated July 23, 2002, subject to completion of its terms. (Incorporated by reference to Exhibit 10(z) of Form 10-K filed November 18, 2002.) \*
- 10(aa) Agreement to Acquire Shares between the Company and Greenland Corporation, dated August 5, 2002, subject to completion of its terms. (Incorporated by reference to Exhibit 10(aa) to Form 10-K filed November 18, 2002.) \*
- 10(ab) Acquisition Agreement, dated December 13, 2002, between the Company and Baseline Worldwide, Limited. (Incorporated by reference to Exhibit 99.3 of Form 8-K filed December 19, 2002.) \*
- 10(ac) Secured Promissory Note in the amount of \$2,250,000 issued by the Company to Greenland Corporation, dated January 7, 2003. (Incorporated by reference to Exhibit 99.1 of Form 8-K filed January 21, 2003.) \*
- 10(ad) Security Agreement, dated January 7, 2003, between the Company and Greenland Corporation. (Incorporated by reference to Exhibit 99.2 of Form 8-K filed January 21, 2003.) \*
- 10(ae) Agreement to Acquire Shares, dated August 9, 2002 between the Company and Greenland Corporation. (Incorporated by reference to Exhibit 99.3 of Form 8-K filed January 21, 2003.) \*
- 10(af) Closing Agreement, dated January 7, 2003, between the Company and Greenland Corporation. (Incorporated by reference to Exhibit 99.4 of Form 8-K filed January 21, 2003.) \*
- 10(ag) Share Acquisition Agreement, dated June 12, 2002, between the Company and Quik Pix, Inc. (Incorporated by reference to Exhibit 99.5 of Form 8-K filed January 21, 2003.) \*
- 10(ah) Closing Agreement, dated July 23, 2002, between the Company and Quik Pix, Inc. (Incorporated by reference to Exhibit 99.6 of Form 8-K filed January 21, 2003.) \*

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- 10(ai) Stock Purchase Agreement among the Company, Greenland Corporation, and ExpertHR- Oklahoma, dated March 18, 2003. (Incorporated by reference to Exhibit 10(j) to Form 10-Q filed May 20, 2003). \*
- 10(aj) Assignment of Patent between John Capezzuto and Quik Pix, Inc. dated January 14, 2003. \*
- 10(ak) Promissory Note between the Company and John Capezzuto dated June 1, 2003 (signed June 9, 2003). \*

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- 10(al) Promissory Note between the Company and John Capezzuto dated June 9, 2003 \*
- 10(am) Agreement and Assignment of Rights, dated February 1, 2003, between Accord Human Resources, Inc. and Greenland Corporation, and Imaging Technologies. (Incorporated by reference to Exhibit 10(k) of Form 10-KSB filed April 7, 2003 by Greenland Corporation.) \*
- 10(an) Agreement and Assignment of Rights, dated March 1, 2003, between StaffPro Leasing 2, Greenland Corporation, and ExpertHR. (Incorporated by reference to Exhibit 10(l) of Form 10-KSB filed April 7, 2003 by Greenland Corporation.) \*
- 10(ao) Promissory Note, dated March 1, 2003, payable to StaffPro Leasing 2 by Greenland Corporation. (Incorporated by reference to Exhibit 10(k) of Form 10-KSB filed April 7, 2003 by Greenland Corporation.) \*
- 10(op) Agreement to Acquire Shares between the Company and The Christensen Group, et al, dated April 1, 2003. \*
- 10(aq) Agreement and Assignment of Rights, dated October 24, 2003, between SourceOne Group, Inc. and ePEO Link, incorporated by reference to Exhibit 10(a) of Form 10-Q, filed November 24, 2003. \*
- 10(ar) Alpha Capital Aktiengesellschaft December 17, 2003 convertible note, incorporated by reference to Exhibit 10(a) to Form 10-QSB, filed February 13, 2004. \*
- 10(as) Gamma Opportunity Capital Partners, LP December 17, 2003 convertible note, incorporated by reference to Exhibit 10(c) to Form 10-QSB, filed February 13, 2004. \*
- 10(at) Gamma Opportunity Capital Partners, LP December 17, 2003 warrant, incorporated by reference to Exhibit 10(d) to Form 10-QSB, filed February 13, 2004. \*
- 10(au) Longview Fund, LP December 17, 2003 convertible note, incorporated by reference to Exhibit 10(e) to Form 10-QSB, filed February 13, 2004. \*
- 10(av) Longview, LP December 17, 2003 warrant, incorporated by reference to Exhibit 10(f) to Form 10-QSB, filed February 13, 2004. \*



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- 10(aw) Stonestreet Limited Partnership December 17, 2003 convertible note, incorporated by reference to Exhibit 10(g) to Form 10-QSB, filed February 13, 2004. \*
- 10(ax) Stonestreet Limited Partnership December 17, 2003 warrant, incorporated by reference to Exhibit 10(h) to Form 10-QSB, filed February 13, 2004. \*
- 10(ay) Subscription Agreement December 17, 2003, incorporated by reference to Exhibit 10(i) to Form 10-QSB, filed February 13, 2004. \*

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- 10(az) Agreement of Acquisition between the Company and Quik Pix, Inc., dated April 16, 2004, incorporated by reference to Exhibit 10.1 to Form 10-QSB, filed May 19, 2004.
- 10(bb) Employment agreement, Chief Executive Officer
- 21 List of Subsidiaries of the Company \*
- 31.1 Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) (Section 302 of the Sarbanes-Oxley Act of 2002) \*\*
- 31.2 Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) (Section 302 of the Sarbanes-Oxley Act of 2002) \*\*
- 32.1 Certification of the Chief Executive Officer pursuant to 18 U.S.C.ss.1350 (Section 906 of the Sarbanes-Oxley Act of 2002) \*\*

All exhibits except those followed by an asterisk (\*) are incorporated by reference only and a copy is not included in this Form 10-K filing. Those exhibits followed by a double asterisk (\*\*) are included as part of this filing.

The Company will furnish a copy of any exhibit to a requesting shareholder upon payment of the Company's reasonable expenses in furnishing such exhibit.

### (b) Reports on Form 8-K

| Date      | Subject  |
|-----------|--|
| ----      | -----  |
| 5/24/2005 | Transfer Solvis Group to Quik Pix, Inc. a wholly owed subsidiary     |
| 9/20/2005 | Appointment of Chief Financial Officer                               |
| 2/13/2006 | ITEM 1.01: Private Placement   |
| 4/15/2006 | ITEM 5.02: Resignations and appointments of directors and officers   |
| 09/18/06  | ITEM 2.01. Acquisition of All Staffing, Inc. a Tennessee corporation |

### ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The Company paid or accrued the following fees in each of the prior two fiscal years to its independent certified public accountants, Pohl, McNabola Berg & Company, LLP

For the Year Ended June 30,

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|                    | 2006      | 2005      |
|--------------------|-----------|-----------|
| Audit Fees         | \$140,000 | \$110,000 |
| Audit-Related Fees | \$75,000  | 95,023    |
| Tax Fees           | -         | -         |
| All Other Fees     | -         | -         |
| -----              |           |           |
| Total Fees         | \$215,000 | \$205,033 |

"Audit Fees" consisted of fees billed for services rendered for the audit of the Company's annual financial statements and audit related fees are for review of the financial statements included in the Company's quarterly reports on Form 10-QSB.

AUDIT COMMITTEE'S PRE-APPROVAL POLICIES AND PROCEDURES

The Audit committee is in the process of establishing a pre-approval policy and procedure.

PERCENTAGE OF HOURS EXPENDED

There were no hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

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SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DALRADA FINANCIAL CORPORATION

By: /s/ BRIAN BONAR

-----  
Brian Bonar, Chief Executive Officer

Dated: October XX, 2006

By: /s/ David Lieberman

-----  
David Lieberman, Chief Accounting Officer

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below hereby constitutes and appoints, Brian Bonar as his attorney-in-fact, each with full power of substitution and resubstitution, for him or her in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K (including post-effective amendments), and to file the same, with exhibits

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thereto and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorney-in-fact full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming that said attorney-in-fact, or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof. Pursuant to the requirements of the Securities Exchange Act of 1934, this Annual Report on Form 10-K has been signed below by the following persons in the capacities and on the dates indicated.

| SIGNATURE   | TITLE  | DATE              |
|---|--|-------------------|
| /s/ Brian Bonar<br>-----<br>Brian Bonar             | Chairman of the Board of Directors,<br>Chief Executive Officer, and<br>(PRINCIPAL EXECUTIVE OFFICER) | October 13 , 2005 |
| /s/ David Lieberman<br>-----<br>David Lieberman     | Director; Chief Accounting Officer   | October 13, 2005  |
| /s/ Eric W. Gaer<br>-----<br>Eric W. Gaer           | Director   | October 13, 2005  |
| /s/ Stanley Hirschman<br>-----<br>Stanley Hirschman | Director   | October 13 , 2005 |
| /s/ Richard H. Green<br>-----<br>Richard H. Green   | Director   | October 13 , 2005 |

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DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED FINANCIAL STATEMENTS  
YEARS ENDED JUNE 30, 2006 AND 2005

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|  |     |
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### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders  
Dalrada Financial Corporation  
San Diego, California

We have audited the accompanying consolidated balance sheet of Dalrada Financial Corporation and Subsidiaries as of June 30, 2006, and the related consolidated statements of operations, stockholders' deficit and cash flows for years ended June 30, 2006 and 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with standards of the Public Company 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 consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Dalrada Financial Corporation and Subsidiaries as of June 30, 2006 and the consolidated results of their operations and their consolidated cash flows for each of the years ended June 30, 2006 and 2005, in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the accompanying consolidated financial statements, for the year ended June 30, 2006 the Company experienced a loss from continuing operations of \$4,739,000 and as of June 30, 2006, the Company had a negative working capital deficit of \$24,916,000 and had a negative stockholders' deficit of \$21,620,000. In addition, the Company is in default on certain note payable obligations and is being sued by numerous trade creditors for nonpayment of amounts due. The Company is also deficient in its payments relating to payroll tax liabilities. These conditions raise substantial doubt about its ability to continue as a going concern. Management's plan in regard to these matters is also discussed in Note 1. These consolidated financial statements do not include any adjustments

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that might result from the outcome of this uncertainty.

/s/ POHL, McNABOLA, BERG & COMPANY, LLP  
POHL, McNABOLA, BERG & COMPANY, LLP  
CERTIFIED PUBLIC ACCOUNTANTS

San Francisco, California  
October 13, 2006

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### DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

Consolidated Balance Sheet  
(in thousands, except share data)

#### ASSETS

##### CURRENT ASSETS

Cash and cash equivalents  
Accounts receivable, net of allowance of \$639 (includes related party balance of \$1,065)  
Debt issue costs  
Other current assets  
Net assets of discontinued operations

##### TOTAL CURRENT ASSETS

CUSTOMER LIST, net of accumulated amortization of \$54  
PROPERTY AND EQUIPMENT, net of accumulated depreciation of \$368  
WORKER'S COMPENSATION DEPOSIT  
INVESTMENT IN ALLIANCE INSURANCE GROUP  
RECEIVABLE FROM RELATED PARTY  
OTHER LONG-TERM ASSETS

##### TOTAL ASSETS

#### LIABILITIES AND STOCKHOLDERS' DEFICIT

##### CURRENT LIABILITIES

Notes payable, current portion (includes related party note of \$65)  
Accounts payable (includes related party balance of \$758)  
PEO payroll taxes and other payroll deductions  
Accrued payroll and related payroll taxes and deductions  
Other accrued expenses (includes related party balance of \$108)  
Warrant liability  
Accrued derivative liability

##### TOTAL CURRENT LIABILITIES

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CONVERTIBLE DEBENTURES, net of discounts of \$5,414  
 NOTES PAYABLE, net of current portion (includes related party note of \$393)

TOTAL LIABILITIES

MINORITY INTEREST

COMMITMENTS AND CONTINGENCIES

STOCKHOLDERS' DEFICIT

Series A convertible, redeemable preferred stock, \$1,000 par value,  
 7,500 shares authorized 420.5 shares issued and outstanding  
 Common stock; \$0.005 par value; 1,000,000,000 shares  
 authorized; 4,917,527 shares issued and outstanding  
 Common stock warrants  
 Additional paid-in capital  
 Prepaid consulting  
 Accumulated deficit

TOTAL STOCKHOLDERS' DEFICIT

TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT

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

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### DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

#### Consolidated Statements of Operations (in thousands, except share data)

|                             | YEARS ENDED      |                  |
|-----------------------------|------------------|------------------|
|                             | JUNE 30,<br>2006 | JUNE 30,<br>2005 |
| REVENUES                    |                  |                  |
| Temporary staffing services | \$ 68,226        | \$ 17,029        |
| PEO Services                | 1,382            | 1,930            |
| Sales of products           | 772              | 517              |
|                             | 70,380           | 19,476           |
| TOTAL REVENUES              |                  |                  |
| COST OF REVENUES            |                  |                  |
| Cost of temporary staffing  | 62,897           | 15,010           |
| Cost of PEO services        | 998              | 1,424            |
| Cost of products sold       | 34               | 96               |
|                             | 63,929           | 16,530           |
| TOTAL COST OF REVENUES      |                  |                  |

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|  |          |            |
|--|----------|------------|
|  | -----    | -----      |
| GROSS PROFIT   | 6,451    | 2,946      |
| OPERATING EXPENSES   |          |            |
| Selling, general and administrative  | 11,190   | 5,402      |
| Impairment of patent   | -        | 1,348      |
| TOTAL OPERATING EXPENSES   | 11,190   | 6,750      |
| INCOME (LOSS) FROM OPERATIONS  | (4,739)  | (3,804)    |
| OTHER INCOME (EXPENSES):   |          |            |
| Interest expense   | (2,697)  | (1,709)    |
| Settlement with investors  | (908)    |            |
| Penalties and interest   | (1,101)  | (1,312)    |
| Gain on extinguishment of debt   | 8,546    | 829        |
| Gain resulting from reconciliation of payroll tax liabilities<br>to taxing authorities | 1,924    | 1,895      |
| Change in derivative and warrant liabilities   | 1,988    |            |
| Other, net   | 14       | -          |
| TOTAL OTHER INCOME (EXPENSE)   | 7,766    | (297)      |
| INCOME (LOSS) BEFORE PROVISION FOR INCOME TAXES<br>AND DISCONTINUED OPERATIONS         | 3,027    | (4,101)    |
| PROVISION FOR INCOME TAXES   | 40       | -          |
| INCOME (LOSS) BEFORE MINORITY INTEREST AND<br>DISCONTINUED OPEATIONS                   | 2,987    | (4,101)    |
| MINORITY INTEREST IN SUBSIDIARY (INCOME) LOSS  | -        | 59         |
| NET INCOME (LOSS) FROM CONTINUING OPERATIONS   | 2,987    | (4,042)    |
| DISCONTINUED OPERATION:  |          |            |
| Loss from discontinued operation   | (363)    | (176)      |
|  | (363)    | (176)      |
| NET INCOME (LOSS)  | 2,624    | (4,218)    |
| PREFERRED STOCK DIVIDENDS  | (21)     | (21)       |
| NET INCOME (LOSS) ATTRIBUTED TO COMMON<br>STOCKHOLDERS                                 | \$ 2,603 | \$ (4,239) |
| NET INCOME (LOSS) PER SHARE - BASIC  |          |            |
| Continuing operations  | \$ 0.72  | \$ (1.23)  |
| Discontinued operations  | (0.09)   | (0.05)     |
|  | \$ 0.63  | \$ (1.29)  |

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|   |            |           |
|---|------------|-----------|
| WEIGHTED AVERAGE COMMON EQUIVALENT<br>SHARES OUSTANDING - BASIC   | 4,110,203  | 3,292,181 |
| NET INCOME (LOSS) PER SHARE - DILUTED                             |            |           |
| Continuing operations   | \$ 0.37    | \$ (1.29) |
| Discontinued operations   | (0.02)     | -         |
|   | -----      | -----     |
|   | \$ 0.35    | \$ (1.29) |
|   | =====      | =====     |
| WEIGHTED AVERAGE COMMON EQUIVALENT<br>SHARES OUSTANDING - DILUTED | 19,347,977 | 3,292,181 |
|   | =====      | =====     |

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

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DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

Consolidated Statement of Stockholders' Deficit  
(in thousands, except share data)

|   | SERIES A PREFERRED STOCK |        | COMMON STOCK |        |
|---|--------------------------|--------|--------------|--------|
|   | SHARES                   | AMOUNT | SHARES       | AMOUNT |
|   | -----                    | -----  | -----        | -----  |
| BALANCE, JUNE 30, 2004  | 420.5                    | 420    | 2,761,794    | 14     |
| Issuance of common stock for:   |                          |        |              |        |
| Services  |                          |        | 73,115       |        |
| Conversion of liabilities   |                          |        | 841,335      | 4      |
| Value of warrants issued with notes                                   |                          |        |              |        |
| Value of warrants issued in Heritage acquisition                      |                          |        |              |        |
| Contribution of Solvis Group to QPI resulting<br>in minority interest |                          |        |              |        |
| Net loss  |                          |        |              |        |
|   | -----                    | -----  | -----        | -----  |
| BALANCE, JUNE 30, 2005  | 420.5                    | 420    | 3,676,244    | 18     |
| Issuance of common stock for:   |                          |        |              |        |
| Services and executive compensation                                   |                          |        | 327,625      | 2      |
| Convertible debentures  |                          |        | 651,237      | 3      |
| Conversion of liabilities   |                          |        | 262,421      | 2      |
| Value of warrants issued for consulting services                      |                          |        |              |        |
| Amortization of prepaid consulting                                    |                          |        |              |        |
| Net income  |                          |        |              |        |
|   | -----                    | -----  | -----        | -----  |
| BALANCE, JUNE 30, 2006  | 420.5                    | \$ 420 | 4,917,527    | 25     |
|   | =====                    | =====  | =====        | =====  |



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(continued)

|   | PREPAID<br>CONSULTING<br>----- | DEFICIT<br>----- | ACCUMULATED<br>TOTAL<br>----- |
|---|--------------------------------|------------------|-------------------------------|
| BALANCE, JUNE 30, 2004  | -                              | (107,677)        | (20,925)                      |
| Issuance of common stock for:   |                                |                  |                               |
| Services  |                                |                  | 73                            |
| Conversion of liabilities   |                                |                  | 392                           |
| Value of warrants issued with notes                                   |                                |                  | 28                            |
| Value of warrants issued in Heritage acquisition                      |                                |                  | 14                            |
| Contribution of Solvis Group to QPI resulting<br>in minority interest |                                |                  | (59)                          |
| Net loss  |                                | (4,218)          | (4,218)                       |
| BALANCE, JUNE 30, 2005  | -                              | (111,895)        | (24,695)                      |
| Issuance of common stock for:   |                                |                  | -                             |
| Services and executive compensation                                   |                                |                  | 318                           |
| Convertible debentures  |                                |                  | 278                           |
| Conversion of liabilities   |                                |                  | 100                           |
| Value of warrants issued for consulting services                      | (302)                          |                  | (302)                         |
| Amortization of prepaid consulting                                    | 57                             |                  | 57                            |
| Net income  |                                | 2,624            | 2,624                         |
| BALANCE, JUNE 30, 2006  | \$ (245)                       | \$ (109,271)     | \$ (21,620)                   |

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

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DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows  
(in thousands, except share data)

|  | YEAR END<br>-----<br>JUNE 30,<br>2006<br>----- |
|--|--|
| CASH FLOWS FROM OPERATING ACTIVITIES:  |  |
| Net loss from continuing operations  | \$ 2,987                                       |
| Adjustment to reconcile net loss to net cash<br>used in operating activities |  |
| Depreciation and amortization  | 150  |
| Stock issued for services  | 268  |
| Amortization of prepaid consulting   | 57   |
| Amortization of debt discounts   | 1,137  |
| Settlements with investors   | 908  |

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|   |          |
|---|----------|
| Change in value of warrant and accrued derivative liabilities                       | (1,988)  |
| Value of repriced options/warrants  | -        |
| Gain on extinguishment of debt  | (8,546)  |
| Gain on forgiveness of inter-company debt from Greenland                            |          |
| Gain resulting from reconciliation of payroll tax liabilities to taxing authorities | (1,924)  |
| Minority interest   | -        |
| Loss on write-off of patent   | -        |
| Changes in operating assets and liabilities:  |          |
| (Increase) decrease in:   |          |
| Accounts receivable   | 618      |
| Prepaid worker's compensation premiums  | 1,130    |
| Other current assets  | (1,979)  |
| Worker's compensation deposit   | (447)    |
| Other assets  | (3)      |
| Increase (decrease) in:   |          |
| Accounts payable and accrued expenses   | 36       |
| Accrued payroll and related payroll taxes and deductions                            | 8,519    |
| PEO liabilities   | 1,600    |
| Net cash provided by (used in) operating activities from continuing operations      | 2,523    |
| Net cash used in operating activities from discontinued operations                  | (375)    |
| Net cash used in operating activities   | 2,148    |
| CASH FLOWS FROM INVESTING ACTIVITIES:   |          |
| Cash acquired with (paid for) acquisition   | 122      |
| Purchase of furniture and equipment   | (220)    |
| Net cash provided by (used in) investing activities from continuing operations      | (98)     |
| Net cash used in investing activities from discontinued operations                  | -        |
| Net cash provided by (used in) investing activities                                 | (98)     |
| CASH FLOWS FROM FINANCING ACTIVITIES:   |          |
| Change in cash overdraft, net   | (162)    |
| Line of credit, net   | (769)    |
| Proceeds from notes payable   | 3,253    |
| Proceeds from issuance of convertible debentures                                    | 5,000    |
| Payment of debt issue costs   | (392)    |
| Repayments of notes payable   | (5,404)  |
| Repayments of borrowings under bank notes payable                                   | (483)    |
| Repayments of capital lease obligations   | (4)      |
| Net cash provided by financing activities from continuing operations                | 1,039    |
| Net cash provided by financing activities from discontinued operations              | -        |
| Net cash provided by financing activities   | 1,039    |
| NET DECREASE IN CASH AND CASH EQUIVALENTS   | 3,089    |
| CASH AND CASH EQUIVALENTS, Beginning of year  | 171      |
| CASH AND CASH EQUIVALENTS, End of year  | \$ 3,260 |

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

DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES  
 Consolidated Statements of Cash Flows, Continued  
 (in thousands, except share data)

|  | YEARS ENDED |       |
|--|-------------|-------|
|  | JUNE 30,    |       |
|  | 2006        |       |
|  | -----       | ----- |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:                        |             |       |
| Interest paid  | \$ -        | \$ -  |
|  | =====       | ===== |
| Income taxes paid  | \$ -        | \$ -  |
|  | =====       | ===== |
| SUPPLEMENTAL NON-CASH INVESTING AND FINANCING ACTIVITIES:                |             |       |
| Conversion of convertible debentures into common stock                   | \$ 278      | \$ -  |
|  | =====       | ===== |
| Conversion of accounts payable and accrued liabilities into common stock | \$ 100      | \$ -  |
|  | =====       | ===== |
| Note payable issued for purchase of interest in Alliance Group           | \$ 2,800    | \$ -  |
|  | =====       | ===== |
| Net assets acquired in business combinations:                            |             |       |
| Cash   | \$ 122      | \$ -  |
| Receivables  | 415         |       |
| Property and equipment   | -           |       |
| Customer list  | 567         |       |
| Accounts payable and accrued liabilities                                 | 546         |       |

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

DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 FOR THE YEARS ENDED JUNE 30, 2006 AND 2005  
 (in thousands, except for share information)

NOTE 1 - ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

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### BASIS OF PRESENTATION

The accompanying consolidated financial statements include the accounts of Dalrada Financial Corporation ("DFCO" or the "Company"), incorporated under the laws of the state of California in March 1982 and subsequently reincorporated under the laws of the state of Delaware in May 1983, and its following active subsidiaries (there are ten inactive subsidiaries not listed):

- a) SourceOne Group, Inc., - 100% owned by DFCO;
- b) The Christianson Group - 100% owned by DFCO;
- c) Heritage Staffing Group, Inc. - 100% owned by DFCO;
- d) Strategic Alternative Staffing, LLC - 100% owned by DFCO and
- e) Quik Pix, Inc. - 85% owned by DFCO.

All significant intercompany accounts and transactions have been eliminated.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. For the year ended June 30, 2006, the Company experienced a loss from continuing operations of \$4,739 and as of June 30, 2006, the Company had a negative working capital deficit of \$24,916 and had a negative stockholders' deficit of \$21,620. In addition, the Company is in default on certain note payable obligations, delinquent on payroll tax obligations and is being sued by numerous trade creditors for nonpayment of amounts due. The Company is also delinquent in its payments relating to payroll tax liabilities. These conditions raise substantial doubt about its ability to continue as a going concern. Management believes that it can continue to raise debt and equity financing to support its operations.

### STOCK SPLITS

On September 15, 2006, the Company authorized a one for two hundred (1 for 200) reverse stock split of its common stock. All share information for common shares has been retroactively restated for this reverse stock split.

### NATURE OF BUSINESS

The Company provides a variety of financial, staffing, professional employer organization outsourcing (PEO) and human resources services to small and medium-size businesses. These services allow the Company's customers to outsource many human resources tasks, including payroll processing, workers' compensation insurance, employee benefits administration, risk management and human resource administration. These financial services relieve existing and potential customers of the burdens associated with personnel management and control.

DFCO provides services through its subsidiaries and divisions: SourceOne Group, Inc. ("SOG") and Heritage Staffing; in addition, through The Solvis Group, Inc., ("Solvis") an 85% owned subsidiary that includes the operating units: CallCenterHR (TM), Solvis Financial Services, Solvis Medical Staffing and Solvis home Health Care. These companies and business units provide a broad range of financial services, including: benefits and payroll administration, health and workers' compensation insurance programs, personnel records management, employer liability management, risk management and safety, and temporary staffing services, to small and medium-sized businesses. Solvis' services cover a broad range of services including payroll debit cards, health insurance, 401(k) and 125-Flex plans, supplemental insurance, payroll advances, and other value-added benefits.

DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005  
(in thousands, except for share information)

Staffing services include on-demand or short-term staffing assignments, long-term or indefinite-term contract staffing and on-site management. In a PEO contract arrangement, the Company becomes a co-employer of the client's existing workforce and assumes some or all of the client's human resource management responsibilities.

As a human resource department and strategic business partner for the Company's clients, its service offerings allow its clients to:

- o comply with ever evolving complex employment related regulatory and tax issues;
- o increase productivity by improving employee satisfaction and retention;
- o reduce payroll expenses with lower workers' compensation costs; and
- o focus on core business activities instead of human resource matters.

In January 2003, the Company completed the acquisition of a controlling in the shares of Quik Pix, Inc. ("QPI"), located in Anaheim, California. At the time of acquisition, QPI's principal business was providing products and services associated with visual marketing support. QPI revenues consist primarily of developing and mounting photographic and digital images for use in display advertising for tradeshows and customer building interiors. QPI also has a proprietary product PhotoMotion Images(TM), ("Photomotion") which is a patented color medium of multi-image transparencies. DFCO moved its ColorBlind(TM) software business into QPI. The business is in the process of being sold to another company, which will be concluded by the end of October 2006.

In July 2005, QPI acquired The Solvis Group, Inc. ("Solvis") from DFCO and changed its name to The Solvis Group and its trading symbol to SLVG. Solvis current trades on the Pink Sheets(R). As of June 30, 2006, Solvis is a wholly-owned subsidiary of QPI.

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 the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reported periods. Significant estimates made by the Company's management include but are not limited to recoverability of property and equipment, payroll tax liabilities, reserves for contingent liabilities and deferred taxes. Actual results could materially differ from those estimates.

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## DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005  
(in thousands, except for share information)

### REVENUE RECOGNITION

#### PEO SERVICE FEES AND WORKSITE EMPLOYEE PAYROLL COSTS

The Company recognizes its revenues associated with its PEO business pursuant to EITF 99-19 "Reporting Revenue Gross as a Principal versus Net as an Agent." The Company's revenues are reported net of worksite employee payroll cost (net method). Pursuant to discussions with the Securities and Exchange Commission staff, the Company changed its presentation of revenues from the gross method to an approach that presents its revenues net of worksite employee payroll costs (net method) primarily because the Company is not generally responsible for the output and quality of work performed by the worksite employees.

In determining the pricing of the markup component of the gross billings, the Company takes into consideration its estimates of the costs directly associated with its worksite employees, including payroll taxes, benefits and workers' compensation costs, plus an acceptable gross profit margin. As a result, the Company's operating results are significantly impacted by the Company's ability to accurately estimate, control and manage its direct costs relative to the revenues derived from the markup component of the Company's gross billings.

Consistent with its revenue recognition policy, the Company's direct costs do not include the payroll cost of its worksite employees. The Company's direct costs associated with its revenue generating activities are comprised of all other costs related to its worksite employees, such as the employer portion of payroll-related taxes, employee benefit plan premiums and workers' compensation insurance premiums.

#### SALES OF PRODUCTS

Revenue is recognized when earned. The Company's revenue recognition policies are in compliance with all applicable accounting regulations, including American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, Software Revenue Recognition, and SOP 98-9, Modification of SOP 97-2, With Respect to Certain Transactions. Revenue from products licensed to original equipment manufacturers is recorded when OEMs ship licensed products while revenue from certain license programs is recorded when the software has been delivered and the customer is invoiced. Revenue from packaged product sales to and through distributors and resellers is recorded when related products are shipped. Maintenance and subscription revenue is recognized ratably over the contract period. When the revenue recognition criteria required for distributor and reseller arrangements are not met, revenue is recognized as payments are received. Provisions are recorded for returns and bad debts. The Company's software arrangements do not contain multiple elements, and the Company does not offer post contract support.

#### TEMPORARY STAFFING

The Company records gross revenue for temporary staffing. The Company has concluded that gross reporting is appropriate because the Company (i) has the risk and responsibility of identifying and hiring qualified employees, (ii) has

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the discretion to select the employees and establish their price and duties and (iii) bears the risk for services that are not fully paid for by customers. Temporary staffing revenues are recognized when the services are rendered by the Company's temporary employees. Temporary employees placed by the Company are the Company's legal employees while they are working on assignments. The Company pays all related costs of employment, including workers' compensation insurance, state and federal unemployment taxes, social security and certain fringe benefits. The Company assumes the risk of acceptability of its employees to its customers.

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### DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005  
(in thousands, except for share information)

#### WORKER'S COMPENSATION

In April 2005, the Company obtained a high deductible policy with an A rated national carrier in order to manage its financial exposure from catastrophic injuries and fatalities. Regulations governing self-insured employers often require the employer to maintain surety deposits of government securities, letters of credit or other financial instruments to cover workers' claims in the event the employer is unable to pay for such claims. The Company's excess workers' compensation insurance annual policy provided coverage for single occurrences exceeding \$250 with an aggregate stop loss provision of \$4,000. The Company was required to post a \$2,625 reserve with the carrier from which claims would be paid until all claims are settled. As of the end of the policy year, ending April 30, 2006, based upon an independent actuary report, the Company reserved \$615 in pending claims against the remaining collateral fund; producing an approximate \$1,800 in excess reserves. For the next policy year beginning May 2006, the carrier raised the Company's stop loss rates, but required the Company to deposit only \$1,600 in the claims collateral fund as the result of the Company's low claims experience in the prior year.

#### CONTINGENT LIABILITIES

The Company accrues and discloses contingent liabilities in its consolidated financial statements in accordance with Statement of Financial Accounting Standards ("SFAS") No. 5, Accounting for Contingencies. SFAS No. 5 requires accrual of contingent liabilities that are considered probable to occur and that can be reasonably estimated. For contingent liabilities that are considered reasonably possible to occur, financial statement disclosure is required, including the range of possible loss if it can be reasonably determined. The Company has disclosed in its audited financial statements several issues that it believes are reasonably possible to occur, although it cannot determine the range of possible loss in all cases. As these issues develop, the Company will continue to evaluate the probability of future loss and the potential range of such losses. If such evaluation were to determine that a loss was probable and the loss could be reasonably estimated, the Company would be required to accrue its estimated loss, which would reduce net income in the period that such determination was made.

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### RECLASSIFICATIONS

Certain reclassifications have been made to the prior year consolidated financial statements to conform to the current year's presentation. These reclassifications had no effect on previously reported results of operations or retained earnings.

### CASH AND CASH EQUIVALENTS

The Company considers all highly liquid investments purchased with original maturities of three months or less to be cash equivalents.

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### DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005  
(in thousands, except for share information)

### CONCENTRATION OF CREDIT RISK

The Company places its cash in what it believes to be credit-worthy financial institutions. However, cash balances may exceed FDIC and SPIC insured levels at various times during the year.

Financial instruments that could potentially subject the Company to concentration of credit risk include accounts receivable. The Company generally requires clients to pay invoices for service fees no later than one day prior to the applicable payroll date. As such, the Company generally does not require collateral.

Additionally, during 2005, 96% of revenue derived from temporary staffing was from two clients and during 2006 47% of revenue derived from temporary staffing was from two clients.

### ALLOWANCE METHOD USED TO RECORD BAD DEBTS

The Company provides an allowance for doubtful accounts equal to the estimated uncollectible amounts. The Company's estimate is based on historical collection experience and a review of the current status of trade accounts receivable. It is reasonably possible that the Company's estimate of the allowance for doubtful accounts will change. Accounts receivable are presented net of an allowance for doubtful accounts of \$639 at June 30, 2006. Accounts deemed uncollectible are written off against the allowance.

### LONG-LIVED ASSETS AND INTANGIBLE ASSETS

In accordance with SFAS Nos. 142 and 144, long-lived assets to be held and used are analyzed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. SFAS No. 142 relates to assets with an indefinite life where as SFAS 144 relates to assets that can be amortized and the life determinable. The Company evaluates at each balance sheet date whether events and circumstances have occurred that indicate possible impairment. If there are indications of impairment, the Company uses



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future undiscounted cash flows of the related asset or asset grouping over the remaining life in measuring whether the assets are recoverable. In the event such cash flows are not expected to be sufficient to recover the recorded asset values, the assets are written down to their estimated fair value. Long-lived assets to be disposed of are reported at the lower of carrying amount or fair value of asset less the cost to sell.

### PROPERTY AND EQUIPMENT

Property and equipment are recorded at cost. Depreciation, including amortization of assets recorded under capitalized leases, is generally computed on a straight-line basis over the estimated useful lives of assets ranging from three to seven years. Amortization of leasehold improvements is provided over the initial term of the lease, on a straight-line basis. Maintenance, repairs, and minor renewals and betterments are charged to expense.

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## DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005  
(in thousands, except for share information)

The Company reviews the carrying value of property and equipment for impairment whenever events and circumstances indicate that the carrying value of an asset may not be recoverable from the estimated future cash flows expected to result from its use and eventual disposition. In cases where undiscounted expected future cash flows are less than the carrying value, an impairment loss is recognized equal to an amount by which the carrying value exceeds the fair value of assets. The factors considered by management in performing this assessment include current operating results, trends and prospects, and the effects of obsolescence, demand, competition, and other economic factors.

### CUSTOMER LISTS

Customer lists includes customer purchased with the acquisition of certain assets of Heritage and SSL. The customer lists for Heritage and SSL are being amortized over their estimated useful life of 36 and 48 months, respectively, using the straight-line method. Amortization expense for the fiscal years 2007, 2008, 2009 and 2010 is expected to be \$166, \$160, \$142 and \$118, respectively.

### PATENT COSTS

Patent costs include direct costs of obtaining the patent. Costs for new patents are capitalized and amortized over the estimated useful life of the patent, generally over the life of the patent on a straight-line method. The cost of patents in process is not amortized until issuance. During the year ended June 30, 2005, the Company determined that the cost of the patent was not recoverable and took a write-off related to the patent of \$1,348.

### ADVERTISING COSTS

The Company expenses advertising and promotion costs as incurred. During fiscal 2006 and 2005, the Company incurred advertising and promotion costs of

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approximately \$84 and \$135, respectively.

### RESEARCH AND DEVELOPMENT

Research and development costs are charged to expense as incurred.

### EARNINGS (LOSS) PER COMMON SHARE

The Company reports earnings (loss) per share in accordance with SFAS No. 128, "Earnings per Share." Basic earnings (loss) per share are computed by dividing income (loss) available to common shareholders by the weighted average number of common shares available. Diluted earnings (loss) per share is computed similar to basic earnings (loss) per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if the potential common shares had been issued and if the additional common shares were dilutive. The Company had the following potential common shares for the years ended June 30, 2006 and 2005, respectively: warrants - 7,330,000 and 157,817; stock options - 135,000 and 195,750; and convertible securities of 15,237,774 and 2,078,758. For the year ended June 30, 2005, all of the above diluted shares were considered anti-dilutive since the Company incurred a net loss. For the year ended June 30, 2006, the warrants and options were considered anti-dilutive since the average stock price for the year was less than the exercise price of the warrants and options.

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Below is a computation of earning (loss) per share:

|   | YEAR ENDED JUNE 30,    |           |                   |
|---|------------------------|-----------|-------------------|
|   | -----<br>2006<br>----- |           | -----             |
|   | INCOME/<br>(LOSS)      | SHARES    | PER<br>SHARE      |
|   | INCOME/<br>(LOSS)      |           | INCOME/<br>(LOSS) |
| <b>BASIC EARNINGS (LOSS) PER SHARE</b>              |                        |           |                   |
| Net income (loss) from continuing operations        | \$ 2,679               |           | \$ (4,042)        |
| Preferred stock dividends                           | (21)                   |           | (21)              |
|   | -----                  |           | -----             |
| Discontinued operations                             | 2,658<br>(363)         |           | (4,063)<br>(176)  |
|   | -----                  |           | -----             |
| Net income (loss) attributed to common stockholders | \$ 2,295               |           | \$ (4,239)        |
|   | =====                  |           | =====             |
| Weighted shares outstanding                         |                        | 4,100,203 |                   |
| Continuing operations                               |                        |           | \$ 0.65           |
| Discontinued operations                             |                        |           | (0.09)            |
|   |                        |           | -----             |

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\$ 0.56  
=====

DILUTED EARNINGS PER SHARE

|  |            |          |
|--|------------|----------|
| Net income from continuing operations                  | \$ 2,679   |          |
| Preferred stock dividends                              | (21)       |          |
| Interest on convertible debentures                     | 476        |          |
| Amortization of discounts on convertible debentures    | 1,137      |          |
|  | -----      |          |
|  | 4,271      |          |
| Discontinued operations                                | (363)      |          |
|  | -----      |          |
| Net income (loss) attributed to common stockholders    | \$ 3,908   |          |
|  | =====      |          |
| Weighted shares outstanding                            | 4,110,203  |          |
| Conversion of convertible debentures into common stock | 15,237,774 |          |
|  | -----      |          |
|  | 19,347,977 |          |
|  | =====      |          |
| Continuing operations                                  |            | \$ 0.22  |
| Discontinued operations                                |            | \$(0.02) |
|  |            | -----    |
|  |            | \$ 0.20  |
|  |            | =====    |

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DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005  
(in thousands, except for share information)

DEBT DISCOUNTS

Debt discounts costs are principally the values attributed to the detachable warrants issued in connection with the convertible debentures and the value of the preferential conversion feature associated with the convertible debentures. These debt issuance costs are accounted for in accordance with Emerging Issues Task Force ("EITF") 00-27 issued by the Financial Accounting Standards Board ("FASB").

MINORITY INTEREST

On April 1, 2005, the Company contributed its wholly-owned subsidiary, Solvis Group, Inc. a Michigan corporation, to QPI, an 85%-owned subsidiary of the Company. QPI subsequently changed its name to The Solvis Group, Inc., a Nevada corporation ("Solvis"). At that date, Solvis had a stockholders' equity of \$393. As a result of this transaction, the Company recognized minority interest on its

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consolidated balance sheet in the amount of \$59. During the year ended June 30, 2005, Solvis incurred a net loss of which 15% or \$251 is attributed to the minority interest. In the consolidated statement of operations for the year ended June 30, 2005, the Company has only recognized the minority interests' share of the net loss to the extent of the minority interest recorded on the consolidated balance sheet. Solvis had net income for the year ended June 30, 2006 of which 15% or \$81 is attributed to minority interest. The net income attributed to minority interest for the year ended June 30, 2006 of \$0 that has been separately designated in the accompanying statement of operations is the current year net income related to minority interest of \$81 offset by the unrecorded loss of \$192 from the year ended June 30, 2005. The Company has an unrecorded loss of \$111 going into the year ended June 30, 2007.

### INCOME TAXES

The Company utilizes SFAS No. 109, "Accounting for Income Taxes," which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each period end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized.

The Company recognizes the amount of taxes payable or refundable for the current year and recognizes deferred tax liabilities and assets for the expected future tax consequences of events and transactions that have been recognized in the Company's financial statements or tax returns. The Company currently has substantial net operating loss carryforwards. The Company has recorded a 100% valuation allowance against net deferred tax assets due to uncertainty of their ultimate realization.

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### DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005  
(in thousands, except for share information)

### STOCK BASED COMPENSATION

The Company adopted SFAS No. 123 (Revised 2004), SHARE BASED PAYMENT ("SFAS No. 123R"), under the modified-prospective transition method on January 1, 2006. SFAS No. 123R requires companies to measure and recognize the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value. Share-based compensation recognized under the modified-prospective transition method of SFAS No. 123R includes share-based compensation based on the grant-date fair value determined in accordance with the original provisions of SFAS No. 123, ACCOUNTING FOR STOCK-BASED COMPENSATION, for all share-based payments granted prior to and not yet vested as of January 1, 2006 and share-based compensation based on the grant-date fair-value determined in accordance with SFAS No. 123R for all share-based

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payments granted after January 1, 2006. SFAS No. 123R eliminates the ability to account for the award of these instruments under the intrinsic value method prescribed by Accounting Principles Board ("APB") Opinion No. 25, ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES, and allowed under the original provisions of SFAS No. 123. Prior to the adoption of SFAS No. 123R, the Company accounted for our stock option plans using the intrinsic value method in accordance with the provisions of APB Opinion No. 25 and related interpretations.

For periods presented prior to the adoption of SFAS No. 123R, pro forma information regarding net loss and loss per share as required by SFAS No. 123R has been determined as if the Company had accounted for its employee stock options under the original provisions of SFAS No. 123. The fair value of these options was estimated using the Black-Scholes option pricing model. For purposes of pro forma disclosure, the estimated fair value of the options is amortized to expense over the option's vesting period. The pro forma information regarding the effect on operations that is required by SFAS 123 has not been presented since there is no pro forma expense to be shown for the six months ended December 31, 2005 or the year ended June 30, 2005.

### FAIR VALUE OF FINANCIAL INSTRUMENTS

For certain of the Company's financial instruments, including accounts receivable, inventories, accounts payable, and accrued expenses, the carrying amounts approximate fair value, due to their relatively short maturities. The amounts owed for long-term debt also approximate fair value because current interest rates and terms offered to the Company are at current market rates.

### COMPREHENSIVE INCOME

The Company adopted SFAS No. 130, "Reporting Comprehensive Income." This statement establishes standards for reporting other comprehensive income and its components in a financial statement. Comprehensive income, as defined, includes all changes in equity (net assets) during a period from non-owner sources. Examples of items to be included in comprehensive income, which are excluded from net income, include foreign currency translation adjustments and unrealized gains and losses on available-for-sale securities. Comprehensive income is not presented in the Company's financial statements since the Company did not have any of the items of other comprehensive income in any period presented.

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## DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005  
(in thousands, except for share information)

### SEGMENT DISCLOSURE

SFAS No. 131, "Disclosure about Segments of an Enterprise and Related Information," was issued, which changes the way public companies report information about segments. SFAS No. 131, which is based on the selected segment information, requires quarterly and entity-wide disclosures about products and services, major customers, and the material countries in which the entity holds assets and reports revenues. The Company has four segments.

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### RECENT ACCOUNTING PRONOUNCEMENTS

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections." This statement applies to all voluntary changes in accounting principle and requires retrospective application to prior periods' financial statements of changes in accounting principle, unless this would be impracticable. This statement also makes a distinction between "retrospective application" of an accounting principle and the "restatement" of financial statements to reflect the correction of an error. This statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. SFAS No. 154 is not expected to have a material effect on the financial position or results of operations of the Company.

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments". SFAS No. 155 amends SFAS No 133, "Accounting for Derivative Instruments and Hedging Activities", and SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities". SFAS No. 155, permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133, establishes a requirement to evaluate interest in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and amends SFAS No. 140 to eliminate the prohibition on the qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. This statement is effective for all financial instruments acquired or issued after the beginning of the Company's first fiscal year that begins after September 15, 2006. SFAS No. 155 may have a material effect on the financial position or results of operations of the Company depending upon management's plans to fund operations.

In March 2006 the FASB issued SFAS 156 'Accounting for Servicing of Financial Assets' this Statement amends FASB Statement No. 140, ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, with respect to the accounting for separately recognized servicing assets and servicing liabilities. This Statement:

1. Requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract.
2. Requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable.
3. Permits an entity to choose 'Amortization method' or Fair value measurement method' for each class of separately recognized servicing assets and servicing liabilities:

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4. At its initial adoption, permits a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other available-for-sale securities under Statement 115, provided that the available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value.
5. Requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities.

This Statement is effective as of the beginning of the Company's first fiscal year that begins after September 15, 2006. Management believes that this statement will not have a significant impact on the financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This statement clarifies the definition of fair value, establishes a framework for measuring fair value and expands the disclosures on fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. Management has not determined the effect, if any, the adoption of this statement will have on the financial statements.

### NOTE 2 - PROPERTY AND EQUIPMENT

The cost of property and equipment at June 30, 2006 consisted of the following:

|  |    |       |
|--|----|-------|
| Computer and other equipment                   | \$ | 611   |
| Office furniture and fixtures                  |    | 112   |
| Leasehold improvements                         |    | -     |
|  |    | ----- |
|  |    | 723   |
| Less accumulated depreciation and amortization |    | (368) |
|  |    | ----- |
|  | \$ | 355   |
|  |    | ===== |

Depreciation expense for the years ended June 30, 2006 and 2005 was \$103 and \$77, respectively.

### NOTE 3 - RELATED PARTY TRANSACTIONS

#### TRANSACTIONS WITH OFFICERS AND KEY EXECUTIVES

During the years ended June 30, 2006 and 2005, the Company issued 252,625 and 36,361 shares of common stock to the Company's CEO as payment for compensation valued at \$253 and \$109, respectively.

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### WARNING MANAGEMENT SERVICES, INC.

The Company's CEO and Chairman, Mr. Brian Bonar, is also the CEO and Chairman of Warning Management Services, Inc. In addition, the Company's former CFO, Mr. Randall A. Jones, is also the CFO of Warning Management Services, Inc. Warning a public company, located in Southern California. Warning's operations consist of a modeling agency and providing temporary staffing services to government agencies and private companies. Mr. Jones resigned from the Company effective April 15, 2006.

### GUARANTEE OF INDEBTEDNESS OF WARNING

As of September 8, 2004, Warning Management Services, Inc. ("Warning") purchased all of the issued and outstanding shares of Employment Systems, Inc. ("ESI") for \$1,500. The purchase was \$750 cash paid at the closing and a \$750 note payable by Warning. In connection with this transaction, the Company agreed to be a guarantor of the \$750 note payable. As inducement to enter into this guarantee, the Company was given a non-cancelable 2-year payroll processing contract with ESI. The ESI note payable has been settled, paid, and released.

### WARNING HAS A MONTH-TO-MONTH LEASE WITH THE COMPANY

Warning leases offices for its ESI subsidiary, on a month-to-month basis from the Company that started in October 2004. Monthly rental expense will be approximately \$3 per month.

### PEO SERVICES AGREEMENT WITH WARNING PROVIDES FOR A FEE AT PREVAILING MARKET RATE

In April 2004, the Company entered into an Agreement to provide PEO services for Warning. The Company receives from Warning a monthly administrative fee. During the year ended June 30, 2006, the Company invoiced Warning for \$87 and Warning's ESI subsidiary for \$520 for management services. During the year ended June 30, 2005, the Company invoiced Warning \$390 for management services and \$45 for reimbursement of costs. Warning also paid expenses of \$38 on behalf of the Company during the year ended June 30, 2005. As of June 30, 2006, the Company has an amount due to Warning of \$3 that is included in current liabilities.

### NOTE 4 - ACQUISITIONS

#### STRATEGIC ALTERNATIVE STAFFING, LLC.

On May 1, 2006, DFCO completed its acquisition of Strategic Alternative Staffing LLC ("SSL"). The purchase price was \$558 consisting of a \$550 note payable to the owner of SSL and 50,000 warrants to purchase shares of DFCO common stock valued at \$8. SSL is a professional employer organization and a broker of certain employee benefits. The Company acquired SSL as part of its strategic growth plan.

The operating results of SSL beginning May 1, 2006 are included in the accompanying consolidated statements of operations.



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## DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED JUNE 30, 2006 AND 2005 (in thousands, except for share information)

The total purchase price was valued at \$558 and is summarized as follows in accordance with SFAS No. 141 and 142:

|                                       |    |       |
|---------------------------------------|----|-------|
| Cash                                  | \$ | 122   |
| Accounts receivable                   |    | 415   |
| Customer list                         |    | 567   |
| Accounts payable and accrued expenses |    | (546) |
|                                       |    |       |
| Purchase price                        | \$ | 558   |
|                                       |    |       |

The customer list is being amortized over 48 months.

The pro forma financial information that the consolidated operations of the Company as if the SSL acquisition had occurred as of the beginning of the periods presented is not presented since the operations of SSL prior to the acquisition by DFCO were immaterial.

#### HERITAGE STAFFING GROUP, INC.

On April 4, 2005, DFCO completed its acquisition of certain assets of Heritage Staffing Group, Inc. ("Heritage"). The purchase price was \$79 consisting of \$20 in cash, a \$45 note payable to the owner of Heritage and 25,000 warrants to purchase shares of DFCO common stock valued at \$14. These warrants expired on March 31, 2006. Heritage is in the temporary staffing business and the Company acquired certain assets of Heritage to complement its other temporary staffing business.

The operating results of Heritage beginning April 4, 2005 are included in the accompanying consolidated statements of operations.

The total purchase price was valued at \$80 and is summarized as follows in accordance with SFAS No. 141 and 142:

|                        |    |    |
|------------------------|----|----|
| Computer equipment     | \$ | 4  |
| Furniture and fixtures |    | 3  |
| Customer list          |    | 72 |
|                        |    |    |
| Purchase price         | \$ | 79 |
|                        |    |    |

The customer list is being amortized over 36 months.

The pro forma financial information that the consolidated operations of the Company as if the Heritage acquisition had occurred as of the beginning of the periods presented is not presented since the operations of Heritage prior to the acquisition by DFCO were immaterial.

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## DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED JUNE 30, 2006 AND 2005 (in thousands, except for share information)

#### NOTE 5 - INVESTMENT IN ALLIANCE INSURANCE GROUP

On February 3, 2006, Solvis, a subsidiary of DFCO and Employment Systems, Inc., ("ESI") a wholly owned subsidiary of Warning Management Services, a related party, purchased an eighteen (18%) percent interest in Alliance Insurance Group for \$2,800. The purpose of the investment was to obtain access to a low cost worker's compensation insurance policy for both companies.

The \$2,800 purchase price is being financed through Bank Direct at 7.25% over 23 months. Both Solvis and ESI are co-signatories on the note. As Solvis is a co-guarantor of the note, the Company recorded the whole note of \$2,800 on its books and recorded a \$1,400 related party receivable from ESI. Additionally, the Company recorded a \$1,400 investment in the insurance company. Solvis' \$1,400 investment represents a 9% interest in the insurance company. ESI's \$1,400 payable to Solvis is secured by ESI's 9% investment interest in the insurance company. The Company has accounted for this investment in Alliance Insurance Group using the cost method.

#### NOTE 6 - OTHER ACCRUED EXPENSES

Other accrued expenses at June 30, 2006 consisted of the following as of:

|                                |    |       |
|--------------------------------|----|-------|
| Accrued interest and penalties | \$ | 270   |
| Accrued judgments              |    | 2,268 |
| Taxes payable                  |    | 63    |
| Deposits                       |    | 293   |
| Other                          |    | 626   |
|                                |    | ----- |
|                                |    | 3,520 |
|                                |    | ===== |

#### NOTE 7 - BORROWINGS UNDER BANKS NOTES PAYABLE

The Company had outstanding two notes payable to Imperial Bank and Export-Import Bank in the amounts of \$1,490 and \$1,730, respectively. In December 2005, the Company entered into an agreement with these two banks whereby the Company paid a total of \$483 as full satisfaction of all outstanding principal (\$3,220) and accrued interest (\$1,383) relating to these two notes payable. The Company recognized a gain on the settlement of debt related to this transaction of \$4,120.

#### NOTE 8 - FACTORING LINES OF CREDIT

The Company's temporary staffing division entered into a factoring agreement that expires in January 2007 and is renewable for successive periods of 12 months assuming certain conditions are met. The agreement provides for the Company to borrow against factored accounts receivables at a discount of approximately 2% for each 30 day period the balances remain unpaid. Customer

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payments are made directly to the factoring company and there is full recourse for uncollected accounts. In February 2006, we paid off the factoring line with the proceeds of the February 13, 2006 notes payable refinancing.

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### DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

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#### NOTE 9 - CONVERTIBLE DEBT FINANCING AND DERIVATIVE LIABILITIES

In accordance with Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended ("SFAS 133"), the holder's conversion right provision, interest rate adjustment provision, liquidated damages clause, cash premium option, and the redemption option (collectively, the debt features) contained in the terms governing the Notes are not clearly and closely related to the characteristics of the Notes. Accordingly, the features qualified as embedded derivative instruments at issuance and, because they do not qualify for any scope exceptions within SFAS 133, they were required by SFAS 123 to be accounted for separately from the debt instrument and recorded as derivative financial instruments.

During the year ended June 30, 2006, we recorded an other income item of \$1,234 and \$754, which relates to the debt features and warrants, respectively, to reflect the change in fair value of the derivative liability.

At each balance sheet date, we adjust the derivative financial instruments to their estimated fair value and analyze the instruments to determine their classification as a liability or equity. As of June 30, 2006, the estimated fair value of our derivative liability was \$1,483, as well as a warrant liability of \$3,138. The estimated fair value of the debt features was determined using the probability weighted averaged expected cash flows / Lattice Model. The model uses several assumptions, including: historical stock price volatility (utilizing a rolling 120-day period), risk-free interest rate (3.50%), remaining maturity, and the closing price of the Company's common stock to determine estimated fair value of the derivative asset. In valuing the debt features at June 30, 2006 the Company used the closing price of \$0.15 and the respective conversion and exercise prices for the warrants.

#### NOTES PAYABLE

During the year ended June 30, 2006, the Company issued notes to third parties, which included eight investors. As part of the several financing transactions, the Company also issued warrants to purchase shares of stock at various exercise prices.

| DATE OF NOTE | AMOUNT OF NOTES | CONVERSION PRICE (1) | TERM OF NOTE |
|--------------|-----------------|----------------------|--------------|
| -----        | -----           | -----                | -----        |

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|                      |    |       |    |         |         |
|----------------------|----|-------|----|---------|---------|
| January 27, 2006 (1) | \$ | 112   | \$ | 0.452   | 2 years |
| February 9, 2006 (1) | \$ | 246   | \$ | 0.452   | 2 years |
| February 13, 2006    | \$ | 7,545 |    | 75% (3) | 2 years |

| DATE OF WARRANTS ISSUED | NUMBER OF WARRANTS | EXERCISE PRICE | TERM OF WARRANTS |
|-------------------------|--------------------|----------------|------------------|
| February 13, 2006       | 6,760,000          | \$ 1.00        | 7 years          |
| February 13, 2006 (2)   | 520,000            | \$ 1.00        | 7 years          |
| May 1, 2006 (4)         | 50,000             | \$ 20.00       | 7 years          |

(1) = no warrants issued with this financing transaction.

(2) = no debt associated with these warrants.

(3) = 75% of 20-day pre-conversion market-based price.

(4) = warrants issued in connection with SSL acquisition

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### DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED JUNE 30, 2006 AND 2005 (in thousands, except for share information)

The notes contain provisions on interest accrual at the "prime rate" published in The Wall Street Journal from time to time, plus three percent (3%). The Interest Rate shall not be less than fifteen percent (15%). Interest shall be calculated on a 360 day year. Interest on the Principal Amount shall be payable monthly, commencing 120 days from the closing and on the first day of each consecutive calendar month thereafter (each, a "Repayment Date") and on the Maturity Date.

Following the occurrence and during the continuance of an Event of Default (as discussed in the Note), the annual interest rate on the Note shall automatically be increased by two percent (2%) per month until such Event of Default is cured.

The Notes also provide for liquidated damages on the occurrence of several events. As of June 30, 2006, no liquidating damages have been incurred by the Company.

Debt features. The Holder shall have the right, but not the obligation, to convert all or any portion of the then aggregate outstanding Principal Amount of this Note, together with interest and fees due hereon, into shares of Common Stock.

The proceeds from the financing transactions were allocated to the debt features and to the warrants based upon their fair values. After the latter allocations, the remaining value, if any, is allocated to the Note on the financial statements.

The debt discount is being accreted using the effective interest method over the term of the note.

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The value of the discount on the converted notes on the books is being accreted over the term of the note (two years). For the year ended June 30, 2006, the Company accreted \$884, of debt discount related to the Notes.

### WARRANTS ISSUED

The estimated fair value of the warrants at issuance were as follows:

| DATE OF WARRANTS ISSUED | NUMBER OF WARRANTS | VALUE AT ISSUANCE | VOLATILITY FACTOR |
|-------------------------|--------------------|-------------------|-------------------|
| February 13, 2006       | 6,760,000          | \$ 3,582          | 72%               |
| February 13, 2006       | 520,000            | \$ 302            | 72%               |

These amounts have been classified as a derivative instrument and recorded as a liability on the Company's balance sheet in accordance with current authoritative guidance. The estimated fair value of the warrants was determined using the Black-Scholes option-pricing model with a closing price of on the date of issuance and the respective exercise price, a 7.0 year term, and the volatility factor relative to the date of issuance. The model uses several assumptions including: historical stock price volatility (utilizing a rolling 120 day period), risk-free interest rate (3.50%), remaining time till maturity, and the closing price of the Company's common stock to determine estimated fair value of the derivative liability. In valuing the warrants at June 30, 2006, the Company used the closing price of \$0.15, the respective exercise price, as well as the remaining term on each warrant, as well as a volatility of 90%. In accordance with the provisions of SFAS No. 133, Accounting for Derivative Instruments, the Company is required to adjust the carrying value of the instrument to its fair value at each balance sheet date and recognize any change since the prior balance sheet date as a component of Other Income (Expense). The warrant derivative liability at June 30, 2006, had decreased to a fair value of \$3,138, due in part to a decrease in the market value of the Company's common stock to \$0.15 from \$0.20 at issuance of the February 13, 2006 amount, as well as an increase in the volatility from 72% to 90% which resulted in an "other income" item of \$754 on the Company's books.

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### DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

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The recorded value of such warrants can fluctuate significantly based on fluctuations in the market value of the underlying securities of the issuer of the warrants, as well as in the volatility of the stock price during the term used for observation and the term remaining for the warrants.

### DEBT FEATURES

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In accordance with Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended ("SFAS 133"), the debt features provision (collectively, the features) contained in the terms governing the Notes are not clearly and closely related to the characteristics of the Notes. Accordingly, the features qualified as embedded derivative instruments at issuance and, because they do not qualify for any scope exception within SFAS 133, they were required by SFAS 133 to be accounted for separately from the debt instrument and recorded as derivative financial instruments.

Pursuant to the terms of the Notes, these notes are convertible at the option of the holder, at anytime on or prior to maturity. There is an additional interest rate adjustment feature, a liquidated damages clause, a cash premium option, as well as the redemption option. The debt features represents an embedded derivative that is required to be accounted for apart from the underlying Notes. At issuance of the Notes, the debt features had an estimated initial fair value as follows, which was recorded as a discount to the Notes and a derivative liability on the consolidated balance sheet.

| DATE OF NOTE<br>----- | AMOUNT OF NOTES<br>----- | DEBT FEATURES              |  | CARRYING VALUE<br>----- |
|-----------------------|--------------------------|----------------------------|--|-------------------------|
|                       |                          | VALUE AT ISSUANCE<br>----- |  |                         |
| January 27, 2006      | \$ 112                   | \$ 69                      |  | \$ 43                   |
| February 9, 2006      | \$ 246                   | \$ 133                     |  | \$ 113                  |
| February 13, 2006     | \$ 7,545                 | \$ 2,515                   |  | \$ 1,448                |

In subsequent periods, if the price of the security changes, the embedded derivative financial instrument related to the debt features will be adjusted to the fair value with the corresponding charge or credit to other expense or income. The estimated fair value of the debt features was determined using the probability weighted averaged expected cash flows / Lattice Model with the closing price on original date of issuance, a conversion price based on the terms of the respective contract, a period based on the terms of the notes, and a volatility factor on the date of issuance. The model uses several assumptions including: historical stock price volatility (utilizing a rolling 120 day period), risk-free interest rate (3.50%), remaining maturity, and the closing price of the Company's common stock to determine estimated fair value of the derivative liability. In valuing the debt features at June 30, 2006, the company used the closing price of \$0.21 and the respective conversion price, a remaining term coinciding with each contract, and a volatility of 90%. For the year ended June 30, 2006, due in part to a decrease in the market value of the Company's common stock to \$0.15 the Company recorded an "other income" on the consolidated statement of operations for the change in fair value of the debt features of approximately \$1,234. At June 30, 2006, the estimated fair value of the debt features was approximately \$1,483.

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The recorded value of the debt features related to the Notes can fluctuate significantly based on fluctuations in the fair value of the Company's common stock, as well as in the volatility of the stock price during the term used for observation and the term remaining for the warrants.

The significant fluctuations can create significant income and expense items on the financial statements of the Company.

Because the terms of the convertible notes ("notes") require such classification, the accounting rules required additional convertible notes and non-employee warrants to also be classified as liabilities, regardless of the terms of the new notes and / or warrants. This presumption has been made due to the company no longer having the control to physical or net share settle subsequent convertible instruments because it is tainted by the terms of the notes. Were the notes to not have contained those terms or even if the transactions were not entered into, it could have altered the treatment of the other notes and the conversion features of the latter agreement may have resulted in a different accounting treatment from the liability classification. The notes and warrants, as well as any subsequent convertible notes or warrants, will be treated as derivative liabilities until all such provisions are settled.

For the year ended June 30, 2006, we recorded an other income item of \$1,234 and \$754, related to the decrease in value of the debt features and warrants. A tabular reconciliation of this adjustment follows:

For the year ended June 30, 2006:

|          |   |
|----------|---|
| \$ 754   | income, decrease in value of warrant liability    |
| \$ 1,234 | income, decrease in value of derivative liability |
| -----    |   |
| \$ 1,988 | other income related to convertible debt          |

For the year ended June 30, 2006, the Company recorded \$884 of interest expense related to the accretion of debt related to the convertible financing.

For the year ended June 30, 2006:

|        |  |
|--------|--|
| \$ 884 | of interest expense related to accretion of convertible debt |
| -----  |  |
| \$ 884 | of interest expense related to convertible debt              |

The balance of the carrying value of the convertible debt as of June 30, 2006 is:

|          |   |
|----------|---|
| \$ 1,605 | original carrying value on convertible debt |
| \$ (228) | converted to equity                         |
| \$ 884   | accretion of convertible debt               |
| -----    |   |
| \$ 2,261 | June 30, 2006 carrying value of debt        |

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The balance of the carrying value of the derivative liability as of June 30, 2006 is:

|            |   |
|------------|---|
| \$ 2,717   | original value of derivative liability            |
| \$ (1,234) | income, decrease in value of derivative liability |
| -----      |   |
| \$ 1,483   | June 30, 2006 value of derivative liability       |

The balance of the carrying value of the warrant liability as of June 30, 2006 is:

|          |  |
|----------|--|
| \$ 3,892 | original carrying value of warrant liability   |
| \$ (754) | income, decrease in value of warrant liability |
| -----    |  |
| \$ 3,138 | June 30, 2006 value of warrant liability       |

During the year ended June 30, 2006, the Company discussed with the lead investor the refinancing of certain convertible notes, including disputed amounts for accrued interest, penalties and note balances. As part of the funding described above we recognized an additional settlement of accrued interest, penalties and balances for \$908.

### NOTE 10 - NOTES PAYABLE, INCLUDING AMOUNTS DUE TO RELATED PARTIES

On August 9, 2005, the Company issued two secured promissory notes to two investors totaling \$221. The notes are due on October 9, 2005 and accrue interest at a rate of 12% per annum. These two notes have not been repaid and are currently in default. In addition, on December 22, 2005, the Company issued a promissory note to an investor for \$600. The note was due on January 6, 2006 and accrued interest at a rate of 15% per annum through February 1, 2006 and 24% per annum thereafter until the note is paid in full. This note was repaid from the proceeds of the February 13, 2006 funding.

During the year ended June 30, 2006 a subordinated non-convertible note payable of \$1,500 plus accrued interest of \$1,390 to a former director was reduced to \$750 and recognized as a gain on extinguishment of debt of \$2,140. The former director indicated that he would be willing to accept \$750 as payment in full on his outstanding obligation including accrued interest.

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The following summarizes notes payable (including amounts due to a related party) at June 30, 2006:

Note payable in connection with SSL acquisition,



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|   |          |
|---|----------|
| payable from net profits  | \$ 202   |
| Note payable to two investors, interest at 8% per annum, payable upon demand  | 49       |
| Notes payable to related party, interest at 8%, ranging from payable upon demand to due in 2008   | 458      |
| Note payable to investor, interest at 10% per quarter, payable upon demand  | 70       |
| Note payable to bank related to financing of worker's compensation deposit, interest at 7.5%, payable over 10 months through March 2007                 | 2,553    |
| Note payable to Direct Bank related to purchase of Alliance Insurance Group, interest at 7.5%, payable over 23 months with balance due in February 2008 | 2,340    |
| Note payable to a former director   | 750      |
| Other   | 4        |
|   | -----    |
|   | 6,426    |
| Less current portion  | (5,156)  |
|   | -----    |
| Long-term portion   | \$ 1,270 |
|   | =====    |

Notes payable mature as follows:

|                                 |          |
|---------------------------------|----------|
| During the years ended June 30, |          |
| 2007                            | \$ 5,156 |
| 2008                            | 1,270    |
|                                 | -----    |
|                                 | \$ 6,426 |
|                                 | =====    |

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NOTE 11 - STOCKHOLDERS' DEFICIT

AMENDMENT TO THE CERTIFICATE OF INCORPORATION.

On May 14, 2004, the Company's shareholders approved a Board proposal to amend the Certificate of Incorporation to increase the number of shares of common stock that the Company is authorized to issue from 500,000,000 to 1,000,000,000 shares.

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### 5% SERIES A CONVERTIBLE, REDEEMABLE PREFERRED STOCK

Holders of the 5% convertible preferred stock ("Series A") are entitled to receive, when and as declared by the Board of Directors, but only out of amounts legally available for the payment thereof, cumulative cash dividends at the annual rate of \$50.00 per share, payable semi-annually.

The 5% convertible preferred stock is convertible, at any time, into shares of the Company's common stock, at a price of \$3.5 per common share. This conversion price is subject to certain anti-dilution adjustments, in the event of certain future stock splits or dividends, mergers, consolidations or other similar events. In addition, the Company shall reserve, and keep reserved, out of its authorized but un-issued shares of common stock, sufficient shares to effect the conversion of all shares of the 5% convertible preferred stock.

In the event of any involuntary or voluntary liquidation, dissolution or winding up of the affairs of the Company, the 5% convertible preferred shareholders shall be entitled to receive \$1 per share, together with accrued dividends, to the date of distribution or payment, whether or not earned or declared.

The 5% convertible preferred stock is callable, at the Company's option, at call prices ranging from \$210 to \$220 per share. No call on the 5% convertible preferred stock was made during fiscal 2006 and 2005. As of June 30, 2006, the accumulated dividend in arrears was approximately \$474 on the Series A.

### COMMON STOCK WARRANTS

The following is a summary of the warrant activity:

|                              | PRICE PER<br>SHARE | UNDERLYING<br>COMMON<br>SHARES |
|------------------------------|--------------------|--------------------------------|
|                              | -----              | -----                          |
| JUNE 30, 2004                | \$4.00 - \$300.00  | 107,817                        |
| Granted                      | \$0.60 - \$1.00    | 50,000                         |
| Exercised                    | -                  | -                              |
| Canceled                     | -                  | -                              |
|                              |                    | -----                          |
| JUNE 30, 2005                | \$0.60 - \$300.00  | 157,817                        |
| Granted                      | \$1.00 - \$20.00   | 7,330,000                      |
| Exercised                    | -                  | -                              |
| Canceled                     | \$0.60 - \$300.00  | (157,817)                      |
|                              |                    | -----                          |
| EXERCISABLE AT JUNE 30, 2006 |                    | 7,330,000                      |
|                              |                    | -----                          |

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DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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The weighted average remaining contractual life of warrants outstanding at June 30, 2006 is 6.60 years. The intrinsic value of the outstanding warrants at June 30, 2006 was \$0. The exercise prices for warrants outstanding at June 30, 2006 are as follows:

| NUMBER<br>OF<br>WARRANTS | EXERCISE<br>PRICE |
|--------------------------|-------------------|
| -----                    | -----             |
| 7,280,000                | \$1.00            |
| 50,000                   | \$20.00           |
| -----                    |                   |
| 7,330,000                |                   |
| =====                    |                   |

### 2001 STOCK OPTION AND STOCK PURCHASE PLANS

The Company's shareholders approved the 2001 Stock Option Plan, pursuant to which 1,000,000 shares of common stock are reserved for issuance to eligible employees and directors of, and consultants to, the Company or any of its subsidiaries. Upon expiration, cancellation or termination of unexercised options, the shares of the Company's Common Stock subject to such options will again be available for the grant of options under the 2001 Stock Option Plan. Options granted under the 2001 Stock Option Plan may either be incentive or nonqualified stock options.

The Company's shareholders approved the 2001 Stock Purchase Plan, as amended, which enables eligible employees to purchase in the aggregate up to 50,000 shares of common stock.

### STOCK OPTION ACTIVITY

The following is a summary of the stock option activity:

|                              | STOCK OPTION PLANS | UNDERLYING<br>COMMON<br>SHARES |
|------------------------------|--------------------|--------------------------------|
|                              | PRICE PER<br>SHARE | -----                          |
|                              | -----              | -----                          |
| JUNE 30, 2004                | \$2.00 - \$5.00    | 195,750                        |
| Granted                      | -                  | -                              |
| Exercised                    | -                  | -                              |
| Canceled                     | -                  | -                              |
|                              |                    | -----                          |
| JUNE 30, 2005                | \$2.00 - \$5.00    | 195,750                        |
| Granted                      | -                  | -                              |
| Exercised                    | -                  | -                              |
| Canceled/Expired             | \$2.00 - \$3.00    | (60,750)                       |
|                              |                    | -----                          |
| EXERCISABLE AT JUNE 30, 2006 | \$2.00 - \$5.00    | 135,000                        |
|                              |                    | -----                          |

DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

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The weighted average remaining contractual life of options outstanding issued under the Stock Option Plans is 0.17 years at June 30, 2006. The exercise prices for options outstanding at June 30, 2006 are as follows:

| NUMBER<br>OF<br>WARRANTS | EXERCISE<br>PRICE |
|--------------------------|-------------------|
| -----                    | -----             |
| 7,500                    | \$2.00            |
| 127,500                  | \$5.00            |
| -----                    |                   |
| 135,000                  |                   |
| =====                    |                   |

The Company has implemented SFAS 123R for future grants of options to employees. No unvested option grants to employees were outstanding at June 30, 2006.

COMMON STOCK ISSUED FOR SERVICES AND COMPENSATION

The table below shows all the issuances of common stock for services during the year ended June 30, 2006 and 2005. The value of the services was derived by multiplying the market value of the Company's common stock at the date a transaction for services was entered into by the number of shares issued.

FISCAL 2006

| ISSUE<br>DATE | DESCRIPTION             | SHARES<br>ISSUED | AMOUNT |
|---------------|-------------------------|------------------|--------|
| 9/16/05       | Professional Services   | 25,000           | \$ 15  |
| 3/13/06       | Compensation to officer | 50,000           | 50     |
| 6/30/06       | Compensation to officer | 252,625          | 253    |
|               |                         | -----            | -----  |
|               |                         | 327,625          | \$ 318 |
|               |                         | =====            | =====  |

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## DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

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### FISCAL 2005

| ISSUE<br>DATE | DESCRIPTION                  | SHARES<br>ISSUED | AMOUNT |
|---------------|------------------------------|------------------|--------|
| 7/26/04       | Strategic planning/marketing | 2,250            | \$ 2   |
| 9/28/04       | Strategic planning/marketing | 7,500            | 8      |
| 10/19/04      | Strategic planning/marketing | 8,365            | 8      |
| 10/25/05      | Strategic planning/marketing | 25,000           | 25     |
| 6/13/05       | Professional services        | 30,000           | 30     |
|               |                              | -----            | -----  |
|               |                              | 73,115           | \$ 73  |
|               |                              | =====            | =====  |

#### NOTE 12 - SEGMENT AND GEOGRAPHIC INFORMATION

During fiscal 2006 and 2005, the Company managed and internally reported the Company's business as four (4) reportable segments as follows:

- (1) professional employer organization
- (2) temporary staffing
- (3) products;
- (4) corporate;

Segment information for the fiscal year ended June 30, 2006 and 2005, was as follows:

|   | PEO<br>BUSINESS | TEMPORARY<br>STAFFING | PRODUCTS | CORPORA |
|---|-----------------|-----------------------|----------|---------|
| <b>SELECTED STATEMENT OF OPERATIONS ACTIVITY:</b> |                 |                       |          |         |
| Fiscal year ended June 30, 2006                   |                 |                       |          |         |
| Revenues  | 1,382           | 68,226                | 772      | -       |
| Cost of revenues                                  | 998             | 62,897                | 34       | -       |
| Gross profit                                      | 384             | 5,329                 | 738      | -       |
| Total assets at June 30, 2006                     | 1,304           | 11,781                | 146      | 1,467   |
| Fiscal year ended June 30, 2005                   |                 |                       |          |         |
| Revenues  | 1,930           | 17,029                | 517      | -       |
| Cost of revenues                                  | 1,424           | 15,010                | 96       | -       |
| Gross profit                                      | 506             | 2,019                 | 421      | -       |
| Impairment of patent                              | -               | -                     | 1,348    | -       |

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## DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED JUNE 30, 2006 AND 2005 (in thousands, except for share information)

All sales were made in the United States of America

#### NOTE 13 - INCOME TAXES

The Company's provision for income taxes is accounted for in accordance with SFAS 109. SFAS 109 requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under the SFAS 109 asset and liability method, deferred tax assets and liabilities are determined based upon the difference between the financial statement and tax bases of assets and liabilities using the enacted tax rates in effect for the year in which the differences are expected to reverse. A valuation allowance is then provided for deferred tax assets that are more likely than not to not be realized.

The provision (benefit) for income taxes is as follows for the years ended June 30:

|                  | 2006  | 2005  |
|------------------|-------|-------|
|                  | ----- | ----- |
| Current - State  | \$ 40 | \$ -  |
| Deferred benefit | -     | -     |
|                  | ----- | ----- |
|                  | \$ 40 | \$ -  |
|                  | ===== | ===== |

The components of deferred income taxes are as follows at June 30:

|                                  | 2006      | 2005      |
|----------------------------------|-----------|-----------|
|                                  | -----     | -----     |
| Deferred tax assets              |           |           |
| Net operating loss carryforwards | \$ 37,493 | \$ 38,927 |
| Other                            | 475       | 524       |
|                                  | -----     | -----     |
|                                  | 37,968    | 39,451    |
| Valuation allowance              | (37,968)  | (39,451)  |
|                                  | -----     | -----     |
|                                  | \$ -      | \$ -      |
|                                  | =====     | =====     |

The Company's federal and state net operating loss carryforwards expire in various years through 2017. The Company has made numerous equity issuances that could result in limitations on the annual utilization of the Company's net operating loss carryforwards. The Company has not performed an analysis to determine the effect of such changes.

The provision for income taxes results in an effective rate that differs from the federal statutory rate. Reconciliation between the actual tax provision and taxes computed at the statutory rate is as follows for the year ended June 30, 2006:

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## DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED JUNE 30, 2006 AND 2005 (in thousands, except for share information)

|                    | Tax     | Percentage |
|--------------------|---------|------------|
| Federal Tax        | \$ 892  | 34.0%      |
| State tax          | 157     | 6.0%       |
| Penalties          | 374     | 14.3%      |
| Reserves           | 200     | 7.6%       |
| Other              | (41)    | (1.6%)     |
| Net operating loss | (1,542) | (58.8%)    |
|                    | -----   | -----      |
|                    | \$ 40   | 1.5%       |
|                    | =====   | =====      |

Reconciliation between the actual tax provision and taxes computed at the statutory rate is as follows for the year ended June 30, 2005:

|                    | Tax        | Percentage |
|--------------------|------------|------------|
| Federal Tax        | \$ (1,434) | 34.0%      |
| State tax          | (253)      | 6.0%       |
| Penalties          | 306        | (7.3)      |
| Other              | 59         | (1.4%)     |
| Net operating loss | 1,322      | (31.3%)    |
|                    | -----      | -----      |
|                    | \$ -       | 0%         |
|                    | =====      | =====      |

At June 30, 2006, the Company had federal and state net operating loss ("NOL") carryforwards of approximately \$90,000,000 and \$69,000,000, respectively. Federal NOLs could, if unused, expire in varying amounts in the years 2010 through 2020.

#### NOTE 14 - COMMITMENTS AND CONTINGENCIES

##### LEASE COMMITMENT

The Company leases its operating facilities under lease agreements that expire through 2011.

Total rental expense was approximately \$335 and \$299 for the years ended June 30, 2006 and 2005, respectively.

Future minimum lease payments under non-cancelable capital and operating leases with initial or remaining terms of one year or more are as follows:

|                      | Operating Leases |     |
|----------------------|------------------|-----|
| YEAR ENDING JUNE 30, |                  |     |
| 2007                 | \$               | 432 |
| 2008                 |                  | 347 |

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|                            |    |       |
|----------------------------|----|-------|
| 2009                       |    | 192   |
| 2010                       |    | 195   |
| 2011                       |    | 17    |
|                            |    | ----- |
| Net Minimum Lease Payments | \$ | 1,183 |
|                            |    | ===== |

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DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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LEGAL MATTERS

The Company and its SourceOne Group ("SOG") subsidiary have been sued by the Arena Football 2 Operating Company, LLC ("Arena") in Wayne County Circuit Court, Michigan. In April 2006, Dalrada and SourceOne Group, Inc. entered into a settlement with AF2 Operating Company, LLC and other parties involved in the matter of AF2 Operating Company, LLC v. SourceOne Group Inc., et al. The net result of the settlement was that Dalrada and SourceOne Group, Inc. are obligated to make a net settlement payment of \$ 203. In addition, the Company has filed claims against Arena and Arena's agent, Thilman and Filippini, based on, among other things, the representations made to SOG that let it to enter into the agreement with Arena. These claims are currently pending.

The Company and SOG have been sued by Liberty Mutual Insurance Company ("Liberty") in the United States District Court for the Northern District of Illinois. The nature of the specific claims made by Liberty against the Company and SOG are that the Company and SOG were and are obligated to make additional premium payments to Liberty for workers' compensation insurance, which is related to the Arena litigation described above. The initial claim by Liberty was estimated by Liberty to be \$829 and is now claimed to exceed \$1,000. In July 2007, the judge dismissed Dalrada from the litigation and dismissed many, but not all, of the claims against SourceOne Group. Management has vigorously contested the claims made by Liberty. Trial is scheduled for January 2007.

On April 25, 2006, a trial occurred in the matter of LM Insurance Corporation v. Brian Bonar pending in Superior Court of California for the County of San Diego. LM Insurance Corporation asserted that SourceOne Group, Inc. had entered into a policy for insurance coverage and that Brian Bonar had personally guaranteed the premium payments. The court found in favor of Brian Bonar.

On February 10, 2005, Berryman & Henigar Enterprises ("Plaintiff"), filed a complaint in the Superior Court of California, County of San Diego, Case No. GIC842610, against Warning Model Management, Inc. for breach of a promissory note issued pursuant to terms and conditions of a certain stock purchase and sale agreement dated September 9, 2004. The Company allegedly guaranteed payments on the underlying promissory note. Plaintiff seeks principal damages of \$750 in that regard. Warning Model Management, Inc. has taken the position that Plaintiff failed to disclose certain material information in the underlying transaction which thereby negates the promissory note. Warning Model Management, Inc. reached a settlement, effective as of September 30, 2005 with the



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Plaintiff, which requires defendants, collectively, to pay Plaintiff the aggregate sum of \$380. Defendants have made the initial two payments due under the settlement and the final payment in the sum of \$80 was paid in April 2006. Accordingly, the matter has been settled and all claims satisfied.

On March 17, 2005, Greenland Corporation ("Plaintiff"), filed an amended complaint in the Superior Court of California, County of San Diego, Case No. GIC842605, against the Company and multiple other individuals and entities resulting from a transaction as evidenced by the "Agreement to Acquire Shares" dated August 9, 2002, whereby the Company obtained a controlling equity interest in Plaintiff. Plaintiff contends that the Company engaged in various forms of wrongdoing including breach of fiduciary duty, conversion, conspiracy and aiding and abetting. The Company has filed a cross-complaint alleging various causes of action against Plaintiff and its officers, directors and/or managing agents including Thomas J. Beener, Gene Cross, George Godwin, and Edward Sano. The subject cross-complaint seeks pecuniary and punitive damages resulting from various fraudulent transactions as well as legal malpractice against Mr. Beener. In July 2006, the matter was settled with Dalrada paying \$150 of legal fees incurred by Greenland.

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### DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED JUNE 30, 2006 AND 2005 (in thousands, except for share information)

On August 29, 2005, United Bank & Trust filed suit against the Company and other parties. The allegations of the lawsuit are that the Company guaranteed certain debt owed by InfoServices, Inc. and is liable in the amount of \$678. The case is in its early stages and discovery has not yet commenced. However, the Company intends to vigorously defend itself against the claims asserted.

Throughout fiscal 2004 and 2005, trade creditors have made claims and/or filed actions alleging the failure of the Company to pay its obligations to them in a total amount exceeding \$3,000. These actions are in various stages of litigation, with many resulting in judgments being entered against the Company. Several of those who have obtained judgments have filed judgment liens on the Company's assets. These claims range in value from less than \$1 to just over \$1,000, with the great majority being less than \$20.

On September 7, 2005, the arbitrator from the American Arbitration Association awarded to Accord Human Resources a judgment against Greenland Corporation and the Company as the guarantor, an amount equaling \$168. Legal counsel has estimated that the claim could amount to as much as \$214. The Company has reserved \$200 for the claim.

The Company was in a dispute with former creditors regarding the amount of debt converted into common stock. These creditors were seeking damages totaling \$316. The Company proposed a settlement in the amount of \$316, based on the advice of the Company's legal counsel. Consequently, \$316 was charged to operations in the accompanying financial statements for the year ended June 30, 2006. The plaintiffs have accepted the settlement offer.

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### NOTE 15 - GAIN ON SETTLEMENT OF DEBT

During the year ended June 30, 2006 and 2005, the Company recognized a gain on settlement of debt of \$8,546 and \$829, respectively. For the year ended June 30, 2006, the recognized a gain of \$4,120 related to the settlement of two notes payable to banks. (See Note 7) and a gain of \$2,140 related to the settlement of notes payable and accrued interest with a former director (See Note 10). The remaining gain of \$2,286 for the year ended June 30, 2006 and the gain of \$829 for the year ended June 30, 2005 resulted primarily from the write off of stale accounts payable and judgments. The Company, based upon an opinion provided by independent legal counsel, has been released as the obligator of these liabilities. Accordingly, management has elected to adjust its accounts payable and to classify such adjustments as settlement of debt.

### NOTE 16 - GAIN RESULTING FROM RECONCILIATION OF PAYROLL TAX LIABILITIES TO TAXING AUTHORITIES

During the years ended June 30, 2006 and 2005, the Company recorded an adjustment to earnings of \$1,924 and \$1,895, respectively, resulting from a reconciliation with the Internal Revenue Service and certain State taxing authorities of the amounts due for delinquent payment of payroll tax liabilities. The Company continually updates its estimate of the amount due related to delinquent payroll taxes and penalties as it receives correspondence or settlement agreements with the Internal Revenue Service and State taxing authorities.

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## DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED JUNE 30, 2006 AND 2005 (in thousands, except for share information)

The Company is delinquent in filing its payroll tax returns and owes \$8,451 in delinquent payroll tax payments, interest and penalties.

### NOTE 17 - DISCONTINUED OPERATIONS

In November 2005, the Company determined to discontinue operations of Master Staffing, its executive recruiting division. The decision was based on the Master Staffing lack of ability to generate sufficient revenue and the Company's lack of expertise in the executive recruiting business. The Company is completely exiting the executive recruiting business. The Company plans to wind down the operations of Master Staffing and close its only office over the next few months.

For the year ended June 30, 2006 and 2005, Master Staffing's revenues were \$11 and \$0, respectively, and losses from operations were \$363 and \$176, respectively. The results of operations of Master Staffing have been reported separately as discontinued operations.

Master Staffing's net assets at June 30, 2006 were \$22, which consisted of furniture and equipment of \$19 and other assets of \$3.

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### NOTE 18 - SUBSEQUENT EVENTS

#### ALL STAFFING, INC. ACQUISITION

On September 13, 2006 the Company acquired All Staffing, Inc., a Lansford, Pennsylvania-based company that provides staffing, staffing leasing, and professional employer organization ("PEO") services to clients in the northeast U.S. All Staffing establishes an east coast presence for Dalrada, and expands the Company's organization to include expanded operations to pursue a nationwide footprint. Dalrada has offices and subsidiaries in Texas, Michigan, California, and Colorado. The terms of the acquisition include payment of \$3.5 million in cash and common stock.

#### STOCK SPLITS

On September 15, 2006, the Company authorized a one for two hundred (1 for 200) reverse stock split of its common stock. All share information for common shares has been retroactively restated for this reverse stock split.