

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

FORM 10-K

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

For the fiscal year ended October 31, 2008

or

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

For the transition period from _____ to _____



Commission file number 0-24015

STEELCLOUD, INC.

(Exact name of registrant as specified in its charter)

Commonwealth of Virginia

(State or other jurisdiction of incorporation or organization)

14040 Park Center Road, Herndon, Virginia

(Address of principal executive offices)

54-1890464

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

20171

(Zip Code)

(703) 674-5500

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12 (b) of the Exchange Act

Title of each class

None.

Name of exchange on which registered

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

Title of each class

Common Stock, \$.001 par value per share

Name of exchange on which registered

Nasdaq Capital Market

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

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (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 there is disclosure of delinquent filers in response to Item 405 of Regulation S-K contained herein and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

The aggregate market value of the voting stock held by non-affiliates of the issuer as of April 30, 2008 was \$16,076,001.

The number of shares outstanding of the registrant's Common Stock on January 27, 2009 was 14,738,376.

Documents incorporated by reference:

Portions of the Definitive Proxy Statement to be filed pursuant to Regulation 14A for SteelCloud, Inc.'s annual meeting for 2008 are incorporated by reference into Part III of this Form 10-K.

STEELCLOUD, INC
2008 ANNUAL REPORT ON FORM 10-K

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FORWARD-LOOKING STATEMENTS

This Annual Report on form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”) and Section 21e of the Securities Exchange Act of 1934, as amended (the “Exchange Act”) and the Private Securities Litigation Reform Act of 1995 and SteelCloud, Inc. intends that such forward-looking statements be subject to the safe harbors created thereby. The forward-looking statements relate to future events or the future financial performance of SteelCloud, Inc. including, but not limited to, statements contained in: Item 1. “Business” and Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” Readers are cautioned that such statements, which may be identified by words including “anticipates,” “believes,” “intends,” “estimates,” “expects,” and similar expressions, are only predictions or estimations and are subject to known and unknown risks and uncertainties. In evaluating such statements, readers should consider the various factors identified in this Annual Report on Form 10-K which could cause actual events, performance or results to differ materially from those indicated by such statements. In light of the significant uncertainties inherent in the forward-looking information included herein, the inclusion of such information should not be regarded as a representation by SteelCloud, Inc. or any other person that its objectives or plans will be achieved. SteelCloud, Inc. does not undertake and specifically declines any obligation to update any forward-looking statements or to publicly announce the results of any revisions to any statements to reflect new information or future events or developments.

PART I

ITEM 1. BUSINESS

General

Founded in 1987, SteelCloud, Inc. (referred to herein as the "Company," or "SteelCloud," "we," "our," "ours," and "us") is a leading manufacturer of embedded integrated computing systems solutions for the federal marketplace and Independent Software Vendors ("ISV(s)"). We design, manufacture and integrate specialized servers for federal market prime contractors ("federal integrators") and ISVs who use the specialized servers to deliver application software to their clients.

We were originally incorporated as Dunn Computer Operating Company on July 27, 1987 under the laws of the Commonwealth of Virginia. On February 26, 1998, Dunn Computer Corporation ("Dunn") was formed and incorporated in the Commonwealth of Virginia to become a holding company for several entities including Dunn Computer Operating Company. Our subsidiary is International Data Products ("IDP"), which we acquired in May 1998. On May 15, 2001, the shareholders approved an amendment to our Articles of Incorporation to change our corporate name from Dunn Computer Corporation to SteelCloud, Inc. On December 31, 2003, Dunn was merged with and into SteelCloud. On February 17, 2004, we acquired the assets of Asgard Holding, LLC ("Asgard"). In July 2006, as part of our restructuring efforts, we closed our sales office and ceased all of our operations in Florida. Our former subsidiaries, Puerto Rico Industrial Manufacturing Operations Acquisition Corporation ("PRIMO"), and STMS Corporation ("STMS"), are currently inactive.

Unless the context otherwise requires, the "Company," "Dunn Computer Corporation," or "SteelCloud" "we," "our," "ours," and "us" refers to SteelCloud, Inc., its predecessor and its subsidiaries. Our principal executive offices are located at 14040 Park Center Road, Suite 210 Herndon, VA 20171. Our main telephone number is (703) 674-5500. Inquiries may also be sent to SteelCloud at info@steelcloud.com for sales and general information or ir@steelcloud.com for investor relations information.

Going Concern

We have had recurring annual operating losses since our fiscal year ended October 31, 2004. We expect that such losses will continue at least until our fiscal year ending October 31, 2009. The report of our independent registered public accounting firm on our consolidated financial statements for the fiscal year ended October 31, 2008 contains an explanatory paragraph regarding our ability to continue as a going concern based upon our history of net losses.

We are dependent upon available cash and operating cash flow to meet our capital needs. We are considering all strategic options to improve our liquidity and provide us with working capital to fund our continuing business operations which include equity offerings, asset sales or debt financing as alternatives to improve our cash needs however, there can be no assurance that we will be successful in negotiating financing on terms agreeable to us or at all. If adequate funds are not available or are not available on acceptable terms, we will likely not be able to take advantage of unanticipated opportunities, develop or enhance services or products, respond to competitive pressures, or continue as a going concern. There is no assurance we will be successful in raising working capital as needed. There are no assurances that we will have sufficient funds to execute our business plan, pay our operating expenses and obligations as they become due or generate positive operating results.

We are in the process of executing on several restructuring initiatives which have occurred from late 2008 to the present that include:

- A reorganization in November 2008 that included personnel terminations from all parts of the organization;
- Sales of certain of our leased assets to customers;
- Elimination of all non-essential costs; and
- Reduction of occupancy costs.

While we believe that these initiatives will better align our costs with our anticipated revenues going forward, it will take time for these initiatives to have an impact on our net revenue and operating income.

Target Market

Our primary target markets are (1) the embedded integrated computing systems market, specifically within the industrial automation and military Commercial off the Shelf (“COTS”) servers segments, and (2) the BlackBerry® Enterprise Server market for both Federal government and the domestic and international commercial markets. Embedded integrated computing systems are typically defined as purpose built systems that are not visible to the operator and whose primary function is non-office application related. Embedded integrated computing systems also tend to be ruggedized for deployment in harsh environments that typical computing systems can not handle.

We utilize multiple channel models, indirect channels via federal systems integrators and manufacturer representatives and direct to ISVs. We believe that our embedded integrated computing systems are best suited to address the high volume needs of material handling applications such as postal automation while our SteelWorks® Mobile family of products is the best way to implement and manage BlackBerry® Enterprise Servers.

Federal Systems Integrator

Federal integrators outsource their specialized requirements to us and consider us to be their “virtual hardware engineering division.” We design and manufacture specialized embedded integrated computing systems that are the foundation upon which the integrators develop and deliver their application software. This allows the integrators to shift their attention away from computing systems hardware and systems software logistics to their core application software and services. As a result, integrators improve customer satisfaction, shorten time to delivery and lower overall development costs.

We complement our embedded integrated computing systems, which are often designed to withstand harsh environmental conditions, with software integration, quality testing and program lifecycle management services. We also provide configuration management, logistics and support services that are unavailable from traditional computer vendors.

Independent Software Vendors (ISV)

For our ISV customers, we are their “virtual hardware engineering division.” Similar to our federal integrator business, we create a unique product for the ISV by integrating the ISV’s software onto a specialized appliance platform running Linux or one of Microsoft’s operating systems.

In addition, we augment the ISV’s internal capabilities by taking responsibility for those tasks which are necessary to successfully bring an appliance to market, but which are impractical for its software partners to perform. Services include branding, asset tagging, supply chain and inventory management, fulfillment, logistics and program management. The final ISV deliverable is a branded, unique, optimized appliance that is ready-to-deploy when it arrives at the ISV’s end customer’s site.

Our specialized servers and appliances are engineered and developed according to New Product Realization procedures which are compliant with SteelCloud’s ISO 9001:2000 Certified Quality Management System.

BlackBerry® Enterprise Server Solution (SteelWorks® Mobile)

As an extension of our ISV business, we developed an appliance solution specifically for the Blackberry Enterprise Server (“BES”). Developed in conjunction with Research in Motion (“RIM”), we believe the BES appliance solution is the single best way to implement the Blackberry Enterprise Server software environment. SteelWorks Mobile is an integrated server appliance that enables virtually any size organization to implement the BES at a fraction of the cost, time and resource commitment. We have filed for three patents for the appliance related to the technology we created for the installation wizard, backup and restore features. These patents are currently pending approval from the U.S. Patent and Trademark Office.

In addition, we developed SteelWorks FedMobile, our Blackberry Enterprise Server software appliance solution specifically for the Department of Defense (“DoD”) and other related agencies. The SteelWorks FedMobile appliance builds upon our commercial appliance by automating the application of the Defense Information Systems Agency’s (“DISA”) and DoD’s Security Technical Implementation Guide (“STIG”) to the BES installation process. The STIG mandates the policies for which the DoD and related agencies must operate their wireless communications. As a result, our appliance solution allows those agencies to be STIG compliant in a fraction of the time, cost or resources allocated to what is an otherwise time intensive, manual process.

Professional Services

We provide information technology (“IT”) consulting and contract staffing solutions for our clients. Our consultants are subject matter experts in network infrastructure complexities and security technologies including firewalls, content inspection, intrusion detection, spam and vulnerability scanning. For our contract staffing solutions, our personnel function as “virtual” employees, performing work directly under the auspices of client management and serve as an extension to the client’s in-house staff resources

Government Contracts

In fiscal year 2008, we derived approximately 26% of our revenues from sales of hardware and services to U.S. federal, state and local governments. Certain government customers reserve the right to examine our records as they relate to their contracts.

GSA Contract

We have a multiple award schedule contract with the U.S. General Services Administration (the “GSA Contract”). The GSA Contract was originally awarded in April 1996. It was renewed in fiscal years 2002 and 2007, and is valid through March 31, 2012. In August 2006, GSA Contract auditors awarded us an “Outstanding” rating for our management and execution of the GSA Contract. The GSA Contract enables government IT purchasers to acquire all of their needed goods and services from a particular vendor and largely limits the competition to selected vendors holding GSA Contracts. For the fiscal year ended 2008, our GSA Contract had sales of approximately \$1.2 million, which accounted for approximately 6% of our net revenues.

Commercial Contracts

Our commercial customer base consists of several Fortune 500 companies as well as medium-size commercial customers.

Given the nature of the products we manufacture as well as the delivery schedules established by our partners, revenue and accounts receivable concentration by any single customer will fluctuate from quarter to quarter. Future revenues and results of operations could be adversely affected should a customer reduce its purchases, eliminate product lines, or choose not to continue to buy products and services from us. We intend to diversify and increase our commercial customer base in the upcoming fiscal year.

Significant Customer Contract

During fiscal year 2008, we were awarded a contract by a major federal integrator. The contract called for us to supply ruggedized systems. Over the seven month contract engagement, during fiscal year 2008, we produced approximately 2,650 units and recognized approximately \$7.8 million of revenue associated with this contract.

Manufacturing and Production

Our manufacturing and production operations are capable of assembling in excess of 100,000 systems per year in our existing Herndon, Virginia facility, on a three-shift basis. Production is currently operating on a single shift basis.

Our Quality Management System has been ISO 9001:2000 certified since April 2004. Our ISO 9001:2000 certified Quality Management System establishes measurable quality objectives throughout the organization and provides procedures for continuous quality improvement in all aspects of our business. This certification is particularly critical to our success because it promotes continuous improvement in product reliability, on-time deliveries, and communication; all of which directly benefit customers and strengthen relationships. In February 2007, we passed a recertification audit of our entire ISO 9001:2000 Quality Management System to ensure that it conformed to the standard. The recertification further demonstrates our commitment to quality, customer satisfaction and continuous improvement. The current certification is valid through March 2010.

Marketing

We market our products and services to software companies, federal integrators, select commercial accounts, and state, federal, and local government agencies. We use an in-house sales force and program managers to market our products and services. Our products and services are marketed worldwide, either directly through our own sales personnel, or through the marketing organizations of our appliance customers. Strong customer relationships are critical to our success. We believe that a key to building customer loyalty is a team of knowledgeable and responsive account managers with professional technical and support staff. We assign each customer a trained account manager, to which subsequent calls to us are directed. The account manager is augmented with a program manager for our larger customers. We believe that these strong one-on-one relationships improve the likelihood the customer may consider us for future purchases. We intend to continue to provide our customers with products and technical services that offer the customer the best possible return on a customer's investment.

We use electronic commerce technologies in our marketing efforts and expect our customers will continue to utilize these technologies. Prospective customers also use the Internet to advertise new business opportunities. We also use the Internet to research and reference vendor information. We maintain an Internet website containing our GSA catalogue and product offerings located at www.steelcloud.com.

Joint Venture

In October 2008, we created a joint venture in the United Arab Emirates (UAE) region with XSAT, LLC, A UAE organization focused on wireless communications and technology ("XSAT"). SteelCloud MEA, LLC (Middle East, Africa) the newly formed joint venture company, is jointly owned, 20% by XSAT and 80% by SteelCloud. Under the terms of the joint agreement, XSAT will provide a local presence for our products to its customers within the UAE region. XSAT will also provide warranty and support for the products sold within that region.

Competition

The markets for our products and services are highly competitive. Many of our competitors offer broader product lines, have greater economies of scale, and may have more substantial financial, technical, marketing, and other resources. These competitors may benefit from earlier market entry, volume purchasing advantages, and product and process technology license arrangements that are more favorable in terms of pricing and availability than our arrangements.

The IT industry is ever changing. Industry pricing is very aggressive and we expect pricing pressures to continue. The industry is also characterized by rapid changes in technology and customer preferences, short product life cycles, and evolving industry standards.

We compete with a large number of custom computer manufacturers, resellers and IT services companies. We believe it is likely that these competitive conditions will continue in the future. There can be no assurance we will continue to compete successfully against existing or new competitors that may enter markets in which we operate.

Our principal competitors in the specialized server markets are companies specializing in building server products and providing some level of integration services.

Federal Government Market

We sell our specialized servers to the federal government through federal integrators. We also sell our server products, engineering services and software products directly to government end users. Software products come from Microsoft, CA, McAfee, Network General, and others. In addition, we provide consulting services, consulting project work and staffing services.

Sales to the federal government are realized through our own GSA schedule, via the GSA schedules of our strategic partners and through federal government market integrators. The GSA's Federal Supply Services Schedule is a list of pre-approved vendors from which the government and/or federal agencies may purchase goods and services. Our GSA Schedule GS-35F-4085D is an effective procurement vehicle for us.

We believe the government's criteria for selecting vendors consists of price, quality, familiarity with the vendor, and size and financial capability of the vendor. The government has increased the amount of IT products acquired through the GSA Schedule. Our GSA Schedule provides the government with a broad range of IT products and consulting services.

Commercial Market

The commercial market for our IT products and services is highly fragmented, served by thousands of small value-added resellers, specialized manufacturers, software companies and consulting services firms. Many of these companies service a small geographic area and resell national brand computers, network hardware, and/or software.

Our IT solutions are differentiated in the commercial (and federal government) market with technical expertise and professional consulting services. We believe our professional services group competes effectively in the Washington, D.C. metropolitan market because of our technical know-how, market knowledge and name recognition.

In the ISV server appliance market, the principal elements of competition are product reliability, quality, customization, price, customer service, technical support, value-added services, and product availability. We distinguish our ISV server appliance offerings with specialized services such as engineering design, configuration management, logistics, supply chain management and fulfillment services.

Research and Development

By investing in product development, we believe we will have more control over the functionality and marketing of our products. We also believe that the resulting intellectual property will increase the competitiveness of our offerings and improve product margins. During fiscal 2008, we incurred research and development costs of approximately \$702,000. We will continue to incur costs for product development in the future.

We invest in intellectual property in the form of proprietary products such as SteelWorks®. SteelWorks® is an appliance management software that provides self-management and self-maintenance functionality to our appliance server offerings and allows our customers to quickly create a fully integrated turnkey appliance server. We are working to expand SteelWorks® to address the needs of small to midsize businesses that require access to company data and attachments via their BlackBerry handheld device. This product is called SteelWorks® Mobile for the BlackBerry Enterprise Server. This mobile business solution makes a BlackBerry® connection to company data and attachments easy to install and easy to manage. It is hardware and software in a low cost easy to install solution.

Suppliers

We devote significant resources to establishing and maintaining relationships with our key suppliers and when possible, purchase directly from component manufacturers such as Intel and SuperMicro. We also purchase multiple products directly from large national and regional distributors such as Synnex, Ingram Micro, Avnet, and Bell Microproducts.

Certain suppliers provide us with incentives in the form of discounts, rebates, credits, cooperative advertising, and market development funds. We must continue to obtain products at competitive prices from leading suppliers in order to provide competitively priced products for our customers. We believe our relationships with our key suppliers to be good and believe that generally, there are multiple sources of supply available should the need arise. In the event we are unable to purchase components from existing suppliers, we have alternative suppliers we can rely upon.

Patents, Trademarks and Licenses

We work closely with computer product suppliers and other technology developers to stay abreast of the latest developments in computer technology. While we do not believe our continued success depends upon the rights to a patent portfolio, there can be no assurance that we will continue to have access to existing or new technology for use in our products.

On March 20, 2008, we were issued patent 3,396,156 titled "SteelWorks".

On September 15, 2008, we were issued community trademark Registration 006430359 (European); Japan #948064 (International), Canada Application Approval titled "SteelRestore".

On October 21, 2008, we were issued patent 3,521,899 titled "Sure Audit".

We conduct our business under the trademarks and service marks of "SteelCloud," "SteelCloud Company" and "Dunn Computer Corporation." We believe our copyrights, trademarks and service marks have significant value and are an important factor in the marketing of our products.

Employees

As of October 31, 2008 and January 23, 2009, we had 48 and 32 employees, respectively. None of our employees are covered by a collective bargaining agreement and we consider our relationships with our employees to be good.

We believe our future success depends in large part upon our continued ability to attract and retain highly qualified management, technical, and sales personnel. We have an in-house training and mentoring program to develop our own supply of highly qualified technical support specialists. There can be no assurance, however, that we will be able to attract and retain the qualified personnel necessary for our business.

ITEM 1A. RISK FACTORS

Not applicable.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2. PROPERTIES

We lease approximately 24,000 square feet for our operations facility and approximately 19,000 square feet for our headquarters. Both our operations facility and headquarters are located in Herndon, Virginia. Monthly rent for both the operations and headquarters leases, which expire in August 2014 and August 2009, respectively, is approximately \$44,000 inclusive of operating expenses. We currently have plans to consolidate our facilities into one leased location upon expiration of our lease in August 2009 reducing rent expense by approximately \$20,000 a month.

ITEM 3. LEGAL PROCEEDINGS

We have no material legal claims pending against us.

There are routine legal claims pending against us, but in the opinion of management, liabilities, if any, arising from such claims will not have a material adverse effect on our financial condition and results of operation.

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

There were no matters submitted to a vote of our security holders during the fourth quarter of fiscal year 2008.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Prior to the quotation of our common stock beginning on April 22, 1997, there was no established trading market for our common stock. Our common stock is listed on The NASDAQ Stock Market, Inc.'s Capital Market. We changed our symbol from "DNCC" to "SCLD" on October 19, 2000.

The following table sets forth the high and low selling prices as reported on the NASDAQ Capital Market through January 18, 2009, for each fiscal quarter during the fiscal years ended October 31, 2008 and 2007, as well as for the first quarter of fiscal 2009 through January 27, 2009. These quotations reflect inter-dealer prices without retail mark-up, markdown, or commission and may not represent actual transactions.

	Fiscal 2007	
	High	Low
First Quarter	\$ 1.34	\$ 0.61
Second Quarter	\$ 1.47	\$ 0.94
Third Quarter	\$ 1.74	\$ 1.12
Fourth Quarter	\$ 1.68	\$ 1.12
	Fiscal 2008	
	High	Low
First Quarter	\$ 1.25	\$ 0.87
Second Quarter	\$ 1.21	\$ 0.80
Third Quarter	\$ 1.58	\$ 1.06
Fourth Quarter	\$ 1.26	\$ 0.56
	Fiscal 2009	
	High	Low
First Quarter (through January 27, 2009)	\$ 0.75	\$ 0.30

On January 27, 2009, the closing price of our common stock as reported on the NASDAQ Capital Market was \$0.38 per share. There were approximately 5,100 shareholders of the common stock of the Company as of such date.

Dividend Policy

We have not paid cash dividends on our common stock and do not intend to do so in the foreseeable future.

Repurchase of Securities

We did not repurchase any of our common stock during the fiscal year ended October 31, 2008.

Issuance of Unregistered Common Stock

On March 7, 2007, we issued 21,504 shares of our common stock to members of our Board of Directors. The shares were valued at \$0.99. The total expense associated with this stock issuance was approximately \$21,000.

Warrants

On September 14, 2007, we issued 100,000 warrants in exchange for investor relations services valued at approximately \$56,000. The warrants were issued at an exercise price of \$1.28 and expire on September 14, 2012. The fair value of the warrants was estimated in four equal tranches over a four-month vesting period using the Black-Scholes Option pricing fair value model.

On October 24, 2003, we sold 1,887,500 shares of our common stock to private and institutional investors in a private placement transaction at a price of \$4.00 per share. We received gross proceeds of \$7,550,000 in connection with this transaction. Brean Murray & Co., Inc. and Ferris, Baker Watts, Incorporated acted as co-placement agents in connection with this private offering. The co-placement agents received an aggregate of \$437,500 in cash and warrants to purchase 107,422 shares of our common stock as commissions in connection with this offering. Additionally, in connection with this transaction, we issued warrants to purchase 493,359 and 85,938 shares of our common stock at an exercise price of \$5.81 and \$4.00 per share, respectively, which expired on October 24, 2008. The securities were sold pursuant to an exemption from registration provided by section 4(2) of the Securities Act.

NASDAQ

Given the current extraordinary market conditions, NASDAQ has determined to suspend the bid price and market value of publicly held shares requirements through Friday, April 17, 2009. In that regard, on October 16, 2008, NASDAQ filed an immediately effective rule change with the Securities and Exchange Commission, such that companies will not be cited for any new concerns related to bid price or market value of publicly held shares deficiencies. On December 19, 2008, NASDAQ extended the suspension of these requirements. These rules, after the extension, will be reinstated on Monday, April 20, 2009.

NASDAQ believes that this temporary suspension will allow companies to focus on running their businesses, rather than satisfying market-based requirements that are largely beyond their control in the current environment. Moreover, this temporary suspension should help to restore investor confidence in affected NASDAQ companies as the suspension will allow investors to make decisions without considering the likelihood of a very near-term delisting.

ITEM 6. SELECTED FINANCIAL DATA

Not applicable.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Certain statements contained herein may constitute forward-looking statements within the meaning of Section 27A of the Securities Act, Section 21E of the Exchange Act and the Private Securities Litigation Reform Act of 1995. Because such statements include risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to, risks associated with the integration of businesses following an acquisition, concentration of revenue from one source, competitors with broader product lines and greater resources, emergence into new markets, the termination of any of our significant contracts or partnerships, our inability to maintain working capital requirements to fund future operations or our inability to attract and retain highly qualified management, technical and sales personnel.

You should read the following discussion and analysis in conjunction with the audited Financial Statements and Notes attached thereto, and the other financial information appearing elsewhere in this Annual Report.

Overview

Founded in 1987, we are a leading manufacturer of embedded integrated computing systems solutions for the federal marketplace and ISVs. We design, manufacture and integrate specialized servers for federal market prime contractors (“federal integrators”) and Independent Software Vendors (“ISV”)s who use the specialized servers to deliver application software to their clients.

For ISV customers, we design, manufacture and integrate low-maintenance servers (called “appliances” in this market) so ISVs can make their software product easier to deploy and support, more competitive and open new markets by delivering their application software on fully-integrated, ready-to-use appliances.

In addition, we serve information technology end users directly, in both the public and private sectors, with products and services focused on IT centric solutions. Our IT centric solutions include our appliance servers, products from our strategic partners along with our consulting services.

Our ISO 9001:2000 certified Quality Management System establishes measurable quality objectives throughout the organization and provides procedures for continuous quality improvement in all aspects of our business. This certification is particularly critical to our success in the federal government market space as most government end customers require their contractors and sub-contractors to be ISO 9001:2000 certified.

Fiscal Year 2008

Significant Customer Contract

During fiscal year 2008, we were awarded a contract by a major Federal Integrator. The contract called for us to supply ruggedized systems. Over the seven month contract engagement, during fiscal year 2008, we produced approximately 2,650 units and recognized approximately \$7.8 million of revenue associated with this contract.

Launching of SteelWorks Mobile

In 2008, we launched our SteelWorks Mobile and SteelWorks FedMobile appliance solutions. As an extension of our ISV business, we developed an appliance solution specifically for the Blackberry Enterprise Server (“BES”). Developed in conjunction with Research in Motion (“RIM”), we believe the BES appliance solution is the single best way to implement the Blackberry Enterprise Server software environment. SteelWorks Mobile is an integrated server appliance that enables virtually any size organization to implement the BES at a fraction of the cost, time and resource commitment. We have filed for three patents for the appliance related to the technology we created for the installation wizard, backup and restore features. These patents are currently pending approval from the U.S. Patent and Trademark office.

In addition, we developed SteelWorks FedMobile, our Blackberry Enterprise Server software appliance solution specifically for the Department of Defense (“DoD”) and other related agencies. The SteelWorks FedMobile appliance builds upon our commercial appliance by automating the application of DISA’s (Defense Information Systems Agency) and DoD’s Security Technical Implementation Guide (“STIG”) to the BES installation process. The STIG mandates the policies for which the DoD and related agencies must operate their wireless communications. As a result, our appliance solution allows those agencies to be STIG compliant in a fraction of the time, cost or resources allocated to this otherwise time intensive, manual process.

Joint Venture

In October 2008, we created a joint venture in the United Arab Emirates (UAE) region with XSAT. SteelCloud MEA, LLC (Middle East, Africa) the newly formed joint venture company, is jointly owned, 20% by XSAT and 80% by SteelCloud. Under the terms of the joint agreement, XSAT will provide a local presence for our products to its customers within the UAE region. XSAT will also provide warranty and support for the products sold within that region.

Services Business Growth and Focus

In fiscal 2008, we increased our focus on our professional services business. We currently serve customers primarily in the metropolitan Washington DC market but will look to expand that territory in fiscal 2009. We are increasing our expertise within the Microsoft Exchange and SharePoint markets. We believe that the number of professional services opportunities related to these two services will greatly expand in the near future (fiscal 2009 and beyond). As such, we have begun to develop and cultivate this expertise.

In addition, we have won contracts with National Zoo, Blue Cross Blue Shield Association, Graduate Management Admissions Council and WMATA. We anticipate further expansion of the professional services business in fiscal 2009.

Critical Accounting Policies

The preparation of financial statements in conformity with U.S. Generally Accepted Accounting Principles requires management to make certain judgments, estimates and assumptions that could affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. We based our estimates and assumptions on historical experience and on various other assumptions believed to be applicable, and evaluated them on an on-going basis to ensure they remained reasonable under current conditions. Actual results could differ significantly from those estimates.

The significant accounting policies used in the preparation of our financial statements are described in Note 3 "Significant Accounting Policies" to our Financial Statements. Some of these significant accounting policies are considered to be critical accounting policies. A critical accounting policy is defined as one that has both a material impact on our financial condition and results of operations and requires us to make difficult, complex and/or subjective judgments, often as a result of the need to make estimates about matters that are inherently uncertain.

We believe that the following critical accounting policies reflect the more significant judgments and estimates used in the preparation of our consolidated financial statements.

Revenue Recognition

We recognize revenue in accordance with the SEC Staff Accounting Bulletin No. 104, "*Revenue Recognition in Financial Statements, corrected copy*" ("SAB 104"). Generally, SAB 104 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the fee is fixed and determinable; and (4) collectability is reasonably assured.

Effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003, we have adopted Emerging Issues Task Force Issue No. 00-21, "*Revenue Arrangements with Multiple Deliverables*" ("EITF 00-21"). Issued in December 2002 by the Financial Accounting Standards Board ("FASB"), EITF 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. EITF 00-21 addresses when and, if so, how an arrangement involving multiple deliverables should be divided into separate units of accounting. EITF 00-21 does not change otherwise applicable revenue recognition criteria. In the event we enter into a multiple element arrangement and there are undelivered elements as of the balance sheet date, we assess whether the elements are separable and have determinable fair value in determining the amount of revenue to record.

We recognize revenue associated with the resale of maintenance contracts on a net basis in accordance with Emerging Issues Task Force Issue No 99-19, "*Reporting Revenue Gross as a Principal versus Net as an Agent*" ("EITF 99-19"), and interpretations thereof.

We derive our revenue from the following sources: product sales, information technology support services, software license as a reseller and support sales and software training and implementation services.

For product sales where title transfers upon shipment and risk of loss transfers to our customer, we generally recognize revenue at the time of shipment. For product sales where title and risk of loss transfers upon destination, we generally recognize revenue when products reach their destination. Revenue from hardware leased to customers under operating lease arrangements is recognized over the contract term. When product and installation services that are not essential to the functionality of the product are sold as part of a bundled agreement, the fair value of the installation services, based on the price charged for the services when sold separately, is deferred and recognized when the services are performed. The products sold are generally covered by a warranty ranging from one to three years. We accrue an estimated warranty reserve in the period of sale to provide for estimated costs associated with providing warranty services.

In October 2008 we began delivering our appliance solution specifically developed for Blackberry Enterprise Servers ("BES"). This solution is bundled hardware-software system and subject to American Institute of Certified Public Accountants' Statement of Position ("SOP") 97-2, "*Software Revenue Recognition*," as modified by SOP 98-9, "*Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*." Our software does not require significant modification and customization services. We do not have vendor-specific objective evidence ("VSOE") of fair value for our software. Accordingly, when the software is sold in conjunction with the Company's hardware, software revenue is recognized upon delivery of the hardware.

For services revenue under time and material contracts, we recognize revenue as services are provided based on the hours of service at stated contractual rates.

We incur shipping and handling costs, which are recorded in cost of revenues.

Typically our deferred revenue includes amounts received from customers for which revenue has not been recognized. This generally results from certain customer contracts, ISV releases, warranties, hardware maintenance and support, and consulting services. The deferred revenue associated with customer contracts and ISV releases represents payments received for milestones achieved prior to recognition of revenue. This revenue will be recognized as products are shipped. Revenues from warranties and hardware maintenance and support are recognized ratably over the service term selected by the customer. Deferred service revenues from consulting are recognized as the services are performed.

Equity-Based Compensation

We adopted Statement of Financial Accounting Standards No. 123 (Revised 2004), "*Share-Based Payment*" ("SFAS No. 123R") on November 1, 2005. Issued in December 2004 by the FASB, SFAS No. 123R requires that the fair value compensation cost relating to share-based payment transactions be recognized in financial statements. Under the provisions of SFAS No. 123R, share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized over the employee's requisite service period. The fair value of the stock options and employee stock purchase plan ("ESPP") awards was estimated using a Black-Scholes option valuation model. This model requires the input of highly subjective assumptions and elections in adopting and implementing SFAS No. 123R, including expected stock price volatility and the estimated life of each award. The fair value of equity-based awards is amortized over the vesting period of the award and we have elected to use the straight-line method for amortizing our stock option and ESPP awards. We adopted the modified prospective transition method as provided by SFAS No. 123R and compensation costs for all awards granted after the date of adoption and the unvested portion of previously granted awards outstanding are measured at their estimated fair value.

Income Taxes

We recognize deferred tax liabilities and assets for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of certain assets and liabilities. A valuation allowance is established, as necessary, to reduce deferred income tax assets to an amount expected to be realized in future periods. We determine our valuation allowance pursuant to the provisions of FASB Statement of Financial Accounting Standards No. 109, "*Accounting for Income Taxes*," which requires us to weigh all positive and negative evidence including past operating results and forecasts of future taxable income. In assessing the amount of the valuation allowance as of October 31, 2007 and 2008, we considered, in particular, our forecasted taxable income for the upcoming fiscal year, current backlog of orders, including those recently received, and other significant opportunities currently in our sales and marketing pipeline with a high probability of generating revenues. Based upon this review, we have continued to fully reserve for all deferred tax assets as of October 31, 2008.

We adopted the provisions of FASB Interpretation No. 48, "*Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109*" ("FIN 48"), on November 1, 2007. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, "*Accounting for Income Taxes*". It prescribes that a company should use a more-likely-than-not recognition threshold based on the technical merits of the tax position taken. Tax positions that meet the more-likely-than-not recognition threshold should be measured as the largest amount of the tax benefits, determined on a cumulative probability basis, which is more likely than not to be realized upon effective settlement in the financial statements. Our unrecognized tax benefits at October 31, 2008 are approximately \$61,000, which includes approximately \$49,000 of unrecognized tax benefits for windfall tax benefits from stock options exercised that are not recognized under SFAS 123R. During the year ended October 31, 2008, we increased our unrecognized tax benefits by approximately \$100,000 due to windfall benefits from stock options exercised and additional exposures identified during the year. We reduced our unrecognized tax benefits by approximately \$654,000 by adjusting our NOL carryforwards and making an automatic change in accounting method. Both of these adjustments were made with the filing of our income tax return for the tax year ended October 31, 2007. We have a valuation allowance against the full amount of our net deferred tax assets and therefore the adoption of FIN 48 had no impact on our retained earnings. The amount of unrecognized tax benefits that, if recognized, would impact the effective tax rate is \$0.

We conduct business in the U.S. and are subject to U.S. taxes. As a result of our business activities, we file tax returns that are subject to examination by the respective federal and state tax authorities. For income tax returns filed by us, we are no longer subject to U.S. federal, or state tax examination by tax authorities for years before the tax year ended October 31, 2005, although significant net operating loss carryforward tax attributes that were generated prior to the tax year ended October 31, 2005 may still be adjusted upon examination by tax authorities if they either have been or will be utilized. Our accounting policy is to recognize interest and penalties related to income tax matters in general and administrative expense. We have \$0 accrued for interest and penalties as of October 31, 2008.

Inventory

Inventory consists of materials and components used in the assembly of our products or maintained to support maintenance and warranty obligations and are stated at the lower of cost or market using actual costs on a first-in, first-out basis. We maintain a perpetual inventory system and continuously record the quantity on-hand and actual cost for each product, including purchased components, subassemblies and finished goods. We maintain the integrity of perpetual inventory records through periodic physical counts of quantities on hand. Finished goods are reported as inventory until the point of title transfer to the customer. Generally, title transfer is documented in the terms of sale. When the terms of sale do not specify, we assume title transfers when it completes physical transfer of the products to the freight carrier unless other customer practices prevail.

We periodically evaluate our inventory obsolescence to ensure inventory is recorded at its net realizable value. Our policy is to assess the valuation of all inventories, including manufacturing raw materials, work-in-process, finished goods and spare parts in each reporting period. Inherent in managements estimates of excess and obsolete inventory are management's forecasts related to our future manufacturing schedules, customer demand, technological and/or market obsolescence and possible alternative uses. If future customer demand or market conditions are less favorable than our projections, additional inventory write-downs may be required, and would be reflected in cost of sales in the period the revision is made.

Warranty

Typically, the sale of our specialized servers includes providing parts and service warranties to customers as part of the overall price of the systems. We offer warranties for our systems that typically cover a period of one to three years that commences upon shipment of the system to the customer. When appropriate, we record a reserve for estimated warranty expenses to cost of sales for each system upon revenue recognition. The amount recorded is based on an analysis of historical activity. All actual parts and labor costs incurred in subsequent periods are charged to the established reserves.

Actual warranty expenses are incurred on a system-by-system basis, and may differ from our original estimates. While we periodically monitor the performance and cost of warranty activities, if actual costs incurred are different than our estimates, we may recognize adjustments to the reserve in the period in which those differences arise or are identified.

In addition to standard warranties, we offer customer-paid extended warranty services. Revenues for extended maintenance and warranty services with a fixed payment amount are recognized on a straight-line basis over the term of the contract.

Segment Reporting

FASB Statement of Financial Accounting Standards No. 131, "*Disclosures about Segments of an Enterprise and Related Information*" ("SFAS No. 131"), establishes standards for reporting information about operating segments. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by our chief operating decision maker, or decision-making group, in deciding how to allocate resources and in assessing performance. SFAS No. 131 also establishes a quantitative threshold, whereby an enterprise should report separately information about an operating segment if its reported revenue is 10 percent or more of the combined revenue of all reported operating segments. We are organized on the basis of products and services. Our chief operating decision maker is our Chief Executive Officer. While the Chief Executive Officer is apprised of a variety of financial metrics and information, the Chief Executive Officer makes decisions regarding how to allocate resources and assess performance based on a single operating unit.

Recently Issued Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, “*Fair Value Measurements*” (“SFAS No. 157”). SFAS No. 157 provides a common definition of fair value and establishes a framework to make the measurement of fair value in U.S. Generally Accepted Accounting Principles more consistent and comparable. SFAS No. 157 also requires expanded disclosures to provide information about the extent to which fair value is used to measure assets and liabilities, the methods and assumptions used to measure fair value, and the effect of fair value measures on earnings. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. Therefore, we are required to adopt SFAS No. 157 in the first quarter of 2009. We do not believe the provisions of SFAS 157 will have a material impact on our financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, “*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*” (“SFAS No. 159”). SFAS No. 159 provides a choice to measure many financial instruments and certain other items at fair value and requires disclosures about the election of the fair value option. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Therefore, we are required to adopt SFAS No. 159 in the first quarter of 2009. We do not believe the provisions of SFAS 159 will have a material impact on our financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (Revised 2007) “*Business Combinations*” (“SFAS No. 141R”). SFAS No. 141R, which replaces SFAS No. 141, requires that the acquisition method of accounting (which SFAS No. 141 called the “purchase method”) be used for all business combinations and for an acquirer to be identified for each business combination. SFAS No. 141R also establishes principles and requirements for how the acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141R also requires that acquisition-related costs be recognized separately from the business combination. SFAS No. 141R will apply prospectively to business combinations for which the acquisition date is after fiscal years beginning on or after December 15, 2008. We have not yet determined the impact that the implementation of SFAS No. 141R will have on our financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, “*Noncontrolling Interests in Consolidated Financial Statements — an amendment of ARB No. 51*” (“SFAS No. 160”). SFAS No. 160 requires all entities to report noncontrolling (minority) interests in subsidiaries as equity in the consolidated financial statements. Its intention is to eliminate the diversity in practice regarding the accounting for transactions between an entity and noncontrolling interests. This statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. We are in the process of evaluating the effect, if any; the adoption of SFAS No. 160 will have on our financial statements.

In February 2008, the FASB issued Staff Position No. 157-2, “*Effective Date of FASB Statement No. 157*” (“FSP 157-2”). FSP 157-2 deferred the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008. We are in the process of evaluating the effect, if any; the adoption of FSP 157-2 will have on our financial statements.

In October 2008, the FASB issued Staff Position No. 157-3, “*Determining the Fair Value of a Financial Asset When the Market for that Asset is not Active*” (“FSP 157-3”). FSP 157-3 provides guidance for determining the fair value of a financial asset in an inactive market. We are in the process of evaluating the effect, if any; the adoption of FSP 157-3 will have on our financial statements.

In May 2008, the FASB issued Staff Position No. APB 14-1, “*Accounting for Convertible Debt Instruments that May be Settled in Cash Upon Conversion*” (“APB 14-1”). APB 14-1 requires that the liability and equity components of convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) be separately accounted for in a manner that reflects an issuer’s nonconvertible debt borrowing rate. The resulting debt discount is amortized over the period the convertible debt is expected to be outstanding as additional non-cash interest expense. APB 14-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Retrospective application to all periods presented is required except for instruments that were not outstanding during any of the periods that will be presented in the annual financial statements for the period of adoption but were outstanding during an earlier period. We are in the process of evaluating the effect, if any; the adoption of APB 14-1 will have on our financial statements.

Fiscal Year Ended October 31, 2008 Compared to Fiscal Year Ended October 31, 2007

Net Revenue Discussion:

The following table summarizes our net revenue for the fiscal years ended October 31, 2007 and 2008 in dollars and as a percentage of net revenues.

	Fiscal Year Ended October 31,					
	2007		2008		Increase (decrease)	
	Dollars	% of Net Revenues	Dollars	% of Net Revenues	Dollars	Percentage
Products	\$ 21,421,129	91.87%	\$ 16,333,600	85.88%	\$ (5,087,529)	(23.75)%
Services	1,894,551	8.13%	2,685,296	14.12%	790,745	41.74%
Total net revenues	\$ 23,315,680	100.00%	\$ 19,018,896	100.00%	\$ (4,296,784)	(18.43)%

The decrease in product revenue is primarily attributable to a decrease in our integrator business as a result of certain program delays and a reduction in purchases from our ISV customers. The current economic downturn has prolonged the award of the integrator programs, as well as affected the amount purchased by our ISV customers. We plan for revenue to grow as we continue to focus our resources on our chosen markets and our end user solution line of products.

The increase in service revenue is the result of to new client acquisitions as a result of the Company expanding its service offerings. We expect service revenue to continue to grow in the future.

Gross Profit Discussion:

The following table summarizes our gross profit for the fiscal years ended October 31, 2007 and 2008 in dollars, as a percentage of gross profit and as a percentage of net revenues.

	Fiscal Year Ended October 31,					
	2007		2008		Increase (decrease)	
	Dollars	% of Gross Profit	Dollars	% of Gross Profit	Dollars	Percentage
Products	\$ 4,356,274	88.09%	\$ 2,569,499	83.02%	\$ (1,786,775)	(41.02)%
<i>Products – GP%</i>	<i>20.34 %</i>		<i>15.73 %</i>			
Services	588,947	11.91%	525,543	16.98%	(63,404)	(10.77)%
<i>Services – GP%</i>	<i>31.09 %</i>		<i>19.57 %</i>			
Total gross profit	\$ 4,945,221	100.00%	\$ 3,095,042	100.00%	\$ (1,850,179)	(37.41)%
<i>Total – GP%</i>	<i>21.21 %</i>		<i>16.27 %</i>			

The decrease in product gross margin percentage is largely attributable to maintaining our production facility at normal capacity in anticipation of receiving the delayed integrator contracts. We expect gross profit as a percentage of net revenues to continue to fluctuate from quarter to quarter as product lines expand, new products are brought to market, start up costs are incurred and new discounts, incentives and rebates become available.

The decrease in services gross profit percentage is attributable to our incurring costs associated with obtaining new clients. We have been successful in expanding our customer base during fiscal year 2008 as compared to fiscal year 2007, which contributed to an increase in services revenue. We will continue to incur lower initial margins as we expand into new markets and increase our service offerings. We anticipate gross profit for services to fluctuate in future quarters as we continue to realign and grow the services division.

Operating Expense Discussion:

The following table summarizes our operating expenses for the fiscal years ended October 31, 2007 and 2008 in dollars and as a percentage of net revenues.

	Fiscal Year Ended October 31,					
	2007		2008		Increase (decrease)	
	Dollars	% of Net Revenues	Dollars	% of Net Revenues	Dollars	Percentage
Selling and marketing	\$ 1,614,817	6.93%	\$ 1,259,416	6.62%	\$ (355,401)	(22.01)%
General and administrative	4,315,254	18.51%	3,901,499	20.51%	(413,755)	(9.59)%
Research and product development	661,550	2.84%	702,231	3.69%	40,681	6.15%
Severance and restructuring costs	317,548	1.36%	-	-	(317,548)	(100.00)%
Total operating expenses	\$ 6,909,169	29.63%	\$ 5,863,146	30.83%	\$ (1,046,023)	(15.14)%

The decrease in selling and marketing expenses is the result of aligning expenses to our current and future business models during fiscal year 2008. During fiscal year 2008, marketing activities, specifically in the area of marketing campaigns and tradeshow, and expense associated with selling and marketing personnel decreased as a result of our cost cutting efforts. Selling and marketing expenses have been kept in line with projected revenue. We will continue to evaluate our costs relative to our revenues and gross margins.

General and administrative expenses decreased as a result of cost cutting efforts incurred during fiscal year 2008 as compared to fiscal year 2007. The cost reductions continue to include curtailing expenses related to non-revenue generating activities, terminating non-essential employees, and instituting across the board departmental expense reductions. Our cost reductions were offset by approximately \$202,000 of fees incurred related to us implementing FIN 48 for the fiscal year 2008. Although we continue to manage our costs relative to our revenues and gross margins, additional resources may be required in order to invest in our federal integrator, ISV, and SteelWorks® Mobile business.

Research and development expenses have remained consistent as the Company continues to make investments in its SteelWorks® mobile products as well as bringing new products to market. We continue to make investments in research and product development to maintain and enhance current products. We believe that research and product development expenses will fluctuate from quarter to quarter as new products are being developed and introduced into the marketplace.

The decrease in severance and restructuring charges for the twelve months ended October 31, 2008 compared to the twelve months ended October 31, 2007 is the result of incurring approximately \$318,000 of non recurring costs associated with the employment resignation agreement entered into with our previous CEO during fiscal year 2007.

Other Income (Expense) Discussion:

The following table summarizes our other income (expense) for the fiscal years ended October 31, 2007 and 2008 in dollars and as a percentage of net revenues.

	Fiscal Year Ended October 31,					
	2007		2008		Increase (decrease)	
	Dollars	% of Net Revenues	Dollars	% of Net Revenues	Dollars	Percentage
Interest income net	\$ 19,353	0.08%	\$ 8,542	0.04%	\$ (10,811)	(55.86)%
Total interest income, net	\$ 19,353	0.08%	\$ 8,542	0.04%	\$ (10,811)	(55.86)%

The decrease in net interest expense for fiscal year 2008 is due to lower interest income attributable to lower cash balances and interest rates earned over the twelve months ended October 31, 2008 compared to the same period in fiscal year 2007.

Net (Loss) Discussion:

The following table summarizes our net (loss) for the fiscal years ended October 31, 2007 and 2008 in dollars and as a percentage of net revenues.

	Fiscal Year Ended October 31,					
	2007		2008		Increase (decrease)	
	Dollars	% of Net Revenues	Dollars	% of Net Revenues	Dollars	Percentage
Net (loss)	\$ (1,944,595)	8.34%	\$ (2,759,562)	14.51%	\$ 814,967	41.91%

The increase in net loss for the twelve months ended October 31, 2008 as compared to the same period in fiscal 2007 is the result of lower revenues and corresponding gross margin dollars. We have instituted a conservative revenue and cost of goods sold plan to minimize our net loss in fiscal year 2009. This plan also includes company-wide personnel terminations and the elimination of all non-essential costs to reduce our operating expenses for the upcoming year.

Liquidity and Capital Resources

We have experienced recurring losses from operations and negative cash flows. For the fiscal year ended October 31, 2008, we incurred a net loss of \$2,759,562 and an accumulated deficit of \$44,868,564 as of that date. The report from our independent registered public accounting firm on our audited financial statements at October 31, 2008 contains an explanatory paragraph regarding doubt as to our ability to continue as a going concern as a result of our net loss from operations. Despite our history of revenues, there is no assurance that we will be able to maintain or increase our revenues in fiscal 2009 or that we will be successful in reaching profitability or generate positive cash flows from our operations. We are considering all strategic options to improve our liquidity and provide us with working capital to fund our continuing business operations including equity offerings, asset sales and debt financing as alternatives to improve our cash needs however, there can be no assurance that we will be successful in negotiating financing terms. If adequate funds are not available or are not available on acceptable terms, we will likely not be able to take advantage of unanticipated opportunities, develop or enhance services or products, respond to competitive pressures, or continue as a going concern.

Our consolidated financial statements for the fiscal year ended October 31, 2008 do not give effect to any adjustments to recorded amounts and their classifications, which would be necessary should we be unable to continue as a going concern and therefore, be required to realize our assets and discharge our liabilities in other than the normal course of business and at amounts different from those reflected in the consolidated financial statements.

As of October 31, 2008, we had cash and cash equivalents of approximately \$750,000 and working capital of approximately \$1.7 million. We do not have any working capital commitments nor do we not presently have any external sources of working capital. Historically, our revenues have not been sufficient to fund our operations and we have relied on capital provided through the sale of equity securities. Our working capital needs in future periods depend primarily on the rate at which we can increase our revenues while controlling our expenses and decreasing the use of cash from operations. Additional capital may be needed to fund acquisitions of additional companies or assets, although we are not a party to any pending agreements at this time and, accordingly, cannot estimate the amount of capital which may be necessary, if any, for acquisitions. We believe cash on hand together with cash generated from operations will provide sufficient financial resources to finance our current operations through the end of fiscal 2009 although we can provide no assurance we will be able to do so.

In fiscal 2008, we used approximately \$1.7 million in cash flow from operating activities. Our primary use of cash was to finance operating losses and reduce our accounts payable balance by approximately \$1.1 million. The collection of accounts receivable generated \$1.1 million of cash.

In fiscal year 2008, we invested approximately \$425,000 in property and equipment. We have monetized certain of these leased assets to customers in fiscal year 2009.

Our financing activities consisted of the exercise of options associated with our stock option and warrant exercises which generated approximately \$245,000 in cash. In addition, we reduced our notes payable balance by approximately \$13,000.

On March 6, 2008, we renewed our bank line of credit that allows us to borrow an amount to the lesser of our collateralized cash on hand or \$3.5 million. The line of credit bears interest at the LIBOR Market Index rate plus 1.25%. The line of credit is secured by all of our assets and expires on March 31, 2009. There can be no assurance that we will be able to renew this line of credit. There were no outstanding borrowings on the line of credit at October 31, 2007 and October 31, 2008.

We have short-term (less than one year) obligations under our operating lease and employment agreement commitments of approximately \$1,786,000 and \$1,144,000 respectively, for fiscal year 2008.

From time to time, we may pursue strategic acquisitions or mergers, which may require significant additional capital. In such event, we may seek additional financing of debt and/or equity. However, there can be no assurance that we will be successful in negotiating financing on terms agreeable to us or at all.

Off-Balance Sheet Arrangements

Contractual Obligations and Commercial Commitments

We have significant contractual obligations for fiscal year 2008 and beyond for our operating leases. Our total obligation for our headquarters and operations facilities, expiring in August 2009 and August 2014 respectively, is approximately \$44,000 a month. We currently have plans to consolidate our facilities into one leased location upon expiration of our lease in August 2009 reducing rent expense by approximately \$20,000 a month. We do not have any purchase obligations, capital lease obligations or any material commitments for capital expenditures. We have not engaged in off-balance sheet financing, commodity contract trading or significant related party transactions.

Impact of Inflation

We do not believe that inflation has had a material effect on our financial position or results of operations during the past three years. However, we cannot predict the future effects of inflation.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Financial Statements of SteelCloud, Inc.

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES

There were no changes in and disagreements with accountants on accounting and financial issues during the fiscal year ended October 31, 2008.

ITEM 9A(T). CONTROLS AND PROCEDURES

We conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(f) under the Securities Exchange Act of 1934, as amended) (the “Disclosure Controls”) as of the end of the period covered by this Annual Report. The Disclosure Controls evaluation was done under the supervision and with the participation of management, including our Principal Executive Officer (“PEO”) and Principal Accounting Officer (the “PAO” and together with the PEO, the “Certifying Officers”).

Attached as exhibits to this Annual Report are certifications of the Certifying Officers, which are required in accordance with Rule 13a-14 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). This “Controls and Procedures” section includes the information concerning the controls evaluation referred to in the certifications and it should be read in conjunction with the certifications for a more complete understanding of the topics presented.

Disclosure Controls and Procedures

We maintain Disclosure Controls and procedures that are designed to ensure that the information required to be disclosed in our Exchange Act reports is recorded, processed, summarized, authorized and reported on a timely basis, and that such information is accumulated and communicated to our management, including our Certifying Officers, as appropriate, to allow timely decisions regarding required disclosure.

Under the supervision and with the participation of our management, including our Certifying Officers, we evaluated the effectiveness of the design and operation of our Disclosure Controls as of October 31, 2008. Based upon that evaluation, our Certifying Officers concluded that, as of the date of such evaluation, our Disclosure Controls were effective in timely alerting them to information relating to us that is required to be included in our reports filed under the Exchange Act.

Limitations on the Effectiveness of Controls

We maintain a system of internal control over financial reporting to provide reasonable assurance that assets are safeguarded and that transactions are executed in accordance with management’s authorization and recorded properly to permit the preparation of financial statements in accordance with U.S. generally accepted accounting principles. However, our management, including the Certifying Officers, does not expect that our Disclosure Controls or internal control over financial reporting will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our business have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Management’s Annual Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) or 15d-15(f) promulgated under the Exchange Act as a process designed by, or under the supervision of, our principal executive and principal financial officers and effected by our board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Management assessed the effectiveness of our internal control over financial reporting as of October 31, 2008. In making the assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) in “*Internal Control—Integrated Framework*.” Based on this assessment, management believes that, as of October 31, 2008, our internal control over financial reporting was effective based on those criteria.

Management’s assessment of the effectiveness of our internal control over financial reporting as of October 31, 2008 has not been audited by an independent registered certified public accounting firm.

This Annual Report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management’s report was not subject to attestation by our registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Company to provide only management’s report in this Annual Report.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting during our fiscal quarter ended October 31, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

Not applicable.

PART III

The Notice and Proxy Statement for the 2008 Annual Meeting of Stockholders to be filed pursuant to Regulation 14A under the Exchange Act, which is incorporated by reference in this Annual Report on Form 10-K pursuant to General Instruction G (3) of Form 10-K, will provide the information required under Part III, including Item 10 (Directors, Executive Officers and Corporate Governance), Item 11 (Executive Compensation), Item 12 (Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters), Item 13 (Certain Relationships and Related Transactions and Director Independence) and Item 14 (Principle Accounting Fees and Services), which will be filed within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENTS SCHEDULES

(a) 1. Index to Financial Statements

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(a) 2. Index to Financial Statement Schedules

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Schedules, other than those listed above, have been omitted since they are not applicable or the information is included elsewhere herein.

(a) 3. The exhibits which are filed with this report or which are incorporated by reference are set forth in the exhibit index hereto.

Exhibit Number	Description
3.1	Articles of Incorporation of the Company, dated February 25, 1998, and effective as of February 26, 1998. (Filed as Exhibit 3.1 to the Company's Registration Statement on Form S-1, Amendment No. 1, dated April 23, 1998 (File No. 333-47631) and hereby incorporated by reference).
3.2	By-laws of the Company, effective as of March 5, 1998. (Filed as Exhibit 3.2 to the Company's Registration Statement on Form S-1, Amendment No. 2, dated April 23, 1998 (File No. 333-47631) and hereby incorporated by reference).
4.1	Specimen common stock certificate for the Company. (Filed as Exhibit 4.1 to the Company's S-8 dated July 15, 2002 (File No. 333-47631) and hereby incorporated by reference).
10.1	Employment Agreement by and between Dunn and Thomas P. Dunne (Filed as Exhibit 99.2 to Dunn's Registration Statement on Form SB-2, Amendment 2, dated April 4, 1997 (File No. 000-24015) and hereby incorporated by reference).
10.2	1997 Amended Stock Option Plan. (Filed as Exhibit 10.1 to the Company's Registration Statement on Form S-1, Amendment No. 2, dated April 23, 1998 (File No. 333-92406) and hereby incorporated by reference).
10.3	Agreement, dated May 5, 1997, by and between International Data Products, Corp. and the U.S. Air Force, the Desktop V Contract. (Filed as Exhibit 10.13 to the Company's Registration Statement on Form S-1, Amendment No. 2, dated April 23, 1998 (File No. 333-47631) and hereby incorporated by reference).
10.4	Employee Stock Purchase Plan. (Filed as Exhibit 10.22 to the Company's 10-K, dated February 16, 1999 (File No. 000-24015) and hereby incorporated by reference).
10.5	Employment Agreement by and between SteelCloud, Inc. and Kevin Murphy, dated June 8, 2004. (Filed as Exhibit 10.32 to the Company's 10-K, dated January 26, 2005 (File No. 000-24015) and hereby incorporated by reference).

- 10.6 Employment Agreement by and between SteelCloud, Inc. and Brian Hajost, dated June 8, 2004. (Filed as Exhibit 10.33 to the Company's 10-K, dated January 26, 2005 (File No. 000-24015) and hereby incorporated by reference).
- 10.7 Sublease by and between SteelCloud and NEC America Inc., dated September 28, 2004. (Filed as Exhibit 10.35 to the Company's 10-K, dated January 26, 2005 and hereby incorporated by reference).
- 10.8 Revised Rent Commencement Date Agreement, dated March 16, 2005 between OTR and the Company (Filed as Exhibit 10.36 to the Company's 10-K, dated January 30, 2006 (File No. 000-24015) and hereby incorporated by reference).
- 10.9 Standard Industrial Gross Lease, dated November 4, 2004 between OTR and the Company and Lease Amendment #1, dated March 28, 2005 (Filed as Exhibit 10.37 to the Company's 10-K, dated January 30, 2006 (File No. 000-24015) and hereby incorporated by reference).
- 10.10 Loan Agreement, dated January 22, 2004, by and between Steelcloud, Inc. and Wachovia Bank, National Association and Promissory Note issued by SteelCloud, Inc. on March 21, 2005 to Wachovia Bank, National Association (Filed as Exhibit 10.36 to the Company's 10-K, dated January 30, 2006 (File No. 000-24015) and hereby incorporated by reference).
- 10.11 Employment Agreement by and between SteelCloud, Inc. and Clifton W. Sink (Filed as Exhibit 10.1 to the Company's 8-K, dated June 8, 2006 (File No. 000-24015) and hereby incorporated by reference).
- 10.12 Separation Agreement by and between SteelCloud, Inc. and Thomas P. Dunne (Filed as Exhibit 10.1 to the Company's 8-K, dated June 19, 2006 (File No. 000-24015) and hereby incorporated by reference).
- 10.13 Employment Agreement by and between SteelCloud, Inc. and Robert Richmond (Filed as Exhibit 10.1 to the Company's 8-K, dated September 21, 2006 (File No. 000-24015) and hereby incorporated by reference).
- 10.14 Amendment, dated April 19, 2006, to Employment Agreement by and between SteelCloud, Inc. and Brian Hajost, dated June 8, 2004, originally filed as Exhibit 10.33 to the Company's 10-K, dated January 26, 2005 (Filed as Exhibit 10.42 to the Company's 10-K, dated January 23, 2007 (File No. 000-24015) and hereby incorporated by reference).
- 10.15 Employment Agreement as Executive Director by and between SteelCloud, Inc. and Robert E. Frick (Filed as Exhibit 10.1 to the Company's 8-K, dated August 31, 2007 (File No. 000-24015) and hereby incorporated by reference).
- 10.16 Employment Agreement as President and Chief Executive Officer by and between SteelCloud, Inc. and Robert E. Frick (Filed as Exhibit 10.2 to the Company's 8-K, dated August 31, 2007 (File No. 000-24015) and hereby incorporated by reference).
- 10.17 Employment Resignation Agreement and Release by and between SteelCloud, Inc. and Clifton W. Sink (Filed as Exhibit 10.2 to the Company's 8-K, dated August 31, 2007 (File No. 000-24015) and hereby incorporated by reference).
- 10.18 Amendment, dated October 31, 2007, to Employment Agreement by and between SteelCloud, Inc. and Kevin Murphy, dated June 8, 2004, originally filed as Exhibit 10.32 to the Company's 10-K, dated January 26, 2005. (Filed as Exhibit 10.1 to the Company's 8-K, dated November 1, 2007 (File No. 000-24015) and hereby incorporated by reference).
- 10.19 Amended 2002 Employee Stock Option Plan (Filed as Exhibit 4.1 to the Company's S-8, dated June 25, 2007 (File No. 000-24015) and hereby incorporated by reference).
- 10.20 Amended Employee Stock Purchase Plan (Filed as Exhibit 4.3 to the Company's S-8, dated June 25, 2007 (File No. 000-24015) and hereby incorporated by reference).
- *10.21 Form of Restricted Stock Agreement.
- *10.22 Amended 2007 Stock Option and Restricted Stock Plan.
- *10.23 SteelCloud MEA Joint Venture Agreement dated October 2008.
- *21.1 List of Subsidiaries.
- *23.1 Consent of Grant Thornton LLP, Independent Registered Public Accounting Firm.
- *31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- *31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- *32.1 Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes – Oxley Act of 2002.
- *32.2 Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes – Oxley Act of 2002.

* Filed herewith

**SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS
STEELCLOUD, INC.**

Classification	Balance at Beginning of Year	Additions		Deductions	Balance at End of Year
		Charged to Costs and Expenses	Charged to Other Accounts		
Allowance for doubtful accounts:					
Year ended October 31, 2007	\$ 73,000	\$ 4,000	\$ -	\$ 37,000(1)	\$ 40,000
Year ended October 31, 2008	\$ 40,000	\$ 9,500	\$ -	\$ 13,500(1)	\$ 36,000
Warranty reserve:					
Year ended October 31, 2007	\$ 144,000	\$ 292,000	\$ -	\$ 254,000(2)	\$ 182,000
Year ended October 31, 2008	\$ 182,000	\$ 126,000	\$ -	\$ 148,000(2)	\$ 160,000
Deferred tax valuation allowance:					
Year ended October 31, 2007	\$ 17,571,424	\$ 616,096	\$ -	\$ 885,957(3) 687,854(4)	\$ 16,613,709
Year ended October 31, 2008	\$ 16,613,709	\$ 911,323	\$ -	\$ -	\$ 17,525,032

- (1) Write-offs of specific customer accounts.
- (2) Adjustment of reserve for actual expenses incurred.
- (3) Adjustment of valuation allowance associated with a change in state tax rates.
- (4) True-up of net operating loss.

SIGNATURES

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

Date: January 29, 2009

SteelCloud, Inc.
By:

/s/ Brian H. Hajost
Brian H. Hajost
Chief Executive Officer

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

<u>Name</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Brian H. Hajost</u> Brian H. Hajost	Chief Executive Officer and President	January 29, 2009
<u>/s/ Kevin Murphy</u> Kevin Murphy	Chief Financial Officer	January 29, 2009
<u>/s/ VADM E.A. Burkhalter</u> VADM E. A. Burkhalter USN (Ret.)	Director	January 29, 2009
<u>/s/ James Bruno</u> James Bruno	Director	January 29, 2009
<u>/s/ Jay Kaplowitz</u> Jay Kaplowitz	Director	January 29, 2009
<u>/s/ Benjamin Krieger</u> Benjamin Krieger	Director	January 29, 2009
<u>/s/ Ashok Kaveeshwar</u> Ashok Kaveeshwar	Director	January 29, 2009

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SteelCloud, Inc. (a Virginia Corporation)

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders
SteelCloud, Inc.

We have audited the accompanying consolidated balance sheets of SteelCloud, Inc. (a Virginia Corporation) and subsidiaries (the Company) as of October 31, 2008 and 2007, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the two years in the period ended October 31, 2008. Our audits of the basic financial statements included the financial statement schedule listed in the index appearing under Item 15 (a) 2. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of October 31, 2008 and 2007, and the results of its operations and its cash flows for each of the two years in the period ended October 31, 2008 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1, the Company incurred a net loss of \$2,759,562 during the year ended October 31, 2008, and, as of that date, the Company had an accumulated deficit of \$44,868,564 and working capital of \$1,680,645. These factors, among others, as discussed in Note 1 to the consolidated financial statements, raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Grant Thornton LLP

McLean, Virginia
January 29, 2009

STEELCLOUD, INC.
CONSOLIDATED BALANCE SHEETS

	OCTOBER 31,	
	2007	2008
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 2,622,654	\$ 752,351
Accounts receivable, net of allowance for doubtful accounts of \$40,000 and \$36,000 as of October 31, 2007 and 2008, respectively	2,625,372	1,571,673
Inventory, net	1,178,395	521,920
Prepaid expenses and other current assets	255,924	130,446
Deferred contract costs	83,753	-
Total current assets	6,766,098	2,976,390
Property and equipment, net	802,288	626,440
Equipment on lease, net	323,904	442,099
Other assets	44,053	7,020
Total assets	\$ 7,936,343	\$ 4,051,949
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 1,789,329	\$ 718,316
Accrued expenses	1,158,641	561,009
Notes payable, current portion	12,842	7,538
Unearned revenue	98,255	8,882
Total current liabilities	3,059,067	1,295,745
Notes payable, long-term portion	15,442	7,903
Other	154,520	132,055
Total long-term liabilities	169,962	139,958
Stockholders' equity:		
Preferred stock, \$.001 par value; 2,000,000 shares authorized, 0 and 0 shares issued and outstanding at October 31, 2007 and 2008, respectively	-	-
Common stock, \$.001 par value; 50,000,000 shares authorized 14,716,934 and 15,138,376 shares issued at October 31, 2007 and 2008, respectively	14,717	15,138
Additional paid-in capital	50,234,099	50,902,172
Treasury stock, 400,000 shares at October 31, 2007 and 2008, respectively	(3,432,500)	(3,432,500)
Accumulated deficit	(42,109,002)	(44,868,564)
Total stockholders' equity	4,707,314	2,616,246
Total liabilities and stockholders' equity	\$ 7,936,343	\$ 4,051,949

See accompanying notes.

STEELCLOUD, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS

	YEARS ENDED OCTOBER 31,	
	2007	2008
Products	\$ 21,421,129	\$ 16,333,600
Services	1,894,551	2,685,296
Net revenues	<u>23,315,680</u>	<u>19,018,896</u>
Products	17,064,855	13,764,101
Services	1,305,604	2,159,753
Costs of revenues	<u>18,370,459</u>	<u>15,923,854</u>
Gross profit	<u>4,945,221</u>	<u>3,095,042</u>
Selling and marketing	1,614,817	1,259,416
General and administrative	4,315,254	3,901,499
Research and product development	661,550	702,231
Severance and restructuring	<u>317,548</u>	<u>-</u>
Loss from operations	(1,963,948)	(2,768,104)
Other income (expense):		
Interest income	46,458	26,912
Interest expense	<u>(27,105)</u>	<u>(18,370)</u>
Net loss attributable to common stockholders	<u>\$ (1,944,595)</u>	<u>\$ (2,759,562)</u>
Loss per share, basic and diluted:		
Net loss per share	<u>\$ (0.14)</u>	<u>\$ (0.19)</u>

See accompanying notes.

STEELCLOUD, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	<u>Preferred Stock</u>		<u>Common Stock</u>		<u>Additional</u>	<u>Treasury</u>	<u>Accumulated</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>	<u>Paid-In</u> <u>Capital</u>	<u>Stock</u>	<u>Deficit</u>	
Balance at October 31, 2006	–	–	14,662,176	\$ 14,662	\$49,834,658	\$ (3,432,500)	\$ (40,164,407)	\$ 6,252,413
Issuance of common stock in connection with employee stock purchase plan exercises	–	–	33,254	33	16,037	–	–	16,070
Stock compensation expense	–	–	–	–	322,136	–	–	322,136
Issuance of warrants in conjunction with the retainage of a financial services firm	–	–	–	–	40,000	–	–	40,000
Issuance of common stock to the Company's board of directors	–	–	21,504	22	21,268	–	–	21,290
Net (loss)	–	–	–	–	–	–	(1,944,595)	(1,944,595)
Balance at October 31, 2007	–	–	14,716,934	14,717	\$50,234,099	\$ (3,432,500)	\$ (42,109,002)	\$ 4,707,314
Issuance of common stock in connection with employee stock purchase plan exercises	–	–	5,152	5	4,408	–	–	4,413
Issuance of common stock in connection with employee stock option plan exercises	–	–	196,290	196	121,503	–	–	121,699
Stock compensation expense	–	–	–	–	368,032	–	–	368,032
Issuance of common stock in connection with exercise of warrants	–	–	220,000	220	118,580	–	–	118,800
Issuance of warrants in conjunction with the retainage of an investor relations firm	–	–	–	–	55,550	–	–	55,550
Net (loss)	–	–	–	–	–	–	(2,759,562)	(2,759,562)
Balance at October 31, 2008	–	–	15,138,376	15,138	\$50,902,172	\$ (3,432,500)	\$ (44,868,564)	\$ 2,616,246

See accompanying notes.

STEELCLOUD, INC
CONSOLIDATED STATEMENTS OF CASH FLOWS

	YEARS ENDED OCTOBER 31,	
	2007	2008
Operating activities		
Net loss	\$ (1,944,595)	\$ (2,759,562)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Stock based compensation	343,426	368,032
Depreciation and amortization of property and equipment	578,920	482,294
Warrant based expense	40,000	55,550
Changes in operating assets and liabilities:		
Accounts receivable, net	1,116,751	1,053,699
Inventory	6,674	656,475
Prepaid expenses and other assets	61,862	162,511
Deferred contract costs	133,741	83,753
Accounts payable	(850,017)	(1,071,013)
Accrued expenses	(224,490)	(613,001)
Unearned revenue	(72,021)	(96,469)
Net cash used in operating activities	<u>(809,749)</u>	<u>(1,677,731)</u>
Investing activities		
Purchase of property and equipment	(223,494)	(424,641)
Net cash used in investing activities	<u>(223,494)</u>	<u>(424,641)</u>
Financing activities		
Proceeds from exercise of common stock options	16,070	244,912
Payments on notes payable	(15,336)	(12,843)
Net cash provided by financing activities	<u>734</u>	<u>232,069</u>
Net decrease in cash and cash equivalents	(1,032,509)	(1,870,303)
Cash and cash equivalents at beginning of year	<u>3,655,163</u>	<u>2,622,654</u>
Cash and cash equivalents at end of year	<u>\$ 2,622,654</u>	<u>\$ 752,351</u>
Supplemental cash flow information		
Interest paid	\$ 27,105	\$ 18,370
Income taxes paid	-	-

See accompanying notes

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
OCTOBER 31, 2007 AND 2008

1. Organization

Founded in 1987, SteelCloud, Inc. (the "Company" or "SteelCloud") is a leading manufacturer of embedded integrated computing systems solutions for the federal marketplace and Independent Software Vendors ("ISV(s)"). The Company designs, manufactures and integrates specialized servers for federal market prime contractors ("federal integrators") and Independent Software Vendors (ISVs) who use the specialized servers to deliver software application to their clients.

SteelCloud was originally incorporated as Dunn Computer Operating Company on July 27, 1987 under the laws of the Commonwealth of Virginia. On February 26, 1998, Dunn Computer Corporation ("Dunn") was formed and incorporated in the Commonwealth of Virginia to become a holding company for several entities including Dunn Computer Operating Company. The Company's subsidiary is International Data Products ("IDP"), acquired in May 1998. On May 15, 2001, the shareholders approved an amendment to the Company's articles of incorporation to change the corporate name from Dunn Computer Corporation to SteelCloud, Inc. On December 31, 2003, Dunn was merged with and into SteelCloud. On February 17, 2004, the Company acquired the assets of Asgard Holding, LLC ("Asgard"). In July of 2006, as part of its restructuring efforts, the Company closed its sales office and ceased all of its operations in Florida. The Company's former subsidiaries, Puerto Rico Industrial Manufacturing Operations Acquisition Corporation ("PRIMO"), and STMS Corporation ("STMS"), are inactive.

The accompanying financial statements include the accounts of the Company and its subsidiaries, International Data Products Corporation ("IDP"), Puerto Rico Industrial Manufacturing Operations Acquisition Corporation ("PRIMO"), and STMS Corporation ("STMS"). All intercompany accounts and activity have been eliminated in the consolidation process.

Going Concern

The Company's independent accountants stated in their report on the consolidated financial statements of the Company for the year ended October 31, 2008 that the Company has had recurring operating losses that raise substantial doubt about its ability to continue as a going concern. For the year ended October 31, 2008, the Company incurred a net loss of \$2,759,562 and had an accumulated deficit of \$44,868,564 as of that date. The consolidated financial statements do not include any adjustments related to the recovery and classification of recorded assets, or the amounts and classification of liabilities that might be necessary in the event the Company cannot continue as a going concern.

The Company is dependent upon available cash and operating cash flow to meet its capital needs. The Company is considering all strategic options to improve its liquidity and provide it with working capital to fund its continuing business operations which include equity offerings, assets sales or debt financing as alternatives to improve its cash needs however, there can be no assurance that it will be successful in negotiating agreeable financing terms or at all. If adequate funds are not available or are not available on acceptable terms, the Company will likely not be able to take advantage of unanticipated opportunities, develop or enhance services or products, respond to competitive pressures, or continue as a going concern. There is no assurance the Company will be successful in raising working capital as needed. There are no assurances that the Company will have sufficient funds to execute its business plan, pay its operating expenses and obligations as they become due or generate positive operating results.

The Company is in the process of executing on several restructuring initiatives which have occurred from late 2008 to the present that include:

- A reorganization in November 2008 that included personnel terminations from all parts of the organization;
- Sales of certain of the Company's leased assets to customers;
- Elimination of all non-essential costs; and
- Reduction of occupancy costs.

While the Company believes that these initiatives will better align its costs with its anticipated revenues going forward, it will take time for these initiatives to have an impact on its net revenue and operating income.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS – (continued)
OCTOBER 31, 2007 AND 2008

2. Management Change, Restructuring and Operations

In August 2007, the Company's Board of Directors appointed Robert Frick as the Company's Executive Director. The appointment was part of the transition plan that the Company initiated in 2006 when Clifton Sink, was charged to lead the Company to a return to profitability and an increased share price. Also in August 2007, the Company entered into an Employment Resignation Agreement with Cliff Sink pursuant to which Mr. Sink resigned his positions as President and Chief Executive Officer and Board Member of the Company effective November 1, 2007. On November 1, 2007, Mr. Frick assumed all leadership responsibilities as President and Chief Executive Officer of the Company and was appointed to the Board of Directors to fill the vacancy created by Mr. Sink's resignation. The financial impact of the Employment Resignation Agreement was recorded as a charge to operations of approximately \$318,000 in the Company's fiscal 2007 fourth quarter.

3. Significant Accounting Policies

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires the Company 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenue Recognition

The Company recognizes revenue in accordance with Security and Exchange Commission ("SEC") Staff Accounting Bulletin No. 104, *Revenue Recognition in Financial Statements, corrected copy* ("SAB 104"). Generally, SAB 104 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the fee is fixed and determinable; and (4) collectibility is reasonably assured.

Effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003, the Company adopted Emerging Issues Task Force Issue No. 00-21, "*Revenue Arrangements with Multiple Deliverables*" ("EITF 00-21"). Issued in December 2002 by the Financial Accounting Standards Board ("FASB"), EITF 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. This Issue addresses when and, if so, how an arrangement involving multiple deliverables should be divided into separate units of accounting. This Issue does not change otherwise applicable revenue recognition criteria. In the event the Company enters into a multiple element arrangement and there are undelivered elements as of the balance sheet date, the Company assesses whether the elements are separable and have determinable fair value in determining the amount of revenue to record.

The Company recognizes revenue associated with the resale of maintenance contracts on a net basis in accordance with Emerging Issues Task Force Issue No 99-19, "*Reporting Revenue Gross as a Principal versus Net as an Agent*" ("EITF 99-19"), and interpretations thereof.

Beginning in June 2006, the FASB Emerging Issues Task Force reached a consensus on Issue No. 06-03, "*How Sales Taxes Collected From Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement*" ("EITF 06-03"). The Company collects and remits sales and property taxes on products and services that it purchases and sells under its contracts with customers, and reports such amounts under the net method in its consolidated statements of operations. Accordingly, there are no sales and property taxes included in gross revenue.

The Company derives its revenue from the following sources: product revenue, information technology support services, software license as a reseller and support revenue and software training and implementation revenue.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS – (continued)
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For product sales where title transfers upon shipment and risk of loss transfers to the customer, the Company generally recognizes revenue at the time of shipment. For product sales where title and risk of loss transfers upon destination, the Company generally recognizes revenue when products reach their destination. Revenue from hardware leased to customers under operating lease arrangements is recognized over the contract term. When product and installation services that are not essential to the functionality of the product are sold as part of a bundled agreement, the fair value of the installation services, based on the price charged for the services when sold separately, is deferred and recognized when the services are performed. The products sold are generally covered by a warranty for periods ranging from one to three years. The Company accrues an estimated warranty reserve in the period of sale to provide for estimated costs to provide warranty services.

In October 2008 the Company began delivering its appliance solution specifically developed for Blackberry Enterprise Servers (“BES”). This solution is a bundled hardware-software system and subject to American Institute of Certified Public Accountants’ Statement of Position (“SOP”) 97-2, “*Software Revenue Recognition*,” as modified by SOP 98-9, “*Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*.” The software does not require significant modification and customization services. The Company does not have vendor-specific objective evidence (“VSOE”) of fair value for its software. Accordingly, when the software is sold in conjunction with the Company’s hardware, software revenue is recognized upon delivery of the hardware.

For services revenue under time and material contracts, the Company recognizes revenue as services are provided based on the hours of service at stated contractual rates.

The Company is a value-added solution provider for certain software products. When resold software licenses, and related maintenance, customization and training services are all provided together to an individual customer the Company recognizes revenue for the arrangement after the Company has delivered the software license and the customer has approved all implementation and training services provided. In instances where the Company only resells the software license and maintenance to the customer, the Company recognizes revenue after the customer has acknowledged and accepted delivery of the software. The software manufacturer is responsible for providing software maintenance. Accordingly, revenue from maintenance contracts is recognized upon delivery or acceptance, as the Company has no future obligation to provide the maintenance services and no right of return exists.

The Company incurs shipping and handling costs, which are recorded in cost of revenues.

Deferred revenue includes amounts received from customers for which revenue has not been recognized. This generally results from certain customer contracts, ISV releases, warranties, hardware maintenance and support, and consulting services. The deferred revenue associated with customer contracts and ISV releases represents payments received for milestones achieved prior to recognition of revenue. This revenue will be recognized as products are shipped. Revenues from warranties and hardware maintenance and support are recognized ratably over the service term selected by the customer. Deferred service revenues from consulting are recognized as the services are performed.

Significant Customers

During fiscal year 2008, contracts with two customers, a Federal Integrator and a Commercial Customer, represented \$9.5 million and \$1.9 million respectively of our net revenues or 50% and 10% of total net revenues, respectively, for the fiscal year 2008. Given the nature of the products manufactured by us as well as the delivery schedules established by our partners, revenue and accounts receivable concentration by any single customer will fluctuate from year to year. Future revenues and results of operations could be adversely affected should these customers reduce their purchases, eliminate product lines or choose not to continue to buy products and services from us.

Equity-Based Compensation

The Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), “*Share-Based Payment*” (“SFAS 123R”) on November 1, 2005. Issued in December 2004, SFAS 123R requires that the fair value compensation cost relating to share-based payment transactions be recognized in financial statements. Under the provisions of SFAS 123R, share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized over the employee’s requisite service period. The fair value of the Company’s stock options and employee stock purchase plan (“ESPP”) awards was estimated using a Black-Scholes option valuation model. This model requires the input of highly subjective assumptions and elections in adopting and implementing SFAS 123R, including expected stock price volatility and the estimated life of each award. The fair value of equity-based awards is amortized over the vesting period of the award and the Company has elected to use the straight-line method for amortizing its stock option and ESPP awards. The Company adopted the modified prospective transition method as provided by SFAS 123R and compensation costs for all awards granted after the date of adoption and the unvested portion of previously granted awards outstanding are measured at their estimated fair value.

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Other equity-based compensation

The Company accounts for equity instruments issued in exchange for the receipt of goods or services from other than employees and non-employee directors in accordance with SFAS No. 123R, and the conclusions reached by the Emerging Issues Task Force (“EITF”) Issue No. 96-18, “*Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring or in Conjunction with Selling, Goods or Services*” (“EITF 96-18”). Costs are measured at the estimated fair market value of the consideration received or the estimated fair value of the equity instruments issued, whichever is more reliably measurable. The value of equity instruments issued for consideration other than employee services is determined on the earlier of a performance commitment or completion of performance by the provider of goods or services as defined by EITF 96-18. Stock-based compensation recognized under SFAS No. 123 and EITF 96-18 for services from non-employees was \$40,000 and \$55,550 during the fiscal years ended October 31, 2007 and 2008, respectively.

Income Taxes

The Company recognizes deferred tax liabilities and assets for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of certain assets and liabilities. A valuation allowance is established, as necessary, to reduce deferred income tax assets to an amount expected to be realized in future periods. The Company determines its valuation allowance pursuant to the provisions of SFAS No. 109, “*Accounting for Income Taxes*”, which requires the Company to weigh all positive and negative evidence including past operating results and forecasts of future taxable income. In assessing the amount of the valuation allowance as of October 31, 2007 and 2008, the Company considered, in particular, its forecasted operations for the upcoming fiscal year, current backlog of orders, including those recently received, and other significant opportunities currently in its sales and marketing pipeline with a high probability of generating revenues. Based upon this review, the Company will continue to fully reserve for all deferred tax assets as of October 31, 2008.

The Company adopted the provisions of FASB Interpretation No. 48, “*Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109*” (“FIN 48”), on November 1, 2007. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with SFAS No. 109, “*Accounting for Income Taxes*”. It prescribes that a company should use a more-likely-than-not recognition threshold based on the technical merits of the tax position taken. Tax positions that meet the more-likely-than-not recognition threshold should be measured as the largest amount of the tax benefits, determined on a cumulative probability basis, which is more likely than not to be realized upon effective settlement in the financial statements. The Company’s unrecognized tax benefits at October 31, 2008 are approximately \$61,000, which includes approximately \$49,000 of unrecognized tax benefits for windfall tax benefits from stock options exercised that are not recognized under SFAS No. 123R. During the year ended October 31, 2008, the Company increased its unrecognized tax benefits by approximately \$100,000 due to windfall benefits from stock options exercised and additional exposures identified during the year. The Company reduced its unrecognized tax benefits by approximately \$654,000 by adjusting its NOL carryforwards and making an automatic change in accounting method. Both of these adjustments were made with the filing of the Company’s income tax return for the tax year ended October 31, 2007. The Company added \$49,000 of unrecognized tax benefit associated with tax deductions for stock option and warrant exercises in excess of corresponding book charges per SFAS 123R. The Company also added \$51,000 of unrecognized tax benefit to account for revisions in supporting documentation. The Company has a valuation allowance against the full amount of its net deferred tax assets and therefore the adoption of FIN 48 had no impact on its retained earnings. The amount of unrecognized tax benefits that, if recognized, would impact the effective tax rate is \$0.

The Company conducts business in the U.S. and is subject to U.S. taxes. As a result of our business activities, the Company files tax returns that are subject to examination by the respective federal and state tax authorities. For income tax returns filed by us, the Company is no longer subject to U.S. federal, or state tax examination by tax authorities for years before the tax year ended October 31, 2005, although significant net operating loss carryforward tax attributes that were generated prior to the tax year ended October 31, 2005 may still be adjusted upon examination by tax authorities if they either have been or will be utilized. The Company’s accounting policy is to recognize interest and penalties related to income tax matters in general and administrative expense. The Company has \$0 accrued for interest and penalties as of October 31, 2008.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS – (continued)
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Inventory

Inventory consists of materials and components used in the assembly of the Company's products or maintained to support maintenance and warranty obligations and are stated at the lower of cost or market using actual costs on a first-in, first-out basis. The Company maintains a perpetual inventory system and continuously records the quantity on-hand and actual cost for each product, including purchased components, subassemblies and finished goods. The Company maintains the integrity of perpetual inventory records through periodic physical counts of quantities on hand. Finished goods are reported as inventory until the point of title transfer to the customer. Generally, title transfer is documented in the terms of sale. When the terms of sale do not specify, the Company assumes title transfers when it completes physical transfer of the products to the freight carrier unless other customer practices prevail.

The Company periodically evaluates its inventory obsolescence reserve to ensure inventory is recorded at its net realizable value. The Company's policy is to assess the valuation of all inventories, including manufacturing raw materials, work-in-process, finished goods and spare parts in each reporting period. In fiscal 2007, the Company adjusted the cost of excess and obsolete inventory to its net realizable value and released the obsolete or excess inventory reserve that was created in prior fiscal years. Inherent in managements estimates of excess and obsolete inventory are management's forecasts related to the Company's future manufacturing schedules, customer demand, technological and/or market obsolescence and possible alternative uses. If future customer demand or market conditions are less favorable than the Company's projections, additional inventory write-downs may be required, and would be reflected in cost of sales in the period the revision is made. For fiscal year ending 2007 and 2008 the Company incurred charges to expense of \$86,000 and \$186,000, respectively, associated with excess and obsolete inventory cost adjustments.

Warranty

Typically, the sale of the Company's specialized servers includes providing parts and service warranty to customers as part of the overall price of the system. The Company offers warranties for its systems that typically cover a period of 1 to 2 years and commence upon shipment of the system to the customer. When appropriate, the Company records a reserve for estimated warranty expenses to cost of sales for each system upon revenue recognition. The amount recorded is based on an analysis of historical activity. All actual parts and labor costs incurred in subsequent periods are charged to the established reserves.

Actual warranty expenses are incurred on a system-by-system basis, and may differ from the Company's original estimates. While the Company periodically monitors the performance and cost of warranty activities, if actual costs incurred are different than its estimates, the Company may recognize adjustments to the reserve in the period in which those differences arise or are identified.

In addition to the provision of standard warranties, the Company offers customer-paid extended warranty services. Revenues for extended maintenance and warranty services with a fixed payment amount are recognized on a straight-line basis over the term of the contract.

Research and Product Development Expenses

The Company expenses research and product development costs as incurred. These costs consist primarily of labor charges associated with development of the Company's commercial and federal products. These research and development expenses amounted to approximately \$662,000 and \$702,000 during fiscal 2007 and 2008, respectively.

The Company invests in intellectual property in the form of proprietary products such as SteelWorks®. SteelWorks® is an appliance management software that provides self-management and self-maintenance functionality to its appliance server offerings and allows its customers to quickly create a fully integrated turnkey appliance server. The Company is working to expand SteelWorks® to address the needs of small to midsize businesses that require access to company data and attachments via their Blackberry handheld device. This product is called SteelWorks® Mobile for the Blackberry Enterprise Server. This mobile business solution makes a BlackBerry® connection to company data and attachments easy to install and easy to manage. It is hardware and software in a low cost easy to install solution.

Cash and Cash Equivalents

The Company maintains demand deposit accounts with principally one financial institution. At times, deposits exceed federally insured limits, but management does not consider this a significant concentration of credit risk based on the strength of the financial institution. The Company considers all highly liquid investments with a maturity of three months or less at the time of purchase to be cash equivalents.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS – (continued)
OCTOBER 31, 2007 AND 2008

Financial Instruments and Concentration of Credit Risk

The carrying value of the Company's financial instruments including cash and cash equivalents, accounts receivable, accounts payable, accrued liabilities, notes payable and its line of credit approximates fair value. Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and accounts receivable. The cash is held by high credit quality financial institutions. For accounts receivable, the Company performs ongoing credit evaluations of its customers' financial condition and generally does not require collateral. The Company maintains reserves for possible credit losses. As of October 31, 2007 and 2008, the Company had allowance for doubtful account balances of approximately \$40,000 and \$36,000, respectively. The carrying amount of the receivables approximates their fair value.

Advertising Expenses

The Company expenses advertising costs as incurred. Advertising costs consisted of expenditures for tradeshows, website maintenance, radio advertisements, and other charges associated with the dissemination of important Company news and product features to the public. Advertising expense amounted to approximately \$125,000 and \$298,000 during fiscal 2007 and 2008, respectively.

Earnings Per Share

The Company follows the provisions of Statement of Financial Accounting Standards No. 128, "*Earnings Per Share*" which requires the Company to present basic and fully diluted earnings per share. Basic earnings per share is based on the weighted average shares outstanding during the period. Diluted earnings per share increases the shares used in the basic share calculation by the dilutive effect on net income from continuing operations of stock options and warrants. The dilutive weighted average number of common shares outstanding excluded potential common shares from stock options of approximately 557,000 and 352,000 for the fiscal years ending October 31, 2007 and 2008 respectively. These shares were excluded from the earnings per share calculation due to their antidilutive effect resulting from the loss from operations.

Recent Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "*Fair Value Measurements*" ("SFAS No. 157"). SFAS No. 157 provides a common definition of fair value and establishes a framework to make the measurement of fair value in U.S. Generally Accepted Accounting Principles more consistent and comparable. SFAS No. 157 also requires expanded disclosures to provide information about the extent to which fair value is used to measure assets and liabilities, the methods and assumptions used to measure fair value, and the effect of fair value measures on earnings. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. Therefore, the Company is required to adopt SFAS No. 157 in the first quarter of 2009. The Company does not believe the provisions of SFAS 157 will have a material impact on its financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*" ("SFAS No. 159"). SFAS No. 159 provides a choice to measure many financial instruments and certain other items at fair value and requires disclosures about the election of the fair value option. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Therefore, the Company is required to adopt SFAS No. 159 in the first quarter of 2009. The Company does not believe the provisions of SFAS 159 will have a material impact on its financial statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS – (continued)
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In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (Revised 2007) “*Business Combinations*” (“SFAS No. 141R”). SFAS No. 141R, which replaces SFAS No. 141, requires that the acquisition method of accounting (which SFAS No. 141 called the “purchase method”) be used for all business combinations and for an acquirer to be identified for each business combination. SFAS No. 141R also establishes principles and requirements for how the acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141R also requires that acquisition-related costs be recognized separately from the business combination. SFAS No. 141R will apply prospectively to business combinations for which the acquisition date is after fiscal years beginning on or after December 15, 2008. The Company is in the process of evaluating the effect, if any; the adoption of SFAS No. 141(R) will have on its financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, “*Noncontrolling Interests in Consolidated Financial Statements — an amendment of ARB No. 51*” (“SFAS No. 160”). SFAS No. 160 requires all entities to report noncontrolling (minority) interests in subsidiaries as equity in the consolidated financial statements. Its intention is to eliminate the diversity in practice regarding the accounting for transactions between an entity and noncontrolling interests. This statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company is in the process of evaluating the effect, if any; the adoption of SFAS No. 160 will have on its financial statements.

In February 2008, the FASB issued Staff Position No. 157-2, “*Effective Date of FASB Statement No. 157*” (“FSP 157-2”). FSP 157-2 deferred the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008. The Company is in the process of evaluating the effect, if any; the adoption of FSP 157-2 will have on its financial statements.

In October 2008, the FASB issued Staff Position No. 157-3, “*Determining the Fair Value of a Financial Asset When the Market for that Asset is not Active*” (“FSP 157-3”). FSP 157-3 provides guidance for determining the fair value of a financial asset in an inactive market. The Company is in the process of evaluating the effect, if any; the adoption of FSP 157-3 will have on its financial statements.

In May 2008, the FASB issued Staff Position No. APB 14-1, “*Accounting for Convertible Debt Instruments that May be Settled in Cash Upon Conversion.*” (“APB 14-1”). APB 14-1 requires that the liability and equity components of convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) be separately accounted for in a manner that reflects an issuer’s nonconvertible debt borrowing rate. The resulting debt discount is amortized over the period the convertible debt is expected to be outstanding as additional non-cash interest expense. APB 14-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Retrospective application to all periods presented is required except for instruments that were not outstanding during any of the periods that will be presented in the annual financial statements for the period of adoption but were outstanding during an earlier period. The Company in the process of evaluating the effect, if any; the adoption of APB 14-1 will have on its financial statements.

4. Inventories

Inventories consisted of the following:

	Years ended October 31,	
	2007	2008
Raw materials	\$ 758,154	\$ 344,898
Work in process	290,603	-
Finished goods	129,638	177,022
	<u>\$ 1,178,395</u>	<u>\$ 521,920</u>

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5. Property and Equipment and Equipment on Lease

Property and equipment, including leasehold improvements, are stated at cost. Property and equipment are depreciated using the straight-line method over the estimated useful lives ranging from one to five years. Furniture and fixtures are depreciated over an estimated useful life of five years. Leasehold improvements are amortized over the related lease term.

Any tenant allowances have been recorded as deferred rent and will be recognized as a reduction in rent expense over the applicable lease term.

Property and equipment consisted of the following:

	Years ended October 31,	
	2007	2008
Computer and office equipment	\$ 637,063	\$ 296,215
Furniture and fixtures	38,530	38,530
Leasehold improvements	941,617	941,617
Other	230,279	112,668
	<u>1,847,489</u>	<u>1,389,030</u>
Less accumulated depreciation and amortization	(1,045,201)	(762,590)
	<u>\$ 802,288</u>	<u>\$ 626,440</u>

As discussed in Note 3 “*Significant Accounting Policies*” to the Notes to Consolidated Financial Statements, the Company owns equipment that is currently at customer sites under multiple operating lease agreements. The cumulative cost of the equipment was \$1,196,195 and \$987,741 at October 31, 2007 and 2008 respectively. The Company depreciates its leased property and equipment assets over the lesser of the related lease term or the useful life of the leased asset. The related cumulative accumulated depreciation on the equipment was \$872,291 and \$545,642 at October 31, 2007 and 2008, respectively.

6. Bank Lines of Credit and Notes Payable

Operating Line of Credit

On March 6, 2008, the Company renewed its bank line of credit that allows the Company to borrow an amount to the lesser of its collateralized cash on hand or \$3.5 million. The line of credit bears interest at the LIBOR Market Index rate plus 1.25%. The line of credit is secured by all assets of the Company and expires and is subject to renewal on March 31, 2009. There were no outstanding borrowings on the line of credit at October 31, 2007 and 2008.

Notes Payable

Notes payable consisted of the following:

	Years ended October 31,	
	2007	2008
Asset loans, bearing interest at annual interest rates from 0.0% to 4.9% due in aggregate monthly payments of \$676 to expire in October 2010, \$348 and \$359, that expired in July 2008 and July 2008, respectively, secured by certain assets of the Company	\$ 28,284	\$ 15,441
Less current portion	12,842	7,538
Notes payable, long-term	<u>\$ 15,442</u>	<u>\$ 7,903</u>

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS – (continued)
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7. Commitments

Operating Leases

The Company has executed non-cancelable leases for its headquarters and operations facilities. The operating expenses associated with these facilities are included in the monthly rent expense. The operations facilities lease expires in August 2014 and the headquarters lease expires in August 2009. The Company recognizes rent holiday periods, scheduled rent increases and tenant improvement allowances on a straight-line basis over the lease term beginning with the commencement date of the lease. Rent expense for office space under these leases, which is recorded on a straight-line basis over the life of each lease, was approximately \$526,000 and \$526,000 for the years ended October 31, 2007, and 2008, respectively.

Additionally, the Company leases office equipment under non-cancelable operating leases expiring in September of 2009. Total rental expense was \$21,000 and \$19,000 for the years ended October 31, 2007, and 2008, respectively.

Future minimum lease expenditures under all non-cancelable operating leases at October 31, 2008 are as follows:

2009	485,823
2010	268,991
2011	268,991
2012	268,991
2013	268,991
2014	224,160
Total	<u>\$ 1,785,947</u>

8. Employment Agreements

The Company has employment contracts for two key executives. The agreements have terms of 3 years, expiring in August 2010 and October 2010, respectively, and automatically renew for additional one-year terms unless terminated by either the Company or the employee. The aggregate annual minimum commitment under these agreements is approximately \$475,000.

In August 2007, the Company entered into an employment agreement with Mr. Frick pursuant to which Mr. Frick will serve as the Company's President and Chief Executive Officer. The term of the Employment Agreement is for three years, subject to certain termination provisions. Also in August 2007, the Company entered into an employment resignation agreement with Cliff Sink pursuant to which Mr. Sink resigned his positions as President and Chief Executive Officer and Board Member of the Company effective November 1, 2007.

On October 31, 2007, the Company entered into an amended employment agreement with Kevin Murphy, the Company's current Chief Financial Officer, pursuant to which the terms of Mr. Murphy's employment agreement, dated June 8, 2004, were amended. Under the terms of the Amended Agreement, Mr. Murphy shall continue to serve as the Chief Financial Officer of the Company for an additional thirty-six (36) months, commencing from the date of the Amended Agreement. Mr. Murphy shall also serve as the Company's Executive Vice President.

9. Stockholders' Equity

Issuance of Unregistered Common Stock

On March 7, 2007, the Company issued 21,504 shares of its common stock to members of its Board of Directors. The shares were valued at \$0.99 based upon the closing price of the Company's common stock on that date. The total expense associated with this stock issuance was approximately \$21,000.

Warrants

On September 14, 2007, the Company issued 100,000 warrants in exchange for investor relations services valued at approximately \$56,000. The warrants were issued at an exercise price of \$1.28 and expire September 14, 2012. The fair value of the warrants was estimated in four equal tranches over a four-month vesting period using the Black- Scholes Option pricing fair value model.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS – (continued)
OCTOBER 31, 2007 AND 2008

The Company recognized \$40,000 and \$56,000 of sales and marketing expense associated with the issuance of warrants in exchange for services for the fiscal years ended October 31, 2007 and 2008 respectively.

10. Stock Based Compensation

The Company adopted Statement of Financial Accounting Standards No. 123 (Revised 2004), “*Share-Based Payment*” (“SFAS No. 123R”) on November 1, 2005. Issued in December 2004, SFAS No. 123R requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. Under the provisions of SFAS No. 123R, share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized over the employee’s requisite service period. Stock-based compensation expense for the year ended October 31, 2007 and 2008 increased the Company’s basic and diluted loss per share by approximately \$0.03 and \$0.03, respectfully. The estimated fair value of the Company’s stock-based awards is amortized on a straight-line basis over the awards’ vesting period.

A summary of the total stock-based compensation expense for the fiscal years ended October 31, 2007 and 2008 is as follows:

Stock based expense allocation	Year ended	
	October 31, 2007	October 31, 2008
Cost of goods sold	\$ -	\$ 24,000
General and administrative	286,000	294,000
Selling and marketing	-	29,000
Research and development	-	21,000
Severance and restructuring	57,000	-
Total stock compensation	\$ 343,000	\$ 368,000

Stock Options

In January 1997, the Company adopted the 1997 Stock Option Plan (the “1997 Option Plan”). Under the 1997 Option Plan, options to purchase a maximum of 2,650,000 shares of the Company’s common stock (subject to adjustments in the event of stock splits, stock dividends, recapitalizations and other capital adjustments) may be granted to employees, officers and directors of the Company and certain other persons who provide services to the Company. In addition, the Company established the 2002 Stock Option Plan (the “2002 Option Plan”) in May 2002, which permits the Company to grant up to 750,000 options to employees, officers and directors of the Company and certain other persons who provide services to the Company under that Plan. In May 2004, the Company’s shareholders approved an amendment to the Company’s 2002 Stock Option Plan to increase the number of options available under the plan from 750,000 to 1,500,000. In May 2007, the Company’s shareholders approved the 2007 Stock Option Plan which permits the Company to grant up to 1,500,000 options to employees, officers and directors of the Company. In May 2008, the Company’s shareholders approved an amendment to the Company’s 2007 Stock Option Plan creating the Amended 2007 Stock Option and Restricted Stock Plan (the “2007 Option and Restricted Stock Plan”). The 2007 Stock Option and Restricted Stock Plan permits the Company to issue restricted stock awards to employees, officers and directors of the Company in addition to stock option awards.

As of October 31, 2008, there were no options available for future grants under the 1997 Option Plan, 158,710 options available for future grants under the 2002 Option Plan and 1,433,334 options and/or restricted stock awards available for future grants under the 2007 Option and Restricted Stock Plan.

Stock options are generally granted at the fair market value of its common stock at the date of grant. The options vest ratably over a stated period of time not to exceed four years. The contractual terms of the options are five or ten years.

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A summary of the Company's stock option activity as of October 31, 2008 is presented below:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (years)
Outstanding at October 31, 2007	1,786,000	\$ 1.13	3.17
Exercisable at October 31, 2007	686,625	\$ 1.60	2.33
Options granted	1,015,000	\$ 1.26	
Options exercised	196,290	\$ 0.62	
Options canceled or expired	622,210	\$ 1.13	
Outstanding at October 31, 2008	1,982,500	\$ 1.24	3.42
Exercisable at October 31, 2008	879,584	\$ 1.36	2.51

The total options outstanding do not include 600,000 non-qualified options granted to the former IDP stockholders that are not included in the Option Plan.

The aggregate intrinsic value of options exercised during the fiscal years ended October 31, 2008 was approximately \$93,000. There were no options exercised during the fiscal year ended October 31, 2007. The intrinsic value of a stock option is the amount by which the market value of the underlying stock exceeds the exercise price of the option. There was no intrinsic value for options outstanding or options exercisable for year ended October 31, 2008.

The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing fair value model. This model is calculated based on exercise price, an expected annual dividend yield of 0% and several subjective assumptions, including the expected term and expected stock price volatility over the expected term. The weighted-average grant-date fair value of options granted during the fiscal years ended October 31, 2007 and 2008 was \$0.39 and \$0.51, respectively.

The fair value of the Company's Stock Option awards granted during the fiscal year ended October 31, 2007 were estimated based upon the following assumptions:

	Years ended October 31,	
	2007	2008
Expected term (years) ¹	0.42 to 3.50	3.25 to 3.70
Expected stock price volatility ²	58.2% to 64.2%	57.6% to 60.1%
Weighted average volatility ²	59.4%	58.80%
Risk-free interest rate ³	3.81% to 5.03%	2.03% to 2.92%

¹ - **Expected term.** For awards granted prior to January 1, 2008, expected term for the stock option awards was calculated based upon the simplified method set out in the SEC Staff Accounting Bulletin No. 107 ("SAB 107"). For awards granted after January 1, 2008 the Company continued to use the simplified method set out in SAB 107 for grants with two-year graded vesting for which it lacked sufficient historical share option exercise data in accordance with SEC Staff Accounting Bulletin No. 110. Expected term for grants of one year cliff vesting stock option awards was calculated based upon historical share option exercises for which the Company did have sufficient historical data.

² - **Expected stock price volatility.** Expected stock price volatility for Stock Option awards is calculated using the weighted average of the Company's historical volatility over the expected term of the award.

³ - **Risk-free interest rate.** The risk-free interest rate is calculated based on the U.S Treasury yield curve on the grant date and the expected term of the award.

The Company modified the stock option agreement of one employee in fiscal year 2007. As a result of the modification the Company recorded an additional \$57,000 of stock-based compensation expense which was recorded as severance and restructuring expense.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS – (continued)
OCTOBER 31, 2007 AND 2008

A summary of the Company's outstanding stock options at October 31, 2008 is as follows:

<u>Range of Exercise Prices</u>	<u>Options Outstanding</u>			<u>Options Exercisable</u>	
	<u>Number Outstanding</u>	<u>Weighted-Average Exercise Price</u>	<u>Average Remaining Contractual Life</u>	<u>Number Outstanding</u>	<u>Weighted-Average Exercise Price</u>
\$0.55-\$1.75	1,687,500	\$ 1.04	3.84	584,584	\$ 0.85
\$1.76-\$4.50	295,000	\$ 2.37	1.00	295,000	\$ 2.37
\$0.55-\$4.50	1,982,500	\$ 1.24	3.42	879,584	\$ 1.36

A summary of the status of the Company's nonvested shares as of October 31, 2008, and changes during the fiscal year ended October 31, 2008, is presented below:

	<u>Shares</u>	<u>Weighted-Average Grant-Date Fair Value</u>
Nonvested at October 31, 2007	1,099,375	\$.046
Options granted	1,015,000	\$ 0.51
Options vested	(606,459)	\$ 0.51
Options forfeited	(405,000)	\$ 0.36
Nonvested at October 31, 2008	1,102,916	\$ 0.52

The Company recognized approximately \$306,000 and \$364,000 of stock-based compensation expense associated with stock option awards in the fiscal years ended October 31, 2007 and 2008, respectively. As of October 31, 2008, unrecognized compensation expense related to nonvested stock options was \$341,000 which is expected to be recognized through September 2010 over a weighted average period of 0.65 years. The total fair value of shares vested during the years ended October 31, 2007, and 2008 was approximately \$111,000 and \$309,000 respectively.

Employee Stock Purchase Plan

In August, 1998, the Board adopted an Employee Stock Purchase Plan ("ESPP") whereby employees may purchase Company stock through a payroll deduction plan. The purchase price of the stock is the lower of 85% of the fair market value on the first or last day of the applicable six month offering period. All employees, including officers but not directors, are eligible to participate in this plan. Executive officers whose stock ownership of the Company exceeds five percent of the outstanding common stock are not eligible to participate in this plan. In May 2007, the Company's shareholders approved an amendment to the ESPP that increased the number of shares available for issuance from 300,000 to 600,000.

As of October 31, 2008, there were 267,765 options available for future grants under the Amended Stock Purchase Plan.

The fair value of each ESPP award is estimated on the date of the grant using the Black-Scholes option-pricing fair value model. This model is calculated based on exercise price, an expected annual dividend yield of 0%, the expected term and a subjective assumption, expected stock price volatility over the expected term. The Company used FASB Technical Bulletin No. 97-1, "Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option," in determining the fair value of its ESPP awards. The fair value of the Company's ESPP awards granted during the fiscal year ended October 31, 2007 and 2008 was estimated based upon the following assumptions:

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS – (continued)
OCTOBER 31, 2007 AND 2008

	Years ended October 31,	
	2007	2008
Expected term (years) ¹	0.50	0.50
Expected stock price volatility ²	67.9% to 83.6%	64.6%
Risk-free interest rate ³	4.15% to 5.09%	1.53%

¹ - **Expected term.** Expected term for ESPP awards is equal to the vesting period of the award.

² - **Expected stock price volatility.** Expected stock price volatility for ESPP awards is calculated using the weighted average of the Company's historical volatility over the expected term of the award.

³ - **Risk-free interest rate.** The risk-free interest rate is calculated based on the U.S. Treasury yield curve on the grant date and the expected term of the award.

The Company recognized approximately \$4,000 of stock-based compensation expense associated with ESPP awards in the fiscal year ended October 31, 2008. As of October 31, 2008, there was not any unrecognized compensation cost related to ESPP awards.

Restricted Stock Awards

Restricted stock awards are issued pursuant to the Company's 2007 Stock Option and Restricted Stock Plan. The Company's restricted stock grants are accounted for as equity awards. The expense is based on the price of the Company's common stock, and is recognized on a straight-line basis over the requisite service period. The Company's restricted stock agreements do not contain any post-vesting restrictions. The restricted stock award grants vest ratably over a two to three year period.

In September of 2007, the Company granted 180,000 shares of restricted stock. The weighted average restricted stock grant fair value for fiscal year ended October 31, 2007 was \$1.22. None of the restricted stock award grants were vested or cancelled in the fiscal year ended October 31, 2007. No restricted stock awards were granted during the fiscal year ended October 31, 2008.

A summary of the Company's restricted stock award activity as of October 31, 2008, and changes during the year then ended are as follows:

	Shares	Weighted-Average Price/Share	Intrinsic Value
Nonvested at October 31, 2007	180,000	\$ 1.22	
Granted	-	\$ -	
Vested and issued	-	\$ -	
Cancelled	(113,334)	\$ 1.24	
Nonvested at October 31, 2008	66,666	\$ 1.20	\$ 39,332

The Company recognized \$5,000 of stock-based compensation expense associated with restricted stock awards in the fiscal year ended October 31, 2007. The Company did not recognize any stock-based compensation expense associated with restricted stock awards in the fiscal year ended October 31, 2008. As of October 31, 2008, unrecognized compensation expense related to nonvested restricted stock awards was \$75,000 which is expected to be recognized through September 2010 over a weighted average period of 1.36 years.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS – (continued)
OCTOBER 31, 2007 AND 2008

11. Income Taxes

The provision for income taxes consists of the following:

	Years ended October 31,	
	2007	2008
Current:		
Federal	\$ -	\$ -
State	-	-
Deferred:		
Federal	-	-
State	-	-
Total Provision for income taxes	\$ -	\$ -

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

Components of the Company's net deferred tax asset balance are as follows:

	Years ended October 31,	
	2007	2008
Deferred tax assets:		
Current portion:		
Accrued expenses	\$ 114,633	\$ 61,390
Asset reserves	14,498	72,156
Other	3,452	31,674
Total current portion	132,583	165,220
Long term portion:		
Net operating loss carryforwards	15,357,452	16,318,196
Deferred rent	65,603	58,768
Stock compensation	25,418	83,890
Investment reserve	55,009	55,252
Depreciation	149,823	153,128
Intangibles	827,821	757,560
Total long term portion	16,481,126	17,426,794
Deferred tax credit:		
Valuation allowance	(16,613,709)	(17,525,032)
Total deferred tax asset	\$ -	\$ 66,982
Deferred tax liabilities:		
Current portion:		
Change in accounting method	-	(33,491)
Long term portion:		
Change in accounting method	-	(33,491)
Total deferred tax liability	\$ -	\$ (66,982)
Net deferred tax asset	\$ -	\$ -

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS – (continued)
OCTOBER 31, 2007 AND 2008

As of October 31, 2008, the Company had approximately \$44.4 million in pretax net operating loss carryforwards reported on its tax returns, which expire between 2011 and 2028. Of this amount, approximately 132,000 is unrecognized in the financial statement under SFAS 123R related to stock-based compensation that has not yet provided a benefit due to the Company's net operating loss position. The Company completed an analysis as of October 31, 2008 to determine whether there was any limitation on its net operating loss carryforwards under Section 382 of the Internal Revenue Code. The Company determined that as of October 31, 2008, there was no limitation on its net operating loss carryforwards.

As of October 31, 2008, the Company has recorded a valuation allowance of approximately \$17.5 million against the total deferred tax asset of \$17.6 million. The portion of the valuation allowance for which subsequently recognized benefits will increase stockholders' equity was \$0.3 million. In assessing the amount of the valuation allowance as of October 31, 2008, we considered, in particular, our forecasted operations for the next fiscal year, taking into account our year to date results of operations, current backlog of orders, including those recently received, and other significant opportunities currently in our sales and marketing pipeline with a high probability of generating revenues. Based upon this review, management determined that it is not more likely than not its net deferred tax assets will be realized and has provided a valuation allowance against all deferred tax assets as of October 31, 2008.

The reconciliation of income tax from the federal statutory rate of 34% is:

	Years ended October 31,	
	2007	2008
Tax at statutory rates:	\$ (661,162)	\$ (938,251)
Non-deductible (income) expenses, net	8,141	8,866
Stock based compensation	92,718	73,784
Valuation allowance	(957,715)	911,323
State income tax, net of federal benefit	(51,974)	(78,216)
Change in state tax rates	885,957	(73,201)
True-up of net-operating loss	687,854	87,985
Other	(3,819)	7,710
	\$ -	\$ -

The Company conducts business in the U.S. and is subject to U.S. taxes. As a result of its business activities, the Company files tax returns that are subject to examination by the respective federal and state tax authorities. For income tax returns filed by the Company, the Company is no longer subject to U.S. federal, or state tax examination by tax authorities for years before the tax year ended October 31, 2005, although significant net operation loss carryforward tax attributes that were generated prior to the tax year ended October 31, 2005 may still be adjusted upon examination by tax authorities if they either have been or will be utilized.

As a result of the adoption of FIN 48, the Company identified unrecognized tax benefits of \$615,674 related to tax positions taken in prior years that did not meet the more-likely-than-not recognition threshold based on the technical merits of the tax position taken. We have a valuation allowance against the full amount of our net deferred tax assets and therefore, the adoption of FIN 48 had no impact on our retained earnings.

During the year ended October 31, 2008, we increased our unrecognized tax benefits by approximately \$100,000 due to windfall benefits from stock options exercised and additional exposures identified during the year. The Company reduced its unrecognized tax benefits by approximately \$654,000 by adjusting its NOL carryforwards and making an automatic change in accounting method. Both of these adjustments were made with the filing of the Company's income tax return for the year ended October 31, 2007 in July 2008.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS – (continued)
OCTOBER 31, 2007 AND 2008

The change in the Company's unrecognized tax benefits related to FIN 48 and SFAS 123R are shown in the table below:

Balance at November 1, 2007	\$ 615,674
Additions related to current year tax positions	50,971
Additions related to current year windfall tax benefits not recognized under SFAS 123R	48,697
Reduction for tax positions related to the current year	-
Additions for tax positions of prior years	54
Reductions for tax positions of prior years	-
The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities	(654,251)
Expiration of the statute of limitations for the assessment of taxes	-
Balance at October 31, 2008	\$ 61,145

The amount of unrecognized tax benefits that, if recognized, would impact the effective tax rate is zero. The Company does not expect its unrecognized tax benefit liability to change significantly over the next 12 months. The Company's accounting policy is to recognize interest and penalties related to income tax matters in general and administrative expense. The Company has \$0 accrued for interest and penalties as of October 31, 2008.

The exercise of stock options during the year ended October 31, 2008 generated an income tax deduction equal to the excess of the fair market value over the exercise price. In accordance with SFAS No. 123R, the Company will not recognize a deferred tax asset with respect to the excess stock compensation deductions until those deductions actually reduce the Company's income tax liability. As such, the Company has not recorded a deferred tax asset related to the net operating losses of approximately \$132,000 resulting from the exercise of these stock options in the accompanying financial statements. At such time as the Company utilizes these net operating losses to reduce income tax payable, the tax benefit will be recorded as an increase in additional paid in capital.

12. Earnings Per Share

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed, using the treasury stock method, as though all potential common shares that are dilutive were outstanding during the period. The following table provides a reconciliation of the numerators and denominators of the basic and diluted computations for net (loss) per share.

	Years ended October 31,	
	2007	2008
Numerator:		
Net (loss) from operations	\$ (1,944,595)	\$ (2,759,562)
Denominator:		
Denominator for basic earnings per share- weighted-average shares	14,286,551	14,493,215
Effect of dilutive securities:		
Employee stock options	-	-
Warrants	-	-
Restricted stock	-	-
Dilutive potential common shares	-	-
Denominator for diluted earnings per share - adjusted weighted-average shares and assumed conversions	14,286,551	14,493,215
(Loss) per share from operations, basic and diluted	\$ (0.14)	\$ (0.19)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS – (continued)
OCTOBER 31, 2007 AND 2008

13. Retirement Plans

401(k) Plans

The Company maintains a 401(k) (the “Plan”) for all current employees. Under the Plan, employees are eligible to participate the first calendar day of the month following their first day of service and attaining the age of 18. Employees could defer up to \$15,500 of compensation in calendar year 2008. Employee contributions are subject to Internal Revenue Service limitations. All employees who contributed to the Plan are eligible to share in discretionary Company matching contributions. The Company match is equal to 50% of employee contributions up to 6%. Company contributions vest over 5 years. In fiscal 2007 and 2008, the Company contributed approximately \$88,000 and \$72,000 to the participants of the 401(k), respectively.

14. Segment Reporting

FASB Statement of Financial Accounting Standards No. 131, “*Disclosures about Segments of an Enterprise and Related Information*” (“SFAS No. 131”), establishes standards for reporting information about operating segments. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision-making group, in deciding how to allocate resources and in assessing performance. SFAS No. 131 also establishes a quantitative threshold, whereby an enterprise should report separately information about operating segments if its reported revenue is 10% or more of the combined revenue of all reported operating segments. The Company is organized on the basis of products and services. The Company’s chief operating decision maker is the Company’s Chief Executive Officer. While the Chief Executive Officer is apprised of a variety of financial metrics and information, the Chief Executive Officer makes decisions regarding how to allocate resources and assess performance based on a single operating unit.

15. Related Party Transactions

An individual who is a director is also founding member of Gersten Savage LLP, who provides legal services to the Company. During the fiscal years ended October 31, 2007 and 2008, the Company paid Gersten Savage LLP approximately \$83,000 and \$93,000, respectively, in legal fees.

16. Commitments and Contingencies

The Company has accrued approximately \$58,000 pertaining to non-income taxes and related interest and penalties that would have resulted from the failure to file the associated returns. The Company intends to file the necessary returns to resolve the contingency.

17. Subsequent Event

On January 12, 2009, the Company and Robert E. Frick, the Company’s Chief Executive Officer and President, mutually terminated Mr. Frick’s employment agreement as a result of Mr. Frick’s health. Mr. Frick also resigned from the Board.

On January 14, 2009, the Board appointed Brian Hajost, a former executive officer of the Company, as the Company’s Chief Executive Officer, President and a member of the Board, and Kevin Murphy, the Company’s current Chief Financial Officer and Executive Vice President, as a member of the Board.

**STEELCLOUD, INC.
FORM OF
RESTRICTED STOCK AGREEMENT**

Granted Under the Amended 2007 Stock Option and Restricted Stock Plan

THIS RESTRICTED STOCK AGREEMENT (the "Agreement") is made as of _____, by and between SteelCloud, Inc., a Virginia corporation (the "Company"), and _____ (the "Employee").

The Board of Directors of the Company (the "Board") has determined that it is in the best interests of the Company and its shareholders to promote the success of the Company by enhancing the ownership of the Company's common stock by the Employee through making this grant of restricted common stock in accordance with the terms set forth below.

AGREEMENT

1. **Award of Restricted Shares.** The Board hereby grants, subject to the terms and conditions set forth in this Agreement and in the Company's Amended 2007 Stock Option and Restricted Stock Plan, as of _____ (the "Grant Date"), to Employee _____ shares of the Company's common stock, par value \$0.001 per share (the "Restricted Shares"). The Restricted Shares will be held in book entry form by the Company's transfer agent in the name of the Employee and shall be delivered to the Employee on the vesting dates set forth in Section 2(a). The Employee agrees that the Restricted Shares shall be subject to the forfeiture provisions set forth in Section 3 of this Agreement and the restrictions on transfer set forth in Section 2(e) of this Agreement.

2. **Delivery of Restricted Shares**

(a) The Restricted Shares may not be transferred by the Employee until such Restricted Shares have vested. Except as otherwise provided in Section 3 hereof, the Restricted Shares shall vest, the restrictions on the Restricted Shares shall lapse, and the Restricted Shares shall be delivered to the Employee over the service period as set forth below:

Number of Shares	Vesting Date
-	MM/DD/YYYY
-	MM/DD/YYYY
-	MM/DD/YYYY
-	MM/DD/YYYY

(b) Until such time as delivery of the Restricted Shares is made to the Employee, or the Employee's right to such Restricted Shares is terminated in accordance with this Agreement, the Company's stock transfer records shall reflect the Employee's status as holder of such Restricted Shares.

(c) Notwithstanding any other provisions of this Agreement, the Company's Board of Directors (the "Board") shall be authorized in its discretion, based upon its review and evaluation of the performance of the Employee and of the Company or its subsidiaries, to accelerate the lapse of any restrictions under this Agreement upon the Restricted Shares, at such times and upon such terms and conditions as the Board shall deem advisable.

(d) Until the Restricted Shares vest and are delivered without restrictions to the Employee in accordance with the terms of this Agreement, the Employee hereby irrevocably appoints the Secretary of the Company as his attorney-in-fact to execute and deliver any stock power or other instrument which may be necessary to effectuate the transfer of the Restricted Shares (or assignment of distributions thereon) on the books and records of the Company.

(e) The Employee shall not effect a Disposition (as defined below) of any Restricted Shares unless, until and to the extent the Restricted Shares have vested in accordance with this Agreement. Any attempt to effect a Disposition of any Restricted Shares prior to the date on which the Restricted Shares have vested and the restrictions have lapsed, shall be void ab initio. For purposes of this Agreement, "Disposition" shall mean any sale, transfer, encumbrance, gift, donation, assignment, pledge, hypothecation, or other disposition, whether similar or dissimilar to those previously enumerated, whether voluntary or involuntary, and including, but not limited to, any disposition by operation of law, by court order, by judicial process, or by foreclosure, levy or attachment.

3. Forfeiture. If prior to the required service period set forth in part 2 above, Employee's employment with the Company or its subsidiaries is terminated for any reason, any unvested Restricted Shares shall be deemed to have been forfeited by the Employee. The Board shall have the power and authority to enforce on behalf of the Company any rights of the Company under this Agreement in the event of the Employee's forfeiture of the Restricted Shares pursuant to this Section 3.

4. Rights with Respect to Restricted Shares.

(a) Except as otherwise provided in this Agreement, the Employee shall have, with respect to all Restricted Shares, all the rights of a shareholder of the Company, including the right to vote the Restricted Shares and the right to receive cash dividends, if any, as may be declared by the Board from time to time. Any shares of the Company's common stock issued to the Employee as a dividend with respect to the Restricted Shares shall have the same status, be subject to the same terms and conditions and shall be held on behalf of the Employee by the Company (on a pro rata basis) as the unvested Restricted Shares, unless otherwise determined by the Board.

(b) In the event that the number of Restricted Shares, as a result of a stock split or stock dividend or combination of shares or any other change or exchange for other securities, by reclassification, reorganization or otherwise, is increased or decreased or changed into or exchanged for a different number or kind of shares of stock or other securities of the Company or of another corporation, the number of unvested Restricted Shares shall be appropriately adjusted to reflect such change. If any such adjustment shall result in a fractional share, such fraction shall be disregarded.

5. Taxes.

(a) If the Employee elects, within thirty (30) days of the date of this Agreement, to include in gross income for federal income tax purposes an amount equal to the fair market value (as of the Grant Date) of the Restricted Shares pursuant to Section 83(b) of the Internal Revenue Code of 1986, as amended (the "Code"), the Employee shall make arrangements satisfactory to the Board to pay to the Company any federal, state or local income taxes required to be withheld with respect to the Restricted Shares. If the Employee shall fail to make such tax payments as are required, the Company shall, to the extent permitted by law, have the right to deduct from any payment of any kind otherwise due to the Employee any federal, state or local taxes of any kind required by law to be withheld with respect to the Restricted Shares.

(b) If the Employee does not make the election described in Subsection 5(a) above, the Employee shall, no later than the date as of which the Restricted Shares vest, pay to the Company, or make arrangements satisfactory to the board for payment of, any federal, state or local taxes of any kind required by law to be withheld with respect to the Restricted Shares, and the Company shall, to the extent permitted by law, have the right to deduct from any payment of any kind otherwise due to Employee any federal, state, or local taxes of any kind required by law to be withheld with respect to the Restricted Shares.

(c) The Employee has reviewed with the Employee's own tax advisors the federal, state, local and other tax consequences of the grant of Restricted Shares. The Employee is relying solely on such advisors and not on any statements or representations of the Company or any of its agents. The Employee understands that the Employee (and not the Company) shall be responsible for the Employee's own tax liability that may arise directly or indirectly as a result of the grant of the Restricted Shares.

6. Delivery upon Death. If the Employee dies prior to all or any portion of the Restricted Shares having vested, but while such Employee is employed by the Company, all such unvested Restricted Shares shall be delivered, free of any restrictions under this Agreement, to the beneficiary or beneficiaries designated by the Employee, or if the Employee has not so designated any beneficiary, or no designated beneficiary survives the Employee, such Restricted Shares shall be delivered to the personal representative of the Employee's estate.

7. Amendment, Modification and Assignment. No provision of this Agreement may be modified, waived or discharged unless such waiver, modification or discharge is agreed to in writing signed by the Employee and the Chairman of the Board or other duly authorized member of the Board. No waiver by either party of any breach by the other party hereto of any condition or provision of this Agreement shall be deemed a waiver of any other conditions or provisions of this Agreement. No agreements or representations, oral or otherwise, express or implied, with respect to the subject matter hereof have been made by either party which are not set forth expressly in this Agreement. This Agreement shall not be assigned by the Employee in whole or in part. The rights and obligations created hereunder shall be binding on the Employee and his heirs and legal representatives and on the successors and assigns of the Company.

8. Miscellaneous.

(a) No Right to Employment. The grant of the Restricted Shares shall not be construed as giving the Employee the right to be retained in the employ of the Company.

(b) No Limit on Other Compensation Arrangements. Nothing contained in this Agreement shall preclude the Company from adopting or continuing in effect other or additional compensation arrangements, and such arrangements may be either generally applicable or applicable only in specific cases.

(c) Severability. If any provision of this Agreement is or becomes or is deemed to be invalid, illegal or unenforceable in any jurisdiction or would disqualify this Agreement or the grant of Restricted Shares under any applicable law, such provision shall be construed or deemed amended to conform to applicable law (or if such provision cannot be so construed or deemed amended without materially altering the purpose or intent of this Agreement and the grant of Restricted Shares, such provision shall be stricken as to such jurisdiction and the remainder of this Agreement and the Award shall remain in full force and effect).

(d) No Trust or Fund Created. Neither this Agreement nor the grant of Restricted Shares shall create or be construed to create a trust or separate fund of any kind or a fiduciary relationship between the Company and the Employee or any other person. To the extent that the Employee or any other person acquires a right to receive payments from the Company pursuant to this Agreement, such right shall be no greater than the right of any unsecured general creditor of the Company.

(e) Governing Law. The validity, interpretation, construction and performance of this Agreement shall be governed by the laws of the Commonwealth of Virginia.

(f) Headings. Headings are given to the Paragraphs and Subparagraphs of this Agreement solely as a convenience to facilitate reference. Such headings shall not be deemed in any way material or relevant to the construction or interpretation of this Agreement or any provision thereof.

(g) Employee's Acknowledgments. The Employee acknowledges that he or she: (i) has read this Agreement; (ii) has been represented in the preparation, negotiation, and execution of this Agreement by legal counsel of the Employee's own choice or has voluntarily declined to seek such counsel; (iii) understands the terms and consequences of this Agreement; (iv) is fully aware of the legal and binding effect of this Agreement; and (v) understands that the law firm of Gersten Savage LLP has acted as counsel to the Company in connection with the transactions contemplated by the Agreement, and not as counsel for the Employee.

(h) Delivery of Certificates. The Employee may request that the Company deliver the vested Restricted Shares in certificated form.

(i) No Deferral. Notwithstanding anything herein to the contrary, neither the Company nor the Employee may defer the delivery of the Restricted Shares.

9. Complete Agreement. This Agreement and those agreements and documents expressly referred to herein embody the complete agreement and understanding among the parties and supersede and preempt any prior understandings, agreements or representations by or among the parties, written or oral, which may have related to the subject matter hereof in any way.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement on the date first written above.

SteelCloud, Inc.

By _____
Name/Title:

Agreed and Accepted:

By: _____

Name/Title: _____

Address: _____

SSN #: _____

STEELCLOUD, INC.
AMENDED 2007 STOCK OPTION AND RESTRICTED STOCK PLAN

As adopted May 7, 2008

1 PURPOSE OF PLAN; ADMINISTRATION

1.1 Purpose.

The SteelCloud, Inc. Amended 2007 Stock Option and Restricted Stock Plan (hereinafter, the “**Plan**”) is hereby established to grant to officers and other employees of the Company or of its parents or subsidiaries (as defined in Sections 424(e) and (f), respectively, of the Internal Revenue Code of 1986, as amended (the “**Code**”), if any (individually and collectively, the Company”), and to non-employee directors, consultants and advisors and other persons who may perform significant services for or on behalf of the Company, to create a stock based incentive for such persons to remain in the employ of or provide services to the Company and to contribute to its success.

The Company may grant under the Plan incentive stock options within the meaning of Section 422 of the Code (“**Incentive Stock Options**”), stock options that do not qualify for treatment as Incentive Stock Options (“**Nonstatutory Options**” and together with the Incentive Stock Options, the “**Options**”), and shares of restricted stock (the “**Restricted Stock**” and together with the Incentive Stock Options and the Nonstatutory Options, the “**Stock**”). All grants hereunder are of, or are underlined by, the Company’s common stock, \$0.001 par value.

1.2 Administration.

The Plan shall be administered by the Board of Directors of the Company (the “**Board**”), if each member is a “Non-Employee Director” within the meaning of Rule 16b-3 under the Securities Exchange Act of 1934, as amended (“**Rule 16b-3**”), or a committee (the “**Committee**”) of two or more directors, each of whom is a Non-Employee Director. Appointment of Committee members shall be effective upon acceptance of appointment. Committee members may resign at any time by delivering written notice to the Board. Vacancies in the Committee may be filled by the Board. Until such time that the Committee is properly appointed, the Board shall administer the Plan in accordance with the terms of this Section 1.2.

A majority of the members of the Committee shall constitute a quorum for the purposes of the Plan. Provided a quorum is present, the Committee may take action by affirmative vote or consent of a majority of its members present at a meeting. Meetings may be held telephonically as long as all members are able to hear one another, and a member of the Committee shall be deemed to be present for this purpose if he or she is in simultaneous communication by telephone with the other members who are able to hear one another. In lieu of action at a meeting, the Committee may act by written consent of a majority of its members.

Subject to the express provisions of the Plan, the Committee shall have the authority to construe and interpret the Plan and all Grant Agreements (as defined in Section 4.4) entered into pursuant hereto and to define the terms used therein, to prescribe, adopt, amend and rescind rules and regulations relating to the administration of the Plan and to make all other determinations necessary or advisable for the administration of the Plan; provided, however, that the Committee may delegate nondiscretionary administrative duties to such employees of the Company as it deems proper; and, provided, further, in its absolute discretion, the Board may at any time and from time to time exercise any and all rights and duties of the Committee under the Plan. Subject to the express limitations of the Plan, the Committee shall designate the individuals from among the class of persons eligible to participate as provided in Section 1.3 who shall receive Stock, whether a grantee will receive Incentive Stock Options, Nonstatutory Options, or Restricted Stock or any combination thereof, and the amount, price, restrictions and all other terms and provisions of such Stock (which need not be identical).

Members of the Committee shall receive such compensation for their services as members as may be determined by the Board. All expenses and liabilities which members of the Committee incur in connection with the administration of this Plan shall be borne by the Company. The Committee may, with the approval of the Board, employ attorneys, consultants, accountants, appraisers, brokers or other persons. The Committee, the Company and the Company's officers and directors shall be entitled to rely upon the advice, opinions or valuations of any such persons. No members of the Committee or Board shall be personally liable for any action, determination or interpretation made in good faith with respect to the Plan, and all members of the Committee shall be fully protected by the Company in respect of any such action, determination or interpretation.

1.3 Participation.

Officers and other employees of the Company, non-employee directors, consultants and advisors and other persons who may perform significant services on behalf of the Company shall be eligible for selection to participate in the Plan upon approval by the Committee; provided, however, that only "employees" (within the meaning of Section 3401(c) of the Code) of the Company shall be eligible for the grant of Incentive Stock Options. An individual who has been granted Stock may, if otherwise eligible, be granted additional Stock if the Committee shall so determine. No person is eligible to participate in the Plan by matter of right; only those eligible persons who are selected by the Committee in its discretion shall participate in the Plan.

1.4 Stock Subject to the Plan.

Subject to adjustment as provided in Section 4.5, the shares of common stock to be offered under the Plan shall be shares of authorized but unissued common stock, including any shares repurchased under the terms of the Plan or any Grant Agreement entered into pursuant hereto. The cumulative aggregate number of shares of common stock to be issued under the Plan shall not exceed 1,500,000, subject to adjustment as set forth in Section 4.5.

If any Option granted hereunder shall expire or terminate for any reason without having been fully exercised, the unpurchased shares subject thereto shall again be available for the purposes of the Plan. For purposes of this Section 1.4, where the exercise price of Options is paid by means of the grantee's surrender of previously owned shares of common stock, only the net number of additional shares issued and which remain outstanding in connection with such exercise shall be deemed "issued" for purposes of the Plan.

2 STOCK OPTIONS

2.1 Exercise Price; Payment.

(a) The exercise price of each Incentive Stock Option granted under the Plan shall be determined by the Committee, but shall not be less than 100% of the "Fair Market Value" (as defined below) of common stock on the date of grant. If an Incentive Stock Option is granted to an employee who at the time such Incentive Stock Option is granted owns (within the meaning of section 424(d) of the Code) more than 10% of the total combined voting power of all classes of capital stock of the Company, the Option exercise price shall be at least 110% of the Fair Market Value of common stock on the date of grant. The exercise price of each Nonstatutory Option also shall be determined by the Committee, but shall not be less than 85% of the Fair Market Value of the common stock on the date of grant. The status of each Option granted under the Plan as either an Incentive Stock Option or a Nonstatutory Option shall be determined by the Committee at the time the Committee acts to grant the Option, and shall be clearly identified as such in the Grant Agreement relating thereto.

"**Fair Market Value**" for purposes of the Plan shall mean: (i) the closing price of a share of common stock on the principal exchange on which shares of common stock are then trading, if any, on the day immediately preceding the date of grant, or, if shares were not traded on the day preceding such date of grant, then on the next preceding trading day during which a sale occurred; or (ii) if common stock is not traded on an exchange but is quoted on NASDAQ or a successor quotation system, (1) the last sales price (if common stock is then listed on the NASDAQ Stock Market) or (2) the mean between the closing representative bid and asked price (in all other cases) for common stock on the day prior to the date of grant as reported by NASDAQ or such successor quotation system; or (iii) if there is no listing or trading of common stock either on a national exchange or over-the-counter, that price determined in good faith by the Committee to be the fair value per share of common stock, based upon such evidence as it deems necessary or advisable.

(b) In the discretion of the Committee at the time the Option is exercised, the exercise price of any Option granted under the Plan shall be paid in full in cash, by check or by the optionee's interest-bearing promissory note (subject to any limitations of applicable state corporations law) delivered at the time of exercise; provided, however, that subject to the timing requirements of Section 2.7, in the discretion of the Committee and upon receipt of all regulatory approvals, the person exercising the Option may deliver as payment in whole or in part of such exercise price certificates for common stock (duly endorsed or with duly executed stock powers attached), which shall be valued at its Fair Market Value on the day of exercise of the Option, or other property deemed appropriate by the Committee; and, provided further, that, subject to Section 422 of the Code, so-called cashless exercises as permitted under applicable rules and regulations of the Securities and Exchange Commission and the Federal Reserve Board shall be permitted in the discretion of the Committee. Without limiting the Committee's discretion in this regard, consecutive book entry stock-for-stock exercises of Options (or "pyramiding") also are permitted in the Committee's discretion.

Irrespective of the form of payment, the delivery of shares issuable upon the exercise of an Option shall be conditioned upon payment by the optionee to the Company of amounts sufficient to enable the Company to pay all federal, state, and local withholding taxes resulting, in the Company's judgment, from the exercise. In the discretion of the Committee, such payment to the Company may be effected through (i) the Company's withholding from the number of shares of common stock that would otherwise be delivered to the optionee by the Company on exercise of the Option a number of shares of common stock equal in value (as determined by the Fair Market Value of common stock on the date of exercise) to the aggregate withholding taxes, (ii) payment by the optionee to the Company of the aggregate withholding taxes in cash, (iii) withholding by the Company from other amounts contemporaneously owed by the Company to the optionee, or (iv) any combination of these three methods, as determined by the Committee in its discretion.

2.2 Option Period.

(a) The Committee shall provide, in the terms of each Grant Agreement, when the Option subject to such agreement expires and becomes unexercisable, but in no event will an Incentive Stock Option granted under the Plan be exercisable after the expiration of ten years from the date it is granted. Without limiting the generality of the foregoing, the Committee may provide in the Grant Agreement that the Option subject thereto expires 30 days following a Termination of Employment (as defined in Section 4.3 hereof) for any reason other than death or disability, or six months following a Termination of Employment for disability or following an optionee's death.

(b) Outside Date for Exercise. Notwithstanding any provision of this Section 2.2, in no event shall any Option granted under the Plan be exercised after the expiration date of such Option set forth in the applicable Grant Agreement.

2.3 Exercise of Options.

Each Option granted under the Plan shall become exercisable and the total number of shares subject thereto shall be purchasable, in a lump sum or in such installments, which need not be equal, as the Committee shall determine; provided, however, that each Option shall become exercisable in full no later than ten years after such Option is granted, and each Option shall become exercisable as to at least 10% of the shares of common stock covered thereby on each anniversary of the date such Option is granted; and provided, further, that if the holder of an Option shall not in any given installment period purchase all of the shares which such holder is entitled to purchase in such installment period, such holder's right to purchase any shares not purchased in such installment period shall continue until the expiration or sooner termination of such holder's Option. The Committee may, at any time after grant of the Option and from time to time, increase the number of shares purchasable in any installment, subject to the total number of shares subject to the Option and the limitations set forth in Section 2.5. At any time and from time to time prior to the time when any exercisable Option or exercisable portion thereof becomes unexercisable under the Plan or the applicable Grant Agreement, such Option or portion thereof may be exercised in whole or in part; provided, however, that the Committee may, by the terms of the Option, require any partial exercise to be with respect to a specified minimum number of shares. No Option or installment thereof shall be exercisable except with respect to whole shares. Fractional share interests shall be disregarded, except that they may be accumulated as provided above and except that if such a fractional share interest constitutes the total shares of common stock remaining available for purchase under an Option at the time of exercise, the optionee shall be entitled to receive on exercise a certified or bank cashier's check in an amount equal to the Fair Market Value of such fractional share of stock.

2.4 Transferability of Options.

Except as the Committee may determine as aforesaid, an Option granted under the Plan shall, by its terms, be nontransferable by the optionee other than by will or the laws of descent and distribution, or pursuant to a qualified domestic relations order (as defined by the Code), and shall be exercisable during the optionee's lifetime only by the optionee or by his or her guardian or legal representative. More particularly, but without limiting the generality of the immediately preceding sentence, an Option may not be assigned, transferred (except as provided in the preceding sentence), pledged or hypothecated (whether by operation of law or otherwise), and shall not be subject to execution, attachment or similar process. Any attempted assignment, transfer, pledge, hypothecation or other disposition of any Option contrary to the provisions of the Plan and the applicable Grant Agreement, and any levy of any attachment or similar process upon an Option, shall be null and void, and otherwise without effect, and the Committee may, in its sole discretion, upon the happening of any such event, terminate such Option forthwith.

2.5 Limitation on Exercise of Incentive Stock Options.

To the extent that the aggregate Fair Market Value (determined on the date of grant as provided in Section 2.1 above) of the common stock with respect to which Incentive Stock Options granted hereunder (together with all other Incentive Stock Option plans of the Company) are exercisable for the first time by an optionee in any calendar year under the Plan exceeds \$100,000, such Options granted hereunder shall be treated as Nonstatutory Options to the extent required by Section 422 of the Code. The rule set forth in the preceding sentence shall be applied by taking Options into account in the order in which they were granted.

2.6 Disqualifying Dispositions of Incentive Stock Options.

If common stock acquired upon exercise of any Incentive Stock Option is disposed of in a disposition that, under Section 422 of the Code, disqualifies the optionee from the application of Section 421(a) of the Code, the holder of the common stock immediately before the disposition shall comply with any requirements imposed by the Company in order to enable the Company to secure the related income tax deduction to which it is entitled in such event.

2.7 Certain Timing Requirements.

At the discretion of the Committee, shares of common stock issuable to the optionee upon exercise of an Option may be used to satisfy the Option exercise price or the tax withholding consequences of such exercise, in the case of persons subject to Section 16 of the Securities Exchange Act of 1934, as amended, only (i) during the period beginning on the third business day following the date of release of the quarterly or annual summary statement of sales and earnings of the Company and ending on the twelfth business day following such date, or (ii) pursuant to an irrevocable written election by the optionee to use shares of common stock issuable to the optionee upon exercise of the Option to pay all or part of the Option price or the withholding taxes made at least six months prior to the payment of such Option price or withholding taxes.

2.8 Issuance of Stock Certificates.

Upon exercise of an Option, the Company shall deliver to the person exercising such Option a stock certificate evidencing the shares of common stock acquired upon exercise. Notwithstanding the foregoing, the Committee in its discretion may require the Company to retain possession of any certificate evidencing common stock acquired upon exercise of an Option which remains subject to repurchase under the provisions of the Grant Agreement or any other agreement signed by the optionee in order to facilitate such repurchase provisions.

2.9 Time of Grant and Exercise of Option.

An Option shall be deemed to be exercised when the Secretary of the Company receives written notice from an optionee of such exercise, payment of the exercise price determined pursuant to Section 2.1 of the Plan and set forth in the Grant Agreement, and all representations, indemnifications and documents reasonably requested by the Committee.

3 RESTRICTED STOCK

3.1 Grant of Restricted Stock.

Subject to the terms and provisions of this Plan, the Committee, at any time and from time to time, may grant Restricted Stock to such individuals and in such amounts as the Committee shall determine.

3.2 Restricted Stock Agreement.

Each Restricted Stock grant shall be evidenced by Grant Agreement that shall specify the period(s) of restriction, the number of shares of Restricted Stock granted, and such other provisions as the Committee shall determine.

3.3 Other Restrictions.

The Committee shall impose such other conditions and/or restrictions on any shares of Restricted Stock granted pursuant to this Plan as it may deem advisable including, without limitation, a requirement that participants pay a stipulated purchase price for each share of Restricted Stock, restrictions based upon the achievement of specific performance goals, time-based restrictions on vesting following the attainment of performance goals, time-based restrictions, and/or restrictions under applicable laws or under the requirements of any stock exchange or market upon which such shares are listed or traded, or holding requirements or sale restrictions placed on the shares by the Company upon vesting of such Restricted Stock.

To the extent deemed appropriate by the Committee, the Company may retain the certificates representing shares of Restricted Stock in the Company's possession until such time as all conditions and/or restrictions applicable to such Shares have been satisfied or lapse.

Except as otherwise provided in this Article 3, shares of Restricted Stock covered by each Restricted Stock award shall become freely transferable by the participant after all conditions and restrictions applicable to such Restricted Stock have been satisfied or lapse (including satisfaction of any applicable tax withholding obligations).

3.4 Certificate Legend.

In addition to any legends placed on certificates pursuant to Section 4.10 (*Legending Share Certificates*), each certificate representing Restricted Stock granted pursuant to this Plan may bear a legend such as the following or as otherwise determined by the Committee in its sole discretion:

"The sale or transfer of shares of stock represented by this certificate, whether voluntary, involuntary, or by operation of law, is subject to certain restrictions on transfer as set forth in the SteelCloud, Inc. 2007 Amended Stock Option and Restricted Stock Plan (the "Plan"), and in the associated grant agreement (the "Agreement"). A copy of the Plan and the Agreement may be obtained from SteelCloud, Inc."

3.5 Voting Rights.

Unless otherwise determined by the Committee and set forth in a Grant Agreement, to the extent permitted or required by law, as determined by the Committee, participants holding Restricted Stock granted hereunder may be granted the right to exercise full voting rights with respect to the Restricted Stock during the period of restriction.

3.6 Section 83(b) Election.

The Committee may provide in a Grant Agreement that the award of Restricted Stock is conditioned upon the participant making or refraining from making an election with respect to the award under Code Section 83(b). If a Participant makes an election pursuant to Code Section 83(b) concerning a Restricted Stock Award, the Participant shall be required to file promptly a copy of such election with the Company.

4 OTHER PROVISIONS

4.1 No Effect on Employment.

Nothing in the Plan or in any Grant Agreement hereunder shall confer upon any grantee any right to continue in the employ of the Company, any Parent Corporation or any Subsidiary or shall interfere with or restrict in any way the rights of the Company, its Parent Corporation and its Subsidiaries, which are hereby expressly reserved, to discharge any grantee at any time for any reason whatsoever, with or without cause.

For purposes of the Plan, “**Parent Corporation**” shall mean any corporation in an unbroken chain of corporations ending with the Company if each of the corporations other than the Company then owns stock possessing 50% or more of the total combined voting power of all classes of stock in one of the other corporations in such chain. For purposes of the Plan, “**Subsidiary**” shall mean any corporation in an unbroken chain of corporations beginning with the Company if each of the corporations other than the last corporation in the unbroken chain then owns stock possessing 50% or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

4.2 Sick Leave and Leaves of Absence.

Unless otherwise provided in Grant Agreement, and to the extent permitted by Section 422 of the Code, a grantee’s employment shall not be deemed to terminate by reason of sick leave, military leave or other leave of absence approved by the Company if the period of any such leave does not exceed a period approved by the Company, or, if longer, if the grantee’s right to reemployment by the Company is guaranteed either contractually or by statute. A Grant Agreement may contain such additional or different provisions with respect to leave of absence as the Committee may approve, either at the time of grant of Stock or at a later time.

4.3 Termination of Employment.

For purposes of the Plan “**Termination of Employment.**” shall mean the time when the employee-employer relationship between the grantee and the Company, any Subsidiary or any Parent Corporation is terminated for any reason, including, but not by way of limitation, a termination by resignation, discharge, death, disability or retirement; but excluding (i) terminations where there is a simultaneous reemployment or continuing employment of the grantee by the Company, any Subsidiary or any Parent Corporation, (ii) at the discretion of the Committee, terminations which result in a temporary severance of the employee-employer relationship, and (iii) at the discretion of the Committee, terminations which are followed by the simultaneous establishment of a consulting relationship by the Company, a Subsidiary or any Parent Corporation with the former employee. Subject to Section 4.1, the Committee, in its absolute discretion, shall determine the affect of all matters and questions relating to Termination of Employment; provided, however, that, with respect to Incentive Stock Options, a leave of absence or other change in the employee-employer relationship shall constitute a Termination of Employment if, and to the extent that such leave of absence or other change interrupts employment for the purposes of Section 422(a)(2) of the Code and the then-applicable regulations and revenue rulings under said Section.

4.4 Terms and Conditions.

The Stock granted under the Plan shall be evidenced by a written stock option agreement or restricted stock agreement (collectively referred to as the “**Grant Agreement**”) between the grantee and the Company providing that the Stock is subject to the terms and conditions of the Plan and to such other terms and conditions not inconsistent therewith as the Committee may deem appropriate in each case.

4.5 Adjustments upon Changes in Capitalization; Merger and Consolidation.

If the outstanding shares of common stock are changed into, or exchanged for cash or a different number or kind of shares or securities of the Company or of another corporation through reorganization, merger, recapitalization, reclassification, stock split-up, reverse stock split, stock dividend, stock consolidation, stock combination, stock reclassification or similar transaction, an appropriate adjustment shall be made by the Committee in the number and kind of shares as to which Options may be granted. In the event of such a change or exchange, other than for shares or securities of another corporation or by reason of reorganization, the Committee shall also make a corresponding adjustment changing the number or kind of shares and the exercise price per share allocated to unexercised Options or portions thereof, which shall have been granted prior to any such change, shall likewise be made. Any such adjustment, however, shall be made without change in the total price applicable to the unexercised portion of the Option (except for any change in the aggregate price resulting from rounding-off of share quantities or prices). No adjustments shall be made to Restricted Stock.

In the event of a “spin-off” or other substantial distribution of assets of the Company which has a material diminutive effect upon the Fair Market Value of the common stock, the Committee in its discretion shall make an appropriate and equitable adjustment to the exercise prices of Options then outstanding under the Plan.

Where an adjustment under this Section 4.5 of the type described above is made to an Incentive Stock Option, the adjustment will be made in a manner which will not be considered a “modification” under the provisions of subsection 424(b)(3) of the Code.

In connection with the dissolution or liquidation of the Company or a partial liquidation involving 50% or more of the assets of the Company, a reorganization of the Company in which another entity is the survivor, a merger or reorganization of the Company under which more than 50% of the common stock outstanding prior to the merger or reorganization is converted into cash or into a security of another entity, a sale of more than 50% of the Company’s assets, or a similar event that the Committee determines, in its discretion, would materially alter the structure of the Company or its ownership, the Committee, upon 30 days prior written notice to the Stock holders, may, in its discretion, do one or more of the following: (i) shorten the period during which Options are exercisable (provided they remain exercisable for at least 30 days after the date the notice is given); (ii) accelerate any vesting schedule to which Stock is subject; (iii) arrange to have the surviving or successor entity grant replacement Options with appropriate adjustments in the number and kind of securities and Option prices, or (iv) cancel Options upon payment to the optionee in cash, with respect to each Option to the extent then exercisable (including any Options as to which the exercise has been accelerated as contemplated in clause (ii) above), of any amount that is the equivalent of the Fair Market Value of the common stock (at the effective time of the dissolution, liquidation, merger, reorganization, sale or other event) or the Fair Market Value of the Option. In the case of a change in corporate control, the Committee may, in considering the advisability or the terms and conditions of any acceleration of the exercisability of any Option pursuant to this Section 4.5, take into account the penalties that may result directly or indirectly from such acceleration to either the Company or the grantee, or both, under Section 280G of the Code, and may decide to limit such acceleration to the extent necessary to avoid or mitigate such penalties or their effects.

No fractional share of common stock shall be issued under the Plan on account of any adjustment under this Section 4.5.

4.6 Rights of Participants and Beneficiaries.

The Company shall pay all amounts payable hereunder only to the Stock holder or beneficiaries entitled thereto pursuant to the Plan. The Company shall not be liable for the debts, contracts or engagements of any Stock holder or his or her beneficiaries, and rights to cash payments under the Plan may not be taken in execution by attachment or garnishment, or by any other legal or equitable proceeding while in the hands of the Company.

4.7 Government Regulations.

The Plan, the grant of Stock, the exercise of Options and the issuance and delivery of shares of common stock under grants hereunder, shall be subject to compliance with all applicable federal and state laws, rules and regulations (including but not limited to state and federal securities law) and federal margin requirements and to such approvals by any listing, regulatory or governmental authority as may, in the opinion of counsel for the Company, be necessary or advisable in connection therewith. Any securities delivered under the Plan shall be subject to such restrictions, and the person acquiring such securities shall, if requested by the Company, provide such assurances and representations to the Company, as the Company may deem necessary or desirable to assure compliance with all applicable legal requirements. To the extent permitted by applicable law, the Plan and Stock granted hereunder shall be deemed amended to the extent necessary to conform to such laws, rules and regulations.

4.8 Amendment and Termination.

The Board or the Committee may at any time suspend, amend or terminate this Plan and may, with the consent of the grantees, make such modifications of the terms and conditions of such grantees Stock as it shall deem advisable, provided, however, that, without approval of the Company's shareholders given within twelve months before or after the action by the Board or the Committee, no action of the Board or the Committee may, (A) materially increase the benefits accruing to participants under the Plan; (B) materially increase the number of securities which may be issued under the Plan; or (C) materially modify the requirements as to eligibility for participation in the Plan. No Stock may be granted during any suspension of the Plan or after such termination. The amendment, suspension or termination of the Plan shall not, without the consent of the grantees affected thereby, alter or impair any rights or obligations under any Stock theretofore granted under the Plan. No Stock may be granted during any period of suspension or after termination of the Plan, and in no event may any Stock be granted under the Plan after the expiration of ten years from the date the Plan is adopted by the Board.

4.9 Privileges of Stock Ownership; Non-Distributive Intent; Reports to Grantees.

A participant in the Plan shall not be entitled to the privilege of stock ownership as to any shares of common stock not actually issued to the grantee. Upon exercise of an Option, or grant of Restricted Stock at a time when there is not in effect, under the Securities Act of 1933, as amended, a Registration Statement relating to the common stock issuable upon exercise, payment therefor or issuance thereof and available for delivery a Prospectus meeting the requirements of Section 10(a)(3) of said Act, the grantee shall represent and warrant in writing to the Company that the shares purchased are being acquired for investment and not with a view to the distribution thereof.

The Company shall furnish to each grantee under the Plan the Company's Annual Report and such other periodic reports, if any, as are disseminated by the Company in the ordinary course to its shareholders.

4.10 Legending Share Certificates.

In order to enforce any restrictions imposed upon the Restricted Stock or the common stock issued upon exercise of an Option granted under the Plan or to which such common stock may be subject, the Committee may cause a legend or legends to be placed on any share certificates representing such Restricted Stock or common stock, which legend or legends shall make appropriate reference to such restrictions, including, but not limited to, a restriction against sale of such common stock for any period of time as may be required by applicable laws or regulations. If any restriction with respect to which a legend was placed on any certificate ceases to apply to the Restricted Stock or common stock represented by such certificate, the owner of the Restricted Stock or common stock represented by such certificate may require the Company to cause the issuance of a new certificate not bearing the legend.

Additionally, and not by way of limitation, the Committee may impose such restrictions on any Stock issued pursuant to the Plan as it may deem advisable, including, without limitation, restrictions under the requirements of any stock exchange upon which the common stock is then traded.

4.11 Use of Proceeds.

Proceeds realized pursuant to the exercise of Options under the Plan shall constitute general funds of the Company.

4.12 Changes in Capital Structure; No Impediment to Corporate Transactions.

The existence of outstanding Stock under the Plan shall not affect the Company's right to effect adjustments, recapitalizations, reorganizations or other changes in its or any other corporation's capital structure or business, any merger or consolidation, any issuance of bonds, debentures, preferred or prior preference stock ahead of or affecting common stock, the dissolution or liquidation of the Company's or any other corporation's assets or business, or any other corporate act, whether similar to the events described above or otherwise.

4.13 Effective Date of the Plan.

The Plan shall be effective as of the date of its approval by the shareholders of the Company within twelve months after the date of the Board's initial adoption of the Plan. Restricted Stock may be granted after shareholder approval of the Plan. Options may be granted but not exercised prior to shareholder approval of the Plan. If any Options are so granted and shareholder approval shall not have been obtained within twelve months of the date of adoption of this Plan by the Board of Directors, such Options shall terminate retroactively as of the date they were granted.

4.14 Termination.

The Plan shall terminate automatically as of the close of business on the day preceding the tenth anniversary date of its adoption by the Board or earlier as provided in Section 4.8. Unless otherwise provided herein, the termination of the Plan shall not affect the validity of any Grant Agreement outstanding at the date of such termination.

4.15 No Effect on Other Plans.

The adoption of the Plan shall not affect any other compensation or incentive plans in effect for the Company, any Subsidiary or any Parent Corporation. Nothing in the Plan shall be construed to limit the right of the Company (i) to establish any other forms of incentives or compensation for employees of the Company, any Subsidiary or any Parent Corporation or (ii) to grant or assume Options or other rights otherwise than under the Plan in connection with any proper corporate purpose including but not by way of limitation, the grant or assumption of Options in connection with the acquisition by purchase, lease, merger, consolidation or otherwise, of the business, stock or assets of any corporation, partnership, firm or association.

4.16 Uncertificated Shares.

To the extent this Plan provides for issuance of certificates to reflect the shares of common stock underlying the Options or shares of Restricted Stock, the transfer of such shares of common stock may be effected on a noncertificated basis, to the extent not prohibited by applicable law or the rules of any stock exchange.

STEELCLOUD, MEA JOINT VENTURE AGREEMENT

This **JOINT VENTURE AGREEMENT** ("Agreement") is entered into on the 13th day of October, 2008, by and among the members listed on Exhibit 1 with respect to the SteelCloud MEA Joint Venture ("Company").

Explanatory Statement

The parties agree to organize and operate the Company in accordance with the terms of, and subject to the conditions set forth in this Agreement. Certain capitalized terms are defined in Paragraph 13.

NOW, THEREFORE, for valuable consideration, the parties, intending legally to be bound, agree as follows:

1. Formation and Name; Office; Purpose; Term.

1.1. Organization. The parties confirm the organization of a Limited Liability Company pursuant to United Arab Emirates/Jebel Ali Free Zone laws, effective upon acceptance of the application of the organization submitted on or about 11 September 2008 by the Jebel Ali Free Zone.

1.2. Name of the Company. The name of the Company is "SteelCloud, MEA Joint Venture" and it shall be an FZCO.

1.3. Purpose. The purposes for which the Company is formed are to provide technology products produced by the Company or its members to end users and resellers in the United Arab Emirates, the Kingdom of Saudi Arabia, and elsewhere as the Company may determine, and to exercise and enjoy all of the powers, rights and privileges granted to, or conferred upon, limited liability companies of a similar character by the General Laws of United Arab Emirates/Jebel Ali Free Zone, now or hereinafter in force related to said Contract.

1.4. Term. The term of the Company began upon the acceptance of the application submitted on or about 11 September 2008 by the Jebel Ali Free Zone, and shall continue for 1 year, which automatically renew on its anniversary, unless terminated pursuant to Paragraph 9 of this Agreement.

1.5. Principal Office. The principal office of the Company shall be 14040 Park Center Drive, Suite 210, Herndon, VA 20171, USA, which is also the office of Member SteelCloud.

1.6. Members. The names, addresses, Membership Units and the Membership Percentages of the Members are set forth on Exhibit 1.

2. Capital; Capital Accounts.

2.1. Member Loans or Services. Loans or services by any Member to the Company shall not be considered contributions to the capital of the Company and shall be upon such commercially reasonable terms as the Member and the Company may negotiate.

2.2. No Interest on Capital Contributions. Members shall not be paid interest on their Capital Contributions.

2.3. Return of Capital Contributions. Except as otherwise provided in this Agreement, no Interest Holder shall have the right to receive the return of any Capital Contribution.

2.4. Capital Accounts. A separate Capital Account shall be maintained for each Interest Holder as set forth in Paragraph 13.1 hereof.

2.5. No Subsequent Capital Contributions. No capital contribution shall be accepted from any Member that alters the ratio of profit and loss allocation from that established on Exhibit 1 as of the date of this Agreement. Members shall have no obligation to contribute any capital to the Company other than the initial Capital Contribution.

3. Currency, Profit, Loss, and Distributions.

3.1. Accepted Currency. All transactions involving the Company and its Members shall be determined in U.S. Dollars. All distributions, dividends and payments due and payable to XSAT FZE shall be payable in Dubai at the address for XSAT FZE.

3.2. Allocation of Profit or Loss. Profit or Loss shall be allocated to the Interest Holders in proportion to their Membership Percentages. Special and regulatory allocations are addressed in Paragraph 12.

3.3. Distributions. The Members, by majority vote, may decide how much, if any, and when distributions are made to the Members.

3.4. Allocation and Distribution to Holder of Record. All Profit and Loss shall be allocated, and all distributions shall be made, to the Persons shown on the records of the Company to have been Interest Holders as of the last day of the taxable year for which the allocation or distribution is to be made. However, if there is a Transfer or an Involuntary Withdrawal during the taxable year, the Profit or Loss shall be allocated between the original Interest Holder and the successor on the basis of the number of days that each was an Interest Holder during the taxable year.

3.5. Distributions Upon Liquidation. Distributions upon liquidation of the Company are addressed in Paragraph 10.

4. Member Meetings.

4.1. Member Meetings. There shall be at least two (2) semi-annual general meetings of the Members per year at a time determined by the Manager.

4.2. Special Meetings. Special meetings of the Members may be called at any time for any purpose or purposes upon the request in writing of the holders of any member or by the Manager. Such request shall state the purpose or purposes of the meeting. Business transacted at all special meetings of Members shall be confined to the purpose or purposes stated in the notice of the meeting.

4.3. Place of Holding Meetings. Unless otherwise agreed by holders of a majority of Membership Units of the Members, all meetings of Members shall be held at the principal office of the Company. Members may attend meetings via teleconference or videoconference.

4.4. Notice of Meetings. Written notice of each meeting of the Members shall be mailed, or e-mailed, to each Member of record entitled to vote at his post office address or e-mail address, as it appears upon the books of the Company, at least ten (10) days before the meeting. Each such notice shall state the place, day, and hour at which the meeting is to be held and, in the case of any special meeting, shall state briefly the purpose or purposes thereof. Any notice of meeting may be waived by any Member.

4.5. Quorum. The presence in person or by proxy of Members holding of record a majority of the Membership Units shall constitute a quorum at all meetings of the Members, except as otherwise provided by law, by the Articles or by this Agreement.

4.6. Voting. At all meetings of Members, every Member entitled to vote shall have a vote equal to the number of his Membership Units. Such vote may be either in person or by proxy appointed by an instrument in writing subscribed by such member or his duly authorized attorney-in-fact, bearing a date not more than three (3) months prior to said meeting, unless such instrument provides for a longer period. Such proxy shall be signed and dated. All elections shall be had and all questions shall be decided by a majority of the votes cast at a duly constituted meeting, except as otherwise provided by law or by this Agreement.

5. Management of Joint Venture and Performance of Work.

5.1. Management Generally. Each party shall participate in the management of the Company. SteelCloud is designated the managing venturer ("Manager"). The parties designate Kevin Murphy, an employee of SteelCloud, as the Manager. Should Murphy's employment with SteelCloud terminate, the parties will cooperatively select a replacement who shall be an employee of SteelCloud. SteelCloud shall maintain the books and records of the Company at the Company's principal office, and shall account to the Members for all revenues and costs of the Company.

5.2. Power, Authority and Duties of Manager. The Manager shall have the right, power and authority, on behalf of the Company and in its name, to exercise all of the rights, powers and authority of the Company under the controlling law, and to adopt such rules and regulations for the conduct of their meetings and the management of the Company, subject to any express limitations set forth herein. The Manager shall have the powers necessary for and shall perform all duties incident to the office of President under the laws of United Arab Emirates/Jebel Ali Free Zone. The Manager will negotiate all contracts on behalf of the Company.

5.3. Compensation of Manager. The Manager shall not receive any compensation for any duties as Manager.

5.4. Equipment and Facilities. SteelCloud and XSAT shall provide the Company the equipment and facilities, if any, listed on Exhibit 2 as part of each Member's capital contributions, at the values stated therein.

5.5. Proposal Preparation. The parties shall use their best effort to prepare proposals for presentation to clients.

5.6. Performance Responsibilities. The responsibilities of the Members with regard to Contract performance, source of labor, and negotiation of the Contract shall be as follows:

5.6.1. SteelCloud's Responsibilities. SteelCloud will provide product and Intellectual Property; appropriate training, control record keeping, finance, administrative and legal matters; product training; production, assembly, testing and image loading of products to be sold by the Company; and provide sales functions and marketing assistance as needed.

5.6.2 XSAT's Responsibilities. XSAT will provide a local presence (includes office space, signage, etc.) in the Territory; create demand for product; provide account management for Company customers; and represent the Company in the Territory. XSAT will work with SteelCloud to ensure that its staff is trained to perform product warranty, support, and logistical services required by the Company. XSAT will stock spare product units and parts, provide fulfillment and logistical administration on Company orders, and provide warranty services as directed by the Company.

5.7. Liability and Indemnification.

5.7.1. The Manager shall at all times act in a fiduciary capacity for the Company. The Manager shall not be liable, responsible or accountable, in damages or otherwise, to any Member or to the Company for any act performed with respect to Company matters, except for fraud, gross negligence or an intentional breach of this Agreement.

5.7.2. The Company shall indemnify the Manager to the fullest extent permitted by law for any act performed by the Manager with respect to Company matters, except for fraud, gross negligence or an intentional breach of this Agreement.

6. Transfer of Interests and Withdrawal of Members.

6.1. General Prohibition on Transfers. A Member may not, without the prior written consent of all of the other Members, voluntarily or involuntarily, under any circumstances and in any manner whatsoever, dispose of or encumber any of the Membership Units which such Member now owns or hereafter at any time shall acquire, other than in strict accordance with the terms of this Agreement. Any such attempted disposition or encumbrance in violation of this Agreement shall be void.

6.2. Right of First Offer. A Member shall have the right to sell his Membership Units to a third party so long as he first offers it to the other Members.

6.2.1. In the event that a Member ("Offering Member") desires to sell all, but not less than all, of his Membership Units ("Offered Units"), the Offering Member shall notify the other Members in writing of such desire ("Offering Notice"). The Offering Notice shall contain the price and terms that the Offering Member desires to accept.

6.2.2. The other Members shall have a period of fourteen (14) days to elect to purchase, on a pro rata basis according to the number of Membership Units owned by such Members, the Membership Units of the Offering Member at the Offer Terms. Such election must be made in writing within such fourteen (14) day period.

6.2.3. In the event that some of the other Members do not exercise their options with respect to the purchase of some but not all of the Offered Units, the Members that exercised their options ("exercising Members") shall have an additional option, for a period of seven (7) days after the expiration of such fourteen (14) day period, to purchase on a pro rata basis according to the number of Membership Units owned by such exercising Members, all of the balance of such Offered Units at the Offer Terms so that all the Membership Units of the Offering Member are purchased. Such election must be made in writing within such additional seven (7) day period. The closing of the purchase of the Offered Units shall take place at the offices of the Company no later than seven (7) days after the expiration of the final option period or by mail as may be appropriate.

6.2.4. If the other Members do not exercise their options to purchase all of the Offered Units, then the Offering Member shall be free, for a period of one hundred eighty (180) days following the expiration of last period within which options could be exercised, to sell the Offered Units to a third party, provided, however, that the Offering Member may sell the Offered Units only for an amount equal to or greater than the price set forth in the Offer Terms and upon terms and conditions reasonably considered more favorable to the Offering Member. In the event that the Offered Units are not sold within such one hundred eighty (180) day period, then the Offering Member shall be required to again comply with the provisions of this paragraph for any subsequent sale.

6.3. Voluntary Withdrawal. No Member shall have the right or power to voluntarily withdraw from the Company.

6.4. Involuntary Withdrawal. Immediately upon the occurrence of any of the following events (“Involuntary Withdrawal”), the successor of the withdrawn Member shall thereupon become an Interest Holder but shall not become a Member without the consent of Members owning at least fifty-one percent (51%) of the Membership Units: (i) making an assignment for the benefit of creditors; (ii) filing a voluntary petition in bankruptcy; (iii) becoming the subject of an order for relief or being declared insolvent in any bankruptcy or insolvency proceeding; (iv) filing a petition or answer seeking for any reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under any statute, law, or regulation; (v) filing an answer or other pleading admitting or failing to contest the material allegation of a petition filed against him in any proceeding of the nature described in subparagraph (iv); (vi) seeking, consenting to, or acquiescing in the appointment of a trustee, receiver, or liquidator of the general partner or of all or any substantial part of his properties; or (vii) transferring all or a majority of the assets or stock of a Member to a successor.

6.5. Substitute Member. Except as otherwise provided, any transferee permitted to acquire or receive an Interest pursuant to this paragraph shall be a substitute Member and shall be bound by all of the provisions of this Agreement.

7. Right of Members to Participate in Future Equity Offerings by the Company.

7.1. Delivery of Offer to Participate. In the event that the Company intends to issue any additional Membership Units in order to raise capital (“Offered Units”), the Company shall deliver to the Members a written notice of any proposed or intended issuance of Offered Units (“Offer”). The Offer shall (i) identify and describe the Offered Units, (ii) describe the price and other terms upon which they will be issued, and the number or manner of Offered Units to be issued, (iii) describe the general terms upon which the Company proposes to effect such Offer or issuance and (iv) offer to issue and sell to such Member a pro rata portion of the Offered Units determined by dividing the aggregate number of Membership Units then held by such Members by the total number of Membership Units then outstanding (“Basic Amount”), and any additional portion of the Offered Units attributable to the Basic Amounts of other members as such Member shall indicate he will purchase or acquire should the other Members subscribe for less than their Basic Amounts (“Under Subscription Amount”). Each Member shall have the right, for a period of fourteen (14) days following delivery of the Offer, to purchase or acquire, at the price and upon the other terms specified in the Offer, the number or amount of Offered Units described above. The Offer by its terms shall remain open and irrevocable for such fourteen (14) day period.

7.2. Member Acceptance of Offer to Participate. To accept an Offer, in whole or in part, a Member must deliver a written notice to the Company prior to the end of the fourteen (14) day period of the Offer setting forth the portion of the Member’s Basic Amount that such Member elects to purchase and, if such Member shall elect to purchase all of his Basic Amount, the Under Subscription Amount, if any, that such Member elects to purchase (“Notice of Acceptance”). If the Basic Amounts subscribed for by all Members are less than the total of all of the Basic Amounts available for purchase, then each Member who set forth Under Subscription Amounts in his Notice of Acceptance shall be entitled to purchase, in addition to the Basic Amounts subscribed for, all Under Subscription Amounts he has subscribed for; provided, however, that should the Under Subscription Amounts subscribed for exceed the difference of all the Basic Amounts available for purchase and the Basic Amounts subscribed for (“Available Under Subscription Amount”), each Member who has subscribed for any Under Subscription Amount shall be entitled to purchase only that portion of the Available Under Subscription Amount as the Under Subscription Amount subscribed for by such Member bears to the total Under Subscription Amounts subscribed for by all Members, subject to an equitable rounding by the Manager to the extent that the Manager reasonably deems necessary.

7.3. Sale of Membership Units of Third Parties. The Company shall have one hundred eighty (180) days from the expiration of the Period set forth in Paragraph 7.2 to issue and sell all or any part of such Offered Units as to which a Notice of Acceptance has not been given by the Members (“Refused Units”), but only upon terms and conditions which are not, in the aggregate, more favorable to the acquiring person or persons and less favorable to the Company than those set forth in the Offer. If the Refused Units are not sold within such one hundred eighty (180) day period, then such Membership Units may not be issued and sold until they are again offered to the Members under the procedures specified in this paragraph.

8. Dispute Resolution. Any claim or controversy arising out of or related to this Agreement, or any breach thereof, that interferes with the conduct of the business shall, upon the request of any Member, be submitted to a single arbitrator selected by the Members and settled by arbitration in accordance with the rules of the American Arbitration Association then in effect. Any decision made pursuant to such arbitration shall be binding and conclusive upon the parties and judgment upon such decision may be entered in any court having jurisdiction thereof. This paragraph shall not apply in the event that a party seeks equitable or other relief not available in arbitration. Any arbitration shall be conducted in the Metropolitan Washington, D.C. area.

9. Dissolution.

9.1. Events of Dissolution. The Company shall be dissolved upon the unanimous written agreement of the Members owning at least seventy-five percent (75%) of the Membership Units, upon 90 days notice to any Member not agreeing to the dissolution.

9.2. Filing of Articles of Cancellation. If the Company is dissolved, the Manager shall promptly file Articles of Cancellation with the United Arab Emirates/Jebel Ali Free Zone authorities.

10. Liquidation.

10.1. Upon termination and dissolution of the Company, the Members shall proceed to wind up the affairs of the Company. The liabilities and obligations of the Company to creditors (other than Members) and all expenses incurred in its liquidation and dissolution will be paid and will have first priority in winding up. The Members may retain from available cash and other assets of the Company sufficient reserves for anticipated and contingent liabilities. Undistributed cash, and other property valued at its fair market value on the date of distribution, will be distributed to the Members in the following order:

10.1.1. First, to repay any loans to the Company by a Member.

10.1.2. Distributions will then be made to the Members in proportion to the credit balances in their Capital Accounts until the capital account of each Member shall be brought to zero.

10.1.3. The balance, if any, will be distributed to the Members in proportion to their respective Membership Units.

10.2. No Interest Holder shall be obligated to restore a Negative Capital Account except where such Interest Holder engaged in fraud, gross negligence or an intentional breach of this Agreement.

11. Books, Records, Accounting, and Tax Elections.

11.1. Bank Accounts. The Company shall establish and administer a special bank account or accounts in the name of the Company. The account(s) may be in the United States or United Arab Emirates, as determined by the Manager.

11.2. Books and Records. The Manager shall keep or cause to be kept complete and accurate books and records of the Company and supporting documentation of the transactions with respect to the conduct of the Company's business. The books and records shall remain available for examination by any Member or the Member's duly authorized representative at any and all reasonable times upon reasonable notice during normal business hours.

11.3. Annual Accounting Period. The annual accounting period of the Company shall be its taxable year. The Company's taxable year shall begin on November 1 and end on October 31 of each calendar year.

11.4. Reports. The Manager shall use its best efforts to cause the Company to deliver to each Member, within twenty-one (21) days after the end of each calendar month, and seventy-five (75) days after the end of the year, financial reports of the Company for such month or year. Monthly reports shall contain reports of operations and a general management report on important events in the prior quarter and coming months. Within seventy-five (75) days after the end of each taxable year of the Company, the Manager shall cause to be sent to each Member a complete accounting of the affairs of the Company for the taxable year then ended. In addition, within seventy-five (75) days after the end of each taxable year of the Company, the Manager shall cause to be sent to each Member, that tax information concerning the Company which is reasonably necessary for preparing the Member's income tax returns for that year.

12. Special and Regulatory Clause

The Members hereby authorize the Manager, upon the advice of the Company's tax or corporate counsel, to amend this Agreement to comply with the United States Internal Revenue Code of 1986, as amended ("Code") and the regulations and rules promulgated thereunder, and/or the laws and rules of the United Arab Emirates/Jebel Ali Free Zone; provided, however, that no amendment shall materially affect the rights of an Interest Holder without the Interest Holder's prior written consent.

13. Defined Terms. The following capitalized terms shall have the meanings specified in this Paragraph 13.

13.1. "Capital Account" means the account maintained by the Company for each Interest Holder in accordance with the following provisions:

13.1.1. an Interest Holder's Capital Account shall be credited with the Interest Holder's Capital Contributions, the amount of any Company liabilities assumed by the Interest Holder (or which are secured by Company property distributed to the Interest Holder), the Interest Holder's distributive share of Profit and any item in the nature of income or gain specially allocated to such Interest Holder pursuant to the provisions of Paragraph 3; and

13.1.2. an Interest Holder's Capital Account shall be debited with the amount of money and the fair market value of any Company property distributed to the Interest Holder, the amount of any liabilities of the Interest Holder assumed by the Company (or which are secured by property contributed by the Interest Holder to the Company), the Interest Holder's distributive share of Loss and any item in the nature of expenses or losses specially allocated to the Interest Holder pursuant to the provisions of Paragraph 3.

If any Interest is transferred pursuant to the terms of this Agreement, the transferee shall succeed to the Capital Account of the transferor to the extent the Capital Account is attributable to the transferred Interest. If the book value of Company property is adjusted, the Capital Account of each Interest Holder shall be adjusted to reflect the aggregate adjustment in the same manner as if the Company had recognized gain or loss equal to the amount of such aggregate adjustment. It is intended that the Capital Accounts of all Interest Holders shall be maintained in compliance with the provisions of United States Internal Revenue Regulation § 1.704-1(b)(2), and all provisions of this Agreement relating to the maintenance of Capital Accounts shall be interpreted and applied in a manner consistent with that Regulation.

13.2. “Capital Contribution” means the total amount of cash and the fair market value of any other assets contributed (or deemed contributed under United States Internal Revenue Regulation § 1.704-1(b)(2)(iv)(d)) to the Company by a Member, net of liabilities assumed or to which the assets are subject. The Capital Contributions of the Members as of the date of this Agreement, with a cost or value schedule, are set forth on Exhibit 2.

13.3. “Interest” means a Person's share of the Profits and Losses of, and the right to receive distributions from, the Company.

13.4. “Interest Holder” means any Person who holds an Interest, whether as a Member or as an un-admitted assignee of a Member.

13.5. “Member” means the individuals listed on Exhibit 1. A Member may also include any Person who subsequently is admitted as a Member of the Company.

13.6. “Membership Percentage” means, as to a Member, the percentage of Units held by such Member in proportion to the total number of Units in the Company, and as to an Interest Holder who is not a Member, the Membership Percentage of the Member whose Membership Units have been acquired by such Interest Holder, to the extent the Interest Holder has succeeded to that Member's Membership Units.

13.7. “Membership Units” means, with respect to any Member, the number or percentage of units set forth opposite each Member's name on Exhibit 1, as amended from time to time. A Unit represents a Person's share of Profits and Losses of, and the right to receive distributions from, the Company.

13.8. “Membership Rights” means all of the rights of a Member in the Company, including a Member's: (i) Interest, (ii) right to inspect the Company's books and records, and (iii) right to participate in the management of and vote on matters coming before the Company.

13.9. “Negative Capital Account” means a Capital Account with a balance of less than zero.

13.10. “Person” means and includes an individual, corporation, partnership, association, limited liability company, trust, estate, or other entity.

13.11. “Profit” and “Loss” means, for each taxable year of the Company (or other period for which Profit or Loss must be computed) the Company's taxable income or loss determined in accordance with United States Internal Revenue Code § 703(a), with the following adjustments:

13.11.1. all items of income, gain, loss, deduction, or credit required to be stated separately pursuant to United States Internal Revenue Code § 703(a)(1) shall be included in computing taxable income or loss;

13.11.2. any United States Internal Revenue tax-exempt income of the Company, not otherwise taken into account in computing Profit or Loss, shall be included in computing taxable income or loss;

13.11.3. any expenditures of the Company described in United States Internal Revenue Code § 705(a)(2)(B) (or treated as such pursuant to United States Internal Revenue Regulation § 1.704-1(b)(2)(iv)(i)) and not otherwise taken into account in computing Profit or Loss, shall be subtracted from taxable income or loss;

13.11.4. gain or loss resulting from any taxable disposition of Company property shall be computed by reference to the adjusted book value of the property disposed of, notwithstanding the fact that the adjusted book value differs from the adjusted basis of the property for federal income tax purposes;

13.11.5. in lieu of the depreciation, amortization or cost recovery deductions allowable in computing taxable income or loss, there shall be taken into account the depreciation computed based upon the adjusted book value of the asset; and

13.11.6. notwithstanding any other provision of this definition, any items which are specially allocated herein shall not be taken into account in computing Profit or Loss.

13.12. "Tax Rate" means the highest blended national, federal, state and local income tax rate applicable to any of the Members.

13.13. "Territory" means the United Arab Emirates, the Kingdom of Saudi Arabia, and elsewhere as the Company may determine.

13.14. "Transfer" means any voluntary or involuntary sale, hypothecation, pledge, assignment, attachment or other transfer.

13.15. "Voluntary Withdrawal" means a Member's dissociation with the Company by means other than a Transfer or an Involuntary Withdrawal.

14. General Provisions.

14.1. Assurances. Each Member shall execute all such certificates and other documents and shall do all such filing recording, publishing, and other acts as the Members deem appropriate to comply with the requirements of law for the formation and operation of the Company and to comply with any laws, rules, and regulations relating to the acquisition, operation, or holding of the property of the Company.

14.2. Notifications. Any notice, demand, consent, election, offer, approval, request, or other communication (collectively, a "notice") required or permitted under this Agreement must be in writing and either delivered personally or sent by certified or registered mail, postage prepaid, return receipt requested. A notice must be addressed to an Interest Holder at the Interest Holder's last known address on the records of the Company. A notice to the Company must be addressed to the Company's principal office. A notice delivered personally will be deemed given only when acknowledged in writing by the person to whom it is delivered. A notice that is sent by mail will be deemed given three (3) business days after it is mailed. Any party may designate, by notice to all of the others, substitute addresses or addressees for notices and, thereafter, notices are to be directed to those substitute addresses or addressees.

14.3. Complete Agreement. This Agreement constitutes the complete and exclusive statement of the agreement among the Members. It supersedes all prior written and oral statements, including any prior representation, statement, condition, or warranty.

14.4. Applicable Law. All questions concerning the construction, validity, and interpretation of this Agreement and the performance of the obligations imposed by this Agreement shall be governed by the laws of the United Arab Emirates/Jebel Ali Free Zone.

14.5. Paragraph Titles. The headings herein are inserted as a matter of convenience only and do not define, limit, or describe the scope of this Agreement or the intent of the provisions hereof.

14.6. Binding Provisions. This Agreement is binding upon, and inures to the benefit of, the parties hereto and their respective heirs, executors, administrators, personal and legal representatives, successors, and assigns.

14.7. Terms. Common nouns and pronouns shall be deemed to refer to the masculine, feminine, neuter, singular and plural, as the identity of the Person may in the context require.

14.8. Separability of Provisions. Each provision of this Agreement shall be considered separable and if, for any reason, any provision or provisions herein are determined to be invalid and contrary to any existing or future law, such invalidity shall not impair the operation of or affect those portions of this Agreement which are valid.

14.9. Counterparts. This Agreement may be executed simultaneously in two or more counterparts each of which shall be deemed an original, and all of which, when taken together, constitute one and the same document. The signature of any party to any counterpart shall be deemed a signature to, and may be appended to, any other counterpart.

14.10. IN WITNESS WHEREOF, the parties have executed, or caused this Agreement to be executed, under seal, as of the date set forth above.

WITNESS:

MEMBER: SteelCloud

(SEAL)

WITNESS:

MEMBER: XSAT

(SEAL)

EXHIBIT 1

MEMBERS

UNITS (TOTAL 100)

SteelCloud, Inc.
14040 Park Center Drive, Suite 210
Herndon, VA 20171
USA

80 units (80%)

XSAT FTZ
JAFZA View 19, Office 2701
Jebel Ali Free Zone
Dubai
UAE

20 units (20%)

EXHIBIT 21.1

LIST OF SUBSIDIARIES

The following company is a subsidiary of SteelCloud, Inc.:

1. International Data Products Corp., a Maryland corporation
-

EXHIBIT 23.1

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We have issued our report dated January 29, 2009, accompanying the consolidated financial statements and schedule included in the Annual Report of SteelCloud, Inc. on Form 10-K for the year ended October 31, 2008. We hereby consent to the incorporation by reference of said report in the Registration Statements of SteelCloud Inc. on Forms S-8 (File No. 333-144031 effective June 25, 2007, File No. 333-92406 effective July 15, 2002, File No. 333-61557 effective August 14, 1998 and File No. 333-52419 effective May 12, 1998).

/s/ Grant Thornton LLP
McLean, Virginia
January 29, 2009

CERTIFICATION

I, Brian H. Hajost certify that:

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

Date: January 29, 2009

By: /s/ Brian H. Hajost.

Name: Brian H. Hajost

Title: Chief Executive Officer and President

CERTIFICATION

I, Kevin Murphy, certify that:

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

Date: January 29, 2009

By: /s/ Kevin Murphy
Name: Kevin Murphy
Title: Chief Financial Officer

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of SteelCloud, Inc. (the "Company") on Form 10-K for the year ended October 31, 2008, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Brian H. Hajost, Chief Executive Officer and President of the Company, certify, pursuant to 18 U.S.C. ss. 1350, as adopted pursuant to ss.906 of the Sarbanes-Oxley Act of 2002, that:

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

Date: January 29, 2009

By: /s/ Brian H. Hajost.

Name: Brian H. Hajost

Title: Chief Executive Officer and President

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of SteelCloud, Inc. (the "Company") on Form 10-K for the year ended October 31, 2008, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Kevin Murphy, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. ss. 1350, as adopted pursuant to ss.906 of the Sarbanes-Oxley Act of 2002, that:

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

Date: January 29, 2009

By: /s/ Kevin Murphy
Name: Kevin Murphy
Title: Chief Financial Officer
