UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2009

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

For the transition period from ____________ to____________

Commission File No. 000-53235

DIGITILITI, INC.

(Exact name of Registrant as specified in its charter)

Delaware

26-1408538

(State or Other Jurisdiction of

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

incorporation or organization)

266 East 7th Street, 4 th Floor

St. Paul, Minnesota 55101

(Address of Principal Executive Offices)

(651) 925-3200

(Registrant s telephone number, including area code)

N/A

(Former name, former address and former fiscal year,

if changed since last report)

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

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

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

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

Yes [ ] No [X]

As of November 13, 2009, the Registrant had 34,736,316 shares of common stock issued and outstanding.

PART I

Table of Contents

Item 1. Financial Statements

DIGITILITI, INC.

CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

ASSETS

September 30,

2009

December 31, 2008

CURRENT ASSETS

Cash

$

116,865

$

36,317

Accounts receivable

589,382

549,127

Prepaid and other current assets

151,978

201,488

TOTAL CURRENT ASSETS

858,225

786,932

PROPERTY AND EQUIPMENT

616,608

1,105,113

SOFTWARE LICENSE

1,115,384

1,302,158

DEFERRED FINANCING COSTS

71,919

202,484

OTHER ASSETS

6,322

6,322

TOTAL ASSETS

$

2,668,458

$

3,403,009

LIABILITIES AND STOCKHOLDERS DEFICIT

CURRENT LIABILITIES

Accounts payable

$

436,985

$

234,957

Accounts payable related parties	
	117,771
	104,869
Accrued expenses	
	920,086
	1,136,408
Due to related parties	

21,074

87,622

Current maturities of note payable

1,829,950

875,365

Current maturities of capital lease obligations

123,766

439,318

Current maturities of notes payable related parties

-

156,540

Current maturities of convertible debt

1,427,183

2,435,466

TOTAL CURRENT LIABILITIES

4,876,815

5,470,545

CAPITAL LEASE OBLIGATIONS

36,141

65,037

CONVERTIBLE DEBT

1,405,442

1,758,252

CONVERTIBLE DEBT related parties

-

342,532

DEFERRED RENT

16,781

18,130

OTHER LIABILITIES

-

3,607

TOTAL LIABILITIES

6,335,179

7,658,103

STOCKHOLDERS DEFICIT

Common stock, $.001 par value; 100,000,000 shares authorized,

34,736,316 and 26,665,020 shares issued and outstanding

34,736

26,665

Additional paid-in capital

13,876,413

10,092,294

Accumulated deficit

(17,577,870

)

(14,374,053

)

TOTAL STOCKHOLDERS DEFICIT

(3,666,721

)

(4,255,094

)

TOTAL LIABILITIES AND STOCKHOLDERS DEFICIT

$	2,668,458
$	3,403,009

See accompanying notes to consolidated financial statements.

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DIGITILITI, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

Three Months Ended

September 30,

Nine Months Ended

September 30,

2009

2008

2009

2008

REVENUES

$

760,017

$

880,549

$

2,479,965

$

2,211,958

COST OF REVENUES

245,479

242,612

681,801

609,249

GROSS PROFIT

514,538

637,937

1,798,164

1,602,709

OPERATING
EXPENSES

Selling and marketing	
	62,046
	195,692
	267,375
	520,815
General and administrative	
	320,413
	1,122,346

1,534,336

2,898,055

Depreciation and amortization

247,011

279,131

817,212

801,449

Research and development

206,504

402,542

539,383

1,339,413

TOTAL OPERATION EXPENSES

835,974

1,999,711

3,158,306

5,559,732

LOSS FROM OPERATIONS

(321,436)

(1,361,774)

(1,360,142

)

(3,957,023

)

LOSS ON SETTLEMENT OF PAYABLE

108,187

-

108,187

-

INTEREST EXPENSE	
	226,217
	643,294
	1,735,488
	1,506,018

NET LOSS

$

(655,840)

$

(2,005,068)

$

(3,203,817

)

$

(5,463,041

)

NET LOSS PER SHARE
BASIC AND DILUTED

$

(0.02)

$

(0.08)

$

(0.09

)

$

(0.22

)

WEIGHTED-AVERAGE SHARES OUTSTANDING BASIC AND DILUTED
34,648,490
25,701,388
33,845,310
25,386,626

See accompanying notes to consolidated financial statements.

DIGITILITI, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Nine Months Ended September 30,	
	2009	**2008**
OPERATING		

ACTIVITIES

Net loss

$

(3,203,817

)

$

(5,463,041

)

Adjustments to reconcile net loss to net cash used by

operating activities:

Depreciation and amortization	
	817,212
	801,449
Amortization of deferred financing costs	
	187,065
	201,848

Amortization of discount on convertible debt	769,336
	675,520
Loss on settlement of payable	108,187
	-
Bad debt expense	20,692

	-
Common stock issued for services	-
	568,149
Common stock issued for purchase of R & D	-
	375,000

Employee stock option expense	
	164,778
	910,402
Additional beneficial conversion feature on converted notes	
	158,597
	-
Warrants expense	

330,744

-

Changes in operating assets and liabilities:

Accounts receivable

(60,947
)

(367,900
)

Prepaid and other current assets	
49,510	
(31,935)	
Accounts payable	
202,028	
155,766	
Accounts Payable-related parties	
12,902	

-

Accrued expenses

330,448

697,909

Deferred rent

(4,956

)

(764

)

Net cash used by operating activities

(118,221

)

(1,477,597

)

INVESTING
ACTIVITIES

Purchase of property and equipment	(29,678)	(480,318)
Net cash used by investing activities	(29,678)	(480,318)

FINANCING ACTIVITIES

Proceeds from issuance of convertible debt	
	630,000
	2,480,370
Financing costs	

(54,500

)

(230,050

)

Payments on capital lease obligations

(352,678

)

(533,011

)

Proceeds from notes payable related parties

-

25,012

Payments on notes payable related parties

-

(10,000

)

Payments on due to related parties

(2,000)

-

Proceeds from notes payable

287,197

-

Payments on notes payable

(279,572)

-

Net cash provided by financing activities

228,447

1,732,321

DIGITILITI, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

(Continued)

	Nine Months Ended September 30,	
	2009	**2008**
NET INCREASE (DECREASE) IN CASH	80,548	

(225,594
)

CASH

Beginning of period

36,317

241,333

End of period

$

116,865

$

15,739

Cash paid for interest	
	59,802
	18,875
Cash paid for taxes	
	-
	-

Non-Cash Financing and Investing Activities:

Equipment acquired under capital lease	8,230	-
Notes payable issued to acquire software	104,025	-

Shares issued for accrued interest on convertible debt	
335,503	
-	
Shares issued for convertible debt	
2,312,700	
-	
Warrant and BCF discount on convertible debt	

237,163

-

Reclassification of related parties debt to non-related party debt

857,484

See accompanying notes to consolidated financial statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1. Organization, Basis of Presentation and Significant Accounting Policies

The accompanying unaudited interim financial statements of Digitiliti, Inc. have been prepared in accordance with accounting principles generally accepted in the United States of America and rules of the Securities and Exchange Commission, and should be read in conjunction with the audited financial statements and notes thereto contained in Digitiliti s audited financial statements for the year ended December 31, 2008. In the opinion of management, all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of financial position and the results of operations for the interim periods presented have been reflected herein. The results of operations for interim periods are not necessarily indicative of the results to be expected for the full year. Notes to the consolidated financial statements, which would substantially duplicate the disclosure contained in the audited financial statements, included in Digitiliti s Form 10-K, have been omitted.

New Accounting Pronouncements

On June 30, 2009, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162. This statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009. We have adopted this statement effective September 15, 2009.

In May 2009, FASB issued ASC Topic 855 Subsequent Events. This standard is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. Specifically, this standard sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. FASB ASC Topic 855 is effective for fiscal years and interim periods ended after June 15, 2009. The Company adopted this standard effective June 15, 2009, and has evaluated any subsequent events through November 13, 2009. The Company has disclosed these subsequent events in Note 7.

2. Going Concern

The accompanying financial statements for the nine months ended September 30, 2009, have been prepared assuming that the Company will continue as a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business.

As shown in the accompanying financial statements, we have incurred a net loss of $655,840 for the three months ended September 30, 2009 and an accumulated deficit of $17,577,870 for the nine months ended September 30, 2009. These conditions raise substantial doubt as to our ability to continue as a going concern.

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

3. Convertible Debt

12% Convertible Debt - $5.5million Private Offering

In November 2008, we initiated a request to all of our 12% convertible debt holders to either extend their respective convertible debt for another 18 months or to convert their principal and accrued interest into common stock. As of September 30, 2009, $2,582,700 of the convertible debt was converted into 8,435,858 shares and $2,917,300 of convertible debt was extended for an additional 18 months. The total extended convertible debts as of September 30, 2009, was $2,917,300, with $902,800 net of discount of $61,785 due in the next 12 months; $765,000 net of discount of $184,622 due in the next 18 months and $659,500 net of discount of $234,604 due in next 24 months. In addition, the Company is in default on $590,000 convertible debt net of discount of $3,832 as of September 30, 2009.

In exchange for extending their convertible debt for an additional 18 months, we agreed to reduce the exercise price of the associated warrants from $1.50 and $2.25 per share to $1.00 per share, respectively for the A and B warrants. In addition, we agreed to extend the term of both the A and B warrants from 5 years to 6 ½ years. Furthermore, the requirement of an effective registration was not removed in the case of extending the note.

In exchange for converting their convertible debt into common stock, we agreed to reduce the exercise price from $0.50 to $0.35 per share. We also agreed to reduce the exercise price of the associated warrants from the $1.50 and $2.25 per share to $1.00 per share, respectively for the A and B warrants. In addition, we agreed to extend the term of both the A and B warrants from 5 years to 6 ½ years. Furthermore, the requirement of an effective registration was removed to allow conversion.

We evaluated the extension event under FASB ASC Topic 470-50. Because the investors did not grant concession on these outstanding loans, the transactions were not accounted for as troubled debt restructuring. Consequently, we evaluated these transactions under FASB ASC Topic 470-50, Debtor s Accounting for a Modification or Exchange of Debt Instruments, to determine if the modification was substantial. As a result, no gain or loss was recorded on the date of the extension since the modification in terms is not considered significant. For the nine months ended September 30, 2009, the Company recognized $85,001 warrant expense associated with the extended debt under FASB ASC Topic 470-20 and charged the unamortized warrant discount to interest expense over the remaining life of the convertible debt under the new terms.

We accounted for the conversion event during the nine months ended September 30, 2009, under the provisions of FASB ASC Topic 470-20 ,Induced Conversions of Convertible Debt, and recognized expense totaling $201,107, which is equal to the fair value of the incremental compensation cost created by the modification of the exercise price of the warrants. The remaining unamortized warrant discount of $158,597 was recognized through Additional Paid in Capital under the guidance of FASB ASC 470-20.

In addition, the contingency related to the contingent beneficial conversion feature was resolved on the date of conversion. The beneficial conversion feature calculated on the commitment date was fully recognized through interest expense and Additional Paid in Capital according to FASB ASC 470-20. During the nine months ended September 30, 2009, $2,312,700 of debt was converted and $158,597 of the contingent beneficial conversion feature was recognized into interest expense.

12% Convertible Debt - $750,000 Private Offering

In April 2009, we engaged M2 Capital Advisors, Inc. (M2) as a consultant to introduce us to potential investors to raise up to $750,000 from the sale of 12% convertible debt and warrants that are secured against the assets associated with our Pharaoh Business Fortress Storage Center, subject to certain other liens. Under the conversion terms, the debt was convertible into common stock at $0.35 per share, subject to an effective registration statement covering the underlying common stock that has been filed with the Securities and Exchange Commission. In addition, for each $1 invested, the investor receives one warrant to acquire one share of common stock with a five year term at $0.50 per share. The warrants are callable at $0.01 per warrant, if the common stock of the Company trades for 20 consecutive days on its principal market above $1.50 per share, provided there is an effective registration statement covering the underlying common stock that has been filed with the Securities and Exchange Commission.

In conjunction with the sale of the 12% convertible debt referenced above, M2 received a 10% introductory fee, which totaled $52,000 pursuant to a Consulting Agreement. An additional $2,500 was paid to an unrelated consultant bringing total deferred financing costs associated with this convertible debt offering to $54,500 as of September 30, 2009. These introductory fees were accounted for as deferred financing cost and are being amortized using the effective interest method over the term of the convertible debt.

Through September 30, 2009, the Company has issued $630,000 in convertible debt and 630,000 warrants (Note 6) exercisable at $0.50 per warrant.

We analyzed the convertible debt and the warrants issued for derivative accounting consideration under FASB ASC Topic 815-15 (previously SFAS 133 and EITF 00-19), and determined that derivative accounting is not applicable for these debts.

The convertible debt was evaluated for a beneficial conversion feature under FASB ASC Topic 470-20 , at which time it was concluded that a contingent beneficial conversion feature existed for a substantial portion of the convertible debt. The beneficial conversion feature was measured using the commitment-date stock price to be $173,973. In addition, the relative fair value of the warrants were measured using the Black-Scholes Option Pricing Model to be $63,190 and recorded as a debt discount, which is being amortized over the life of the debt using the effective interest method. The total discount recorded was $237,163 and the unamortized balance at September 30, 2009, was $229,832.

A summary of the convertible debt as of September 30, 2009, and December 31, 2008 is as follows:

September 30, 2009
December 31, 2008

Gross proceeds from the debts	$ 6,130,000	$ 5,500,000
Less: discount on the warrants	(3,433,064)	(3,369,874)
Less: beneficial conversion feature	(173,973)	-
Less: principal		

converted to common stock

(2,582,700)

(270,000)

Add: accumulated amortization of discount

2,892,362

2,333,592

Subtotal

2,832,625

4,193,718

Less: current maturities

(1,427,183)

(2,435,466)

Long-term portion of convertible debt

1,405,442

1,758,252

A summary of the changes in convertible debt for the nine months ended September 30, 2009 is as follows:

Convertible debt at December 31, 2008	$	4,193,718
Add: gross proceeds from the convertible debt		

	630,000
Less: principal amount converted to common stock	(2,312,700)
Less: discount on the warrant	(63,190)
Less: beneficial conversion feature discount	(173,973)
Add: discount associated with converted debt	378,590
Add: amortization of discount	180,180

Convertible debt at September 30, 2009	$ 2,832,625

4. Related Party Transactions

In February 2009, we received the remaining $75,000 from a related-party under an on-demand note. This note bears interest at 1% above prime per annum. On July 31, 2009, the carrying balance of the note was reclassified to regular short term debt upon the individual s resignation as the director of the Company.

In October 2008, we issued a $250,000 12% convertible debt to an individual. The debt can be converted into our common stock at $0.50 per share, subject to an effective registration statement covering the underlying common stock that has been filed with the Securities and Exchange Commission. The issuance of this debt was originally guaranteed by a stockholder of the Company, but this guarantee was discharged prior to September 30, 2009. As a result, the carrying balance of the convertible debt was reclassified to short term debt. In conjunction with this convertible debt, we issued warrants to purchase 150,000 shares and 100,000 shares, respectively, of our common stock with a five year term at $0.50 per share. During April 2009, the note became due. However, the debt holder agreed to extend the note for additional six months and was then provided additional warrants to purchase 125,000 shares on the same terms. The additional warrants expense, $26,997, valued using Black-Scholes pricing model (Note 6), was expensed in the quarter ended June 30, 2009, as interest expense.

In November 2008, we issued a $250,000 12% convertible debt to a individual. The debt can be converted into our common stock at $0.35 per share, subject to an effective registration statement covering the underlying common stock that has been filed with the Securities and Exchange Commission. In conjunction with this convertible debt, we issued stock warrants to purchase 250,000 shares of our common stock with a five year term at $0.50 per share. The note became due in April 2009. As of November 13, 2009, the Company is in the process of negotiation terms with the debt holder to extend the note. On July 31, 2009, the carrying balance of the convertible debt was reclassified to short term debt upon the individual s resignation as the director of the Company.

Pursuant to a security agreement with the former stockholder, our Pyramid software and vaults along with other intellectual properties serve as the collateral for the above guarantee, convertible debt and the notes payable.

We analyzed the two convertible debts and the warrants issued for derivative accounting consideration under FASB ASC Topic 470-20, and determined that derivative accounting is not applicable for these debts.

Under the provisions of FASB ASC Topic 470-20, we discounted the relative fair value of warrants attached to the debt and calculated the intrinsic value of the beneficial conversion feature of the debt. The resulting discount of $210,974 is being amortized over the life of the debts using the effective interest method. The amortized amount for the nine month ended September 30, 2009, was $196,441, and for the year ended December 31, 2008, was $44,699.

5. Notes Payable

A summary of the notes payable as of September 30, 2009, and December 31, 2008, is as follows:

September 30,

	2009	December 31, 2008
Exanet Software Purchase Agreement	$ 485,000	$ 485,000
Asigra Software vendor financing	440,063	390,365

Note payable to an individual	47,403	-
Reclassification of due to former related party	71,637	-
Reclassification of notes payable to former related party	231,540	-
Reclassification of convertible debt to former related parties		

		554,307
		-
Total Notes Payable	$ 1,829,950	$ 875,365

In September 2009, an individual agreed to provide a loan totaling $70,500 with 15% interest per annum to the Company. The loan shall be funded in three installments of $23,500 each to the Company and as of September 30, 2009, two installments of $23,500 have been made. The loan shall be paid off in three consecutive payments of $20,000 each due on the first day of each month starting December 2009 and the remaining balance and accrued interest shall be due on March 1, 2010. In additions, the individual received 100,000 warrants to acquire shares of the Company (Note 6) in conjunction with the debt.

6. Stockholders Equity

Common Stock:

As of September 30, 2009, several convertible debt holders converted their investment in convertible debt in the amount of $2,312,700, net of discount of $378,590, in principal and accrued interest, to common stock. Total shares issued in exchange for the debt were 7,566,296.

On July 16, 2009, in exchange for the discharge of an approximate $100,227 of unpaid compensation due to 5X Partners, LLC (5X Partner), we issued 252,500 shares of our common stock to each of 5X Partners principals, Larry D. Ingwersen and Rod Johnson (individually). Fair value of the common stocks issued is $126,250 based on the quoted stock price on the date of grant.

Stock Options:

During the first quarter of 2009, options to purchase 650,000 shares of common stock were granted by the Company to four Board members at an exercise price of $0.385. These options have a contractual term of five years, and have a vesting term of three years. Fair value of $74,637 was calculated using the Black-Scholes option-pricing model. Variables used in the Black-Scholes option-pricing model for options issued during the quarter ended March 31, 2009 include (1) discount rate of 1.44%, (2) expected life of 3.5 years, (3) expected volatility of 152.07% and (4) zero expected dividends.

During the second quarter of 2009, options to purchase 450,000 shares of common stock were granted by the Company to two Board members at an exercise price of $0.385. These options have a contractual term of five years, and have a vesting term of three years. Fair value of $244,705 was calculated using the Black-Scholes option-pricing model. Variables used in the Black-Scholes option-pricing model for these options include (1) discount rate of 1.30%, (2) expected life of 3.5 years, (3) expected volatility of 161.08% and (4) zero expected dividends.

During the second quarter of 2009, options to purchase 150,000 shares of common stock were granted by the Company to two employees at an exercise price of $0.35. These options have a contractual term of five years, and have a vesting term of three years. Fair value of $30,498 was calculated using the Black-Scholes option-pricing model. Variables used in the Black-Scholes option-pricing model for these options include (1) discount rate of 1.39%, (2) expected life of 3.5 years, (3) expected volatility of 159.46% and (4) zero expected dividends.

During the second quarter of 2009, the Company also granted options to purchase 225,000 shares of common stock to three employees at an exercise price of $0.35. These options have a contractual term of five years, and the vesting is based upon successful launch of Pyramid product by August 31, 2009 and further extended to November 30, 2009. The shares shall revert back to the Company if the November 2009 launch is not attained. Fair value of $45,746 was calculated using the Black-Scholes option-pricing model for these options include (1) discount rate of 1.39%, (2) expected life of 3.5 years, (3) expected volatility of 159.46% and (4) zero expected dividends. However, the expense will not be recognized until the launch of the Pyramid product by November 30, 2009, becomes certain.

During the third quarter of 2009, options to purchase 450,000 shares of common stock were granted by the Company to two Board members at an exercise price of $0.385. These options have a contractual term of five years, and have a vesting term of three years. Fair value of $79,525 was calculated using the Black-Scholes option-pricing model.

Variables used in the Black-Scholes option-pricing model for these options include (1) discount rate of 1.42%, (2) expected life of 3.5 years, (3) expected volatility of 183% and (4) zero expected dividends.

A summary of option activities for the nine months ended September 30, 2009, was as follows:

	Options	Weighted-Average Exercise Price
Outstanding at December 31, 2008		

4,116,806

$

0.37

Granted

1,700,000

0.38

Forfeited

(1,623,806)

0.37

Outstanding at September 30, 2009

4,193,000

0.37

Stock option expense for the nine months ended September 30, 2009, was $164,778.

Stock Warrants:

During the first quarter of 2009, warrants to purchase 100,000 shares of common stock were granted by the Company to one of its former employee at an exercise price of $0.35. These warrants have a term of five years and they vest immediately. Fair value of $16,270 was calculated using the Black-Scholes option-pricing model. Variables used in the Black-Scholes option-pricing model for warrants issued during the quarter ended March 31, 2009, include (1) discount rate of 1.79%, (2) warrant life of five years, (3) expected volatility of 142.26% and (4) zero expected dividends.

During the second quarter of 2009, warrants to purchase 300,000 shares of common stock were granted by the Company to one of its former employee at an exercise price of $0.385. These warrants have a term of five years and they vest immediately. Fair value of $42,535 was calculated using the Black-Scholes option-pricing model. Variables used in the Black-Scholes option-pricing model for warrants issued during the quarter ended June 30, 2009, include (1) discount rate of 1.79%, (2) warrant life of five years, (3) expected volatility of 165.39% and (4) zero expected dividends.

During the second quarter of 2009, warrants to purchase 50,000 shares of common stock were granted by the Company to one of its employees at an exercise price of $0.35. These warrants have a term of five years and they vest immediately. Fair value of $26,787 was calculated using the Black-Scholes option-pricing model. Variables used in the Black-Scholes option-pricing model for warrants issued during the quarter ended June 30, 2009, include (1) discount rate of 1.79%, (2) warrant life of three years, (3) expected volatility of 168.03% and (4) zero expected dividends.

During the second quarter of 2009, warrants to purchase 125,000 shares of common stock were granted by the Company to one of its convertible note holders at an exercise price of $0.50 (Note 4). These warrants have a term of three years and they vest immediately. Fair value of $26,997 was calculated using the Black-Scholes option-pricing model. Variables used in the Black-Scholes option-pricing model for warrants issued during the quarter ended June 30, 2009, include (1) discount rate of 1.79%, (2) warrant life of three years, (3) expected volatility of 146.35% and (4) zero expected dividends.

During the third quarter of 2009, warrants to purchase 100,000 shares of common stock were granted by the Company to an individual who provided loan to the Company at an exercise price of $0.20. These warrants have a term of five years and they vest immediately. Fair value of $17,048 was calculated using the Black-Scholes option-pricing model. Variables used in the Black-Scholes option-pricing model for warrants issued during the quarter ended September 30, 2009, include (1) discount rate of 1.79%, (2) warrant life of five years, (3) expected volatility of 165.56% and (4) zero expected dividends.

During the third quarter of 2009, in exchange for the discharge of an approximate $100,227 balance of unpaid compensation due a former vendor, 5X Partners, LLC (5X Partner), we issued warrants to purchase 360,000 shares of common stock at an exercise price of $0.385. These warrants have a term of five years and they vest immediately. Fair value of $82,164 was calculated using the Black-Scholes option-pricing model. Variables used in the Black-Scholes option-pricing model for warrants issued during the quarter ended September 30, 2009, include (1) discount rate of 2.52%, (2) warrant life of five years, (3) expected volatility of 160.02% and (4) zero expected dividends.

In connection with a private offering initiated in the nine months ended September 30, 2009, the Company issued warrants to purchase 630,000 shares of its common stock to certain institutional and accredited investors (Note 3). These warrants expire in five years, are exercisable at $0.50 per share immediately. These warrants are classified as equity and have a fair value of $144,898.

A summary of warrant activities for the nine months ended September 30, 2009 was as follows:

	Warrants	Weighted-Average Exercise Price

Outstanding at December 31, 2008

6,200,348

$

1.59

Granted

1,665,000

0.39

Outstanding at September 30,

2009	
	7,865,348
	1.34

Stock warrant expense for the nine months ended September 30, 2009, was $211,801.

7. Subsequent Events

On October 2, 2009, the Company completed the secured convertible debt offering of $750,000 initiated in April of this year. $66,500 in introduction fees were paid as part of this offering, including $ 64,000 to M2.

On October 15, 2009, the Company held its 2009 Annual Shareholder s Meeting and elected Roy A. Bauer (Chairman), Karen Gilles Larson and Kedar Belhe to one year term as Board members.

On October 30, 2009, the Board approved a compensation package for Roy A. Bauer that reflects a base salary and other incentive common stock and warrant issuances based on the Company s future performance.

On November 9, 2009, we entered into a confidential agreement with a holder of a delinquent convertible note that involves an alternative payment arrangement anticipated to be made by an unrelated third party. Successful compliance with this alternative payment arrangement will prevent the filing of a Confession of Judgment executed by the Company.

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

Forward-looking Statements

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

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

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

Plan of Operation

Our business is developing and delivering superior storage technologies and methodologies enabling our customers to manage, control, protect and access their information and data with ease. Our core business is providing a cost effective data protection solution to the small to medium business (SMB) and small to medium enterprise (SME) markets through our remote Pharaoh Business Fortress Storage Center. This data protection solution helps organizations properly manage and protect their entire network from one centralized location. Our solution can backup and restore emails and data on every machine in a network, including desktops, laptops, file and print servers. We provide storage through a utility based computing philosophy, where customers pay for the gigabytes of data they store in our Fortress Storage Center.

Through our Pharaoh Business Fortress Storage Center, we combine powerful, agent-less backup software with our remote, highly protected facility, to deliver to our customers an efficient and effective online-offsite data backup and restore solution. Our facilities enable us to provide offsite disaster recovery emphasizing intraday protection and restore for all of our customer primary data centers and geographically dispersed offices or campus settings. Our Fortress Storage Center is located in the base of the former Minneapolis Federal Reserve Bank. It is a one of a kind facility providing web based on-demand backup/restore service (digitiliti) with all the benefits of direct fiber access to a Level 5 data center. The Fortress Storage Center has 24/7 onsite physical security, including security guards, motion detectors, security cameras, card-key access, separate cages with individual locking cabinets and ladder racking. It also has battery generator back up power, temperature and humidity controls and fire suppression systems. Geographically, we are located at the center point of the Metropolitan area network. Being centrally located at the focal point of the Twin Cities Fiber Channel and Gig loop, the pipeline for data and load capabilities are immense.

The Fortress Storage Center houses all of the hardware and software needed for our digitiliti solution. At the customer site, digitiliti administrator software is loaded on as many or as few workstations as desired and requires a valid logon code, ensuring no unauthorized access. At the customer site, the administrator software console acts as the interface with digitiliti in the Fortress Storage Center and enables the configuration of all backups and restores. The digitiliti backup software is totally agent-less, requiring no additional software to be installed on any machines. From the customer administration console, the customer sets retention policies, schedules automatic backups and initiates restores. The customer decides what files to backup: emails, Windows, Linux, Mac, Lotus, AS400 or many more. Customers typically start backing up one system and then add more systems to their backup sets as they continue to see how easily our digitiliti solution works.

For large data volumes, the initial data backup may be downloaded to a portable disk unit at the customer site. When the full backup of data is complete, the disks are transported to the Fortress Storage Center where the data is loaded onto the equipment in the Fortress Storage Center. From then on, all data is backed up in incremental changes over the Internet. All data is encrypted before it leaves the customer site and when stored offsite. The encryption key is known only to the customer. The data can be unencrypted only by the customer, who would do so upon the need of a restore. If a customer loses their local data, they simply enter the commands to restore it via the administration console and data flows from the Fortress Storage Center back to the customer site. If the customer loses all data, digitiliti can restore the latest data to a location of the customer s choosing using a portable disk unit. In addition to being encrypted, the data is also highly compressed, making it safe and impenetrable from viruses and optimizing customers storage costs per gigabyte.

We contract with XO Communications for our Fortress Storage Center space and communication lines. XO Communications provides voice, data and IP services to businesses and other telecommunications companies in 75 metropolitan markets across the United States. This relationship helps control capital expenditures yet maintains flexibility to set up a new data center in any one of 80 geographically dispersed locations throughout the world, thereby reducing any geographic concerns about our digitiliti.

As a result of our sales and marketing efforts of our existing product, Pharaoh, our customer base has expanded from approximately 20 in fiscal 2005; to approximately 100 in fiscal 2006; to 508 in 2007; to 731 in 2008 and 707 at September 30, 2009. Correspondingly, our annual sales have increased from $402,638 in 2006; to $1,329,386 in 2007; to $3,075,308 in 2008; and to $2,479,965 through the first nine months of 2009. Despite the significantly improved revenue from sales, we continue to struggle with profitability because of new product development, legacy issues of past due accounts payable and potential convertible debt repayment requirements (see more on our action plans, below).

Our primary focus in 2009 is to begin a shift in strategic direction. We considered a number of alternatives in our portfolio including selling our current Pharaoh Vault Business Service in order to satisfy needs for cash. Our reasons for making a strategic shift from current business to our future new product are: (i) to solve a major industry and customer problems of managing their continually growing information volume and associated cost of storage and retrieval; (ii) to be able to access a larger share of opportunity in the information management storage business; (iii) our new technology will offer significant technological advantages in corporate policy level control of information and ability to leverage knowledge from the information it creates; and (iv) our requirement to decide strategically how to apply capital and resources between our current and future business. We strongly considered selling the Vault Business. We signed a Letter of Intent (LOI) to pursue this sale with a buyer, after considering a number of alternative interested parties. From the LOI, we worked for three months to close on an Asset Purchase Agreement (APA). We could not agree to the terms of this agreement, and therefore decided to end the negotiations. Out of that effort, we considered pursuing other potential buyers or evaluating structural changes to take our Vault forward strategically. Given there is synergism in both our current and new business ,it is to our long term advantage to work out a strategy of moving forward with both and systematically transitioning to a new future business model, leveraging information life cycle management and control, client-based access to all stored information and data archiving. Implementing this strategy offers potentially greater shareholder value, but will require a strongly managed effort between short and long term needs and goals.

We invested significant effort in design and market research in 2008, and, after missing our planned development schedule in late 2008 and early 2009, have been in intense development in the first half of 2009. We have implemented a rigorous product development approach, established a concrete architectural framework and a very specific product development plan, with key development milestones and with automated test and integration system. We have restructured the product development team, and we are currently on schedule to introduce our new product in the fourth quarter of 2009 and begin generating sales at that time. We established three key milestones in our development plan, the first being a May 15, 2009, date to have the reference platform completed.

This means that the basic technology underpinnings and performance capabilities of our new product, Pyramid, are operational and meeting requirements. This reference platform is the core intellectual property we will introduce to the market and it validated the feasibility of the approach. The second milestone was June 15, 2009. In this milestone, we began to integrate the end user and back-office functions. The third milestone was July 15, 2009, which constitutes Release 1 Function-freeze. We have successfully completed each milestone and entered customer Beta testing in third quarter 2009. Under Non-Disclosure and Confidentiality agreements, we have been demonstrating our new product capability for the past three months with potential customers, resellers and industry experts, to get feedback and to evaluate our Release 1 content. We have received excellent feedback on the capability, performance and function our new product delivers.

Through these confidential disclosures and demonstrations, we have determined that our new product is positioned to change the current information management and storage approach and achieve significant market opportunity. This is based upon our belief that we will offer a solution addressing the root cause of an industry-wide problem of data proliferation, volume growth, limited-to-no policy-level information control and all of the associated cost and management problems that are a result and that we can solve these problems with significantly better cost performance and simplicity. Our new product represents a significant step toward our goal of becoming a technology leader in the information management marketplace. Pyramid offers a breakthrough approach to how companies store , archive and utilize information for competitive advantage. It will finally enable customers to control the information they create and access that information to gain business intelligence.

We are in the process of refining our digitiliti marketing deliverables, our sales and marketing systems, our product packaging and going forward business plan. We believe we will introduce this new, industry-changing capability well ahead of any other potential competitors. Presently, we believe there are no competitors with our end-to-end capability and client-based architecture. We have high confidence in our development plan and our development team and believe our schedule and capability are attainable in accordance with our goals.

In order to fund the new product launch, we have been aggressively reducing overall operating costs to increase profitability of our Pharaoh operations. Since 2008, we have reduced our annual salaries and wages by over 20%, while increasing operational efficiencies and lowering overall costs of goods sold. Through third quarter 2009, we implemented additional restructuring of our Pharaoh operations to increase profitability, improve cash flow and reduce cash burn rate. Through these actions, we reduced our cash burn rate per month by approximately $100,000. Last quarter, we reported a 35% reduction in operating expenses through the first six months. As you will see in our Results of Operations below, through the first nine months of 2009, we reduced our operating expenses even further, by 44%. We continue to raise additional capital (April 2009 offering, see below) to assure we have the financial resources to achieve our strategy, albeit that we are balancing our desire to aggressively launch our new product with the reality of available capital. We have agreed to a payment plan with our primary Vault software provider, Asigra. This payment plan addresses the approximately $550,000 past due licenses from 2008 as well as those licenses and maintenance fees due in 2009 and the first quarter 2010 of approximately $300,000. The payment plan addresses all of these costs, allocated in a monthly payment plan for the next eight months. We currently are negotiating reductions in those license costs as a result of improvements we have made to the Pharaoh Vault architecture. Further, we expect to complete the Data Sales lease in November, 2009. The objective of these actions is to allow us to achieve break-even cash flow in 2010 as we accelerate new product sales. We held our first annual shareholder meeting on October 15, 2009. The shareholder presentation, along with questions and answers is posted on the www.digitiliti.com web site.

Continuing operations have been funded, in large part, through our $5.5 million offering of 12% convertible notes initiated in March 2007, and our $750,000 convertible note offerings of April 2009. Prior to implementation of the Modification Proposal (discussed below), the March 2007 convertible notes reflected a $0.50 per share conversion rate upon expiration of an 18-month maturity date, currently resulting in principal and accrued interest due of $1,334,770, estimated as of December 31, 2008. In addition, for every dollar invested, these convertible notes allowed each investor to receive one-half warrant to acquire one-half of a share of our common stock with a five year term at $1.50 per share and $2.25 per share, respectively. No warrant could have been exercised during the first six months and one day following issuance, unless there was an effective registration statement covering the underlying common stock that has been filed covering the shares underlying these warrants with the Securities and

Exchange Commission. The April 2009 convertible note offering terms were comprised of 12% convertible notes for 24 months, secured against the Pharaoh Vault, converting to $0.35 per share, and warrant coverage at $0.50 per share We completed the first secured $750,000 offering in October, 2009.

We directly contacted our convertible note holders to seek to restructure this debt by asking the holders to extend the due dates of their respective convertible notes or to encourage them to convert their respective convertible notes (the Modification Proposal). On November 13, 2008, as a demonstration of confidence in our current plan, and as an act of good faith, our Board of Directors unilaterally approved a reduction in the $1.50 and $2.25 exercise prices of the convertible note holders warrants to $1.00 for both classes of warrants. In addition, our Board of Directors approved an overall reduction in the conversion price of all convertible notes from $0.50 per share to $0.35 per share; the resolutions provided that the reduced conversion price would be retroactive to include any convertible note holders who had already elected to convert their respective convertible notes. $35,000 in convertible notes had already been converted at the time of these resolutions; accordingly, we were obligated to issue a total of 109,000 shares of our common stock for division among these holders. The table under Part II, Item 3, below, presents information about our convertible notes that are still outstanding following conversions and extensions of convertible notes under our Modification Proposal. Please see Part II, Item 3. Also, see Note 3 to our consolidated financial statements above. With the emergence of our new product, we have been able to keep most note holders interested in the potential it offers.. We continue to work with convertible note holders who have not converted or extended to work out mutually agreeable solutions to avoid further cash drain as we launch our new product.

Results of Operations

For the three months period ended September 30, 2009, and 2008

Our sales for the quarter ended September 30, 2009, decreased $120,532 to $760,017, compared to $880,549 for the quarter ended September 30, 2008. This 14% decrease in revenue results from the re-pricing of certain select customers and the attrition of 24 customers from our digitiliti service due to competitive pressures brought on by a changing marketplace.. While our core customer organic data growth has remained a consistent 2% - 3% percent growth per month, the overall economic downturn has slowed our new customer growth when compared against previous periods.. Yet, we still continue to heavily market our digitiliti service through attendance at industry tradeshows, enhanced website development, refining our product presentation, positioning and pricing models. And finally, we have continued to enhance our network of resellers throughout the country by providing strong dealer support services and offering a compelling pricing program.

Our quarterly gross profit reflects a decrease of $123,399 with a gross profit of $514,538 in the third quarter 2009, versus $637,937 in third quarter 2008. This decrease in gross profit is attributable to economic pressure requiring us to re-price certain select customer accounts. In addition, we have restructured our operations effective in September 2009 and will experience an approximate savings of $25,400 per month in operating overhead associated with our digitiliti service.

With a 68% gross margin during third quarter 2009, we continue to maintain a consistently strong gross margin percentage by targeting larger profile customers through efficient customer pricing; and benefiting from our customers consistent increase in their organic growth . Again, we have learned that our sales and marketing efforts are better expended targeting larger customers in the Small Medium Business (SMB) and Small Medium Enterprise (SME) markets. We have learned how to sell our digitiliti service to this larger profile customer, which has increased our revenue, proportionately reduced our costs of revenue and has allowed us to leverage our infrastructure and efficiently bill for our customers data growth in our Fortress Storage Center vault.

Research and development expenses decreased from $402,542 to $206,504 comparing the quarterly periods ended September 30, 2008, and 2009. This reduced research and development cost incurred in 2009 reflects our budget and control efforts in developing enhanced storage service offerings that we can deploy through larger, more economical sales channels, thereby enabling faster growth.

Selling and marketing expenses decreased to $62,046 from $195,692 comparing the quarterly periods ended September 30, 2009, and 2008, reflecting a decrease of $133,646. This decrease principally reflects our success in learning to market our digitiliti service to resellers who have the requisite expertise to produce immediate results. Further, we have not only learned to market our digitiliti service to larger profile customers, but also to larger profile and more technically proficient resellers, thereby resulting in increased sales with fewer (or more efficient) marketing expenditures.

General and administrative expenses decreased by $801,933 to $320,413 for the quarterly period ended September 30, 2009, compared to $1,122,346 during the quarterly period ended September 30, 2008. The considerable general and administrative expenses incurred in 2008 are primarily comprised of consulting fees, stock-based compensation and legal and accounting expense that have significant reduced or eliminated through vendor and employee restructuring.

Interest expense during the quarter ended September 30, 2009, decreased by $417,077 to $226,217, compared to $643,294 for the quarter ended September 30, 2008. As a result of the initiative to request all of our 12% convertible debt holders to either extend or convert their respective convertible debt during the first quarter 2009, we experienced a conversion of $2,312,700 of convertible debt into our common stock. Correspondingly, the reduced total of convertible debt resulted in a lower accrued interest total during the third quarter 2009.

For the nine months ended September 30, 2009, and 2008

Our sales through September 30, 2009, increased $268,007 to $2,479,965, compared to $2,211,958 sales through the nine months ended September 30, 2008. This reflects a 12% increase over 2008 sales and primarily results from the average 2-3% monthly increase in our customer s organic data growth. We still continue to market our digitiliti service through attendance at industry tradeshows, enhanced website development, refining our product presentation, positioning and pricing models. And finally, we have continued to enhance our network of resellers throughout the country by providing strong dealer support services and offering a compelling pricing program.

Our gross profit reflects an increase of $195,455 with a gross profit of $1,798,164 through September 30, 2009, versus $1,602,709 through September 30, 2008. Factors contributing to our strong gross profit totals are our deliberate targeting of a larger profile customer for more efficient customer pricing and continued increase in monthly organic growth of our customers data. In short, we have learned that our sales and marketing efforts are better expended targeting larger customers in the SMB and SME markets. We have learned how to sell our digitiliti service to this larger profile customer, which has increased our revenue, proportionately reduced our costs of revenue and has allowed us to leverage our infrastructure and efficiently bill for our customers data growth in our Fortress Storage Center vault.

Research and development expenses decreased from $1,339,413 to $539,383 during the nine months ended September 30, 2008, and 2009, respectively. This significant decrease reflects initial software acquisition costs incurred during 2008. The reduced research and development cost incurred in 2009 reflects our budget and control efforts in developing enhanced storage service offerings that we can deploy through larger, more economical sales channels, thereby enabling faster growth.

Selling and marketing expenses decreased to $267,375 from $520,815 for the nine months ended September 30, 2009, and 2008, respectively, reflecting a decrease of $253,440. This decrease principally reflects our success in learning to market our digitiliti service to resellers who have the requisite expertise to produce immediate results. Targeting our marketing to larger profile customers and more technically proficient resellers has in increased sales with fewer (or more efficient) marketing expenditures.

General and administrative expenses decreased by $1,363,719 to $1,534,336 compared to $2,898,055 during the nine months ended September 30, 2009, and 2008, respectively. The considerable general and administrative expenses incurred in 2008 reflect the consulting fees, stock-based compensation and legal and accounting expense incurred as a result of our efforts in filing our Form 10 Registration Statement with the Securities and Exchange Commission during 2008.

Interest expense during the nine months ended September 30, 2009, increased by $229,470 to $1,735,488, compared to $1,506,018 for the nine months ended September 30, 2008. As referenced in Note 3 of our consolidated financial statements above, we initiated a request to all of our 12% convertible debt holders to either extend or convert their respective convertible debt. As a result of this initiative, during the 1 st quarter of 2009, we experienced a conversion of $2,312,700 of convertible debt into our common stock. This large conversion of convertible debt into our common stock resulted in recognition of the associated unamortized warrant discount and the related contingent beneficial conversion feature to be recognized through an adjustment to interest expense.

Liquidity

Our liquidity is dependent, in the short term, on proceeds from newly issued debt and the sale of our common stock for cash. In the long term, we may need to continue expanding our capacity of the Fortress Storage Center by investing in property and equipment and software licenses.

We have financed our operations, debt service and capital requirements through cash flows generated from operations, the issuance of secured and unsecured convertible debt financing, capital leases and issuance of equity securities. We had a working capital deficit of $4,018,590 at September 30, 2009. We had cash of $116,865 as of September 30, 2009, compared to having cash of $36,317 at December 31, 2008.

We used $118,221 of net cash from operating activities for the nine months ended September 30, 2009, compared to using $1,477,597 for the nine months ended September 30, 2008. Cash used in operating activities during the nine months ended September 30, 2009 funded a net loss of $3,203,817. This net loss was offset by non-cash charges of $817,212 for amortization and depreciation, $164,778 associated with stock options expense, $956,401 related to amortization of the discount on our convertible debt and deferred financing costs, $108,187 loss on settlement of payable, $158,597 additional beneficial conversion feature on converted notes, $330,744 warrants expense, and $202,028 and $330,448, respectively, associated with an increase in accounts payable and accrued expenses, respectively. Cash used in operating activities during the nine months ended September 30, 2008, funded a net loss of $5,463,041. This net loss was offset by non-cash charges of $801,449 for amortization and depreciation, $910,402 associated with stock options expense, $877,368 related to amortization of the discount on our convertible debt and deferred financing costs, $943,149 common stock for services and purchase of R&D, and ($367,900) associated with an increase in accounts receivable and $697,909 associated with an increase in accrued expenses.

Net cash flows used by investing activities was $29,678 for the nine months ended September 30, 2009, compared to net cash flows used in investing activities of $480,318 for the nine months ended September 30, 2008. Both comparable totals are attributed to our purchase of property and equipment during these two periods.

Net cash flow provided by financing activities were $228,447 for the nine months ended September 30, 2009, compared to net cash provided by financing activities of $1,732,231 for the nine month ended September 30, 2008. During the nine months ended September 30, 2009, cash provided by financing activities is primarily due to proceeds of $630,000 received from the issuance of secured convertible debt, and $287,197 received from the proceeds of notes payable offset by $54,500 related financing costs and $352,678 payments on capital leases and $279,572 payments on notes payable. During the nine months ended September 30, 2008, cash provided by financing activities is primarily due to proceeds of $2,480,370 received from the issuance of convertible debt, offset $230,050 of related financing costs and $533,011 payments on capital leases.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

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

Item 4T. Controls and Procedures.

Evaluation of disclosure controls and procedures

Disclosure controls and procedures have been designed to ensure that information required to be disclosed by the Company is collected and communicated to management to allow timely decisions regarding required disclosures. The Chief Executive Officer and the Chief Financial Officer have concluded, based on their evaluation as of September 30, 2009 that, as a result of the following material weaknesses in internal control over financial reporting as described further in the Company s Annual Report on Form 10-K filed with the SEC on May 1, 2009, disclosure controls and procedures were not effective in providing reasonable assurance that material information is made known to them by others within the Company:

(a) We did not maintain sufficient personnel with an appropriate level of technical accounting knowledge, experience, and training in the application of generally accepted accounting principles commensurate with our complexity and our financial accounting and reporting requirements. We have limited experience in the areas of financial reporting and disclosure controls and procedures. As a result, there is a lack of monitoring of the financial reporting process and there is a reasonable possibility that material misstatements of the consolidated financial statements, including disclosures, will not be prevented or detected on a timely basis; and

(b) There is a lack of sufficient accounting staff which results in a lack of segregation of duties necessary for a good system of internal control. This control deficiency, which is pervasive in nature, results in a reasonable possibility that material misstatements of the financial statements will not be prevented or detected on a timely basis.

Management s efforts to address these deficiencies in its disclosure controls and procedures is reflected in its commitment to providing continued education and training for our Chief Financial Officer and accounting staff to ensure the level of expertise required for a public company. In addition, management has budgeted in the coming year for additional accounting staff to address internal control weaknesses associated with lack of segregation of duties.

Changes in internal control over financial reporting

There have been no changes to our internal control in the quarter ended September 30, 2009.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

On July 13, 2009, we were made a party to a legal proceeding seeking recovery of unpaid compensation for alleged services rendered to us during 2008 and 2009. At this time, we dispute the nature of the alleged services rendered as well as the value of said services.

On November 9, 2009, we entered into a confidential agreement with a holder of a delinquent convertible note that involves an alternative payment arrangement anticipated to be made by an unrelated third party. Successful compliance with this alternative payment arrangement will prevent the filing of a Confession of Judgment executed by the Company.

Item 1A. Risk Factors.

This Item is not required of a smaller reporting company like us; however, various risk factors about us and our business prospects and products is contained in Item 1A of our 10-K Annual Report for the year ended December

31, 2008, which was filed with the Securities and Exchange Commission on May 1, 2009, all of which are still applicable to us.

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

Quarterly Period Ended September 30, 2009

During the three months ended September 30, 2009, our Board of Directors approved the issuance of the following equity securities to certain directors: 225,000 stock options to Benno Sand and Rick Rickenbach (individually) granted on September 16, 2009 (the date each was elected to serve on our Board of Directors to fill two vacancies) reflecting a $0.385 exercise price and vesting over a three year period.

On July 16, 2009, in exchange for the discharge of an approximate $100,227 balance of unpaid compensation due a former vendor, 5X Partners, LLC (5X Partner), we issued warrants to purchase up to 180,000 shares of our common stock to each of 5X Partners principals, Larry D. Ingwersen and Rod Johnson (individually), reflecting a price of $0.385 per share exercisable any time prior to June 1, 2014. In addition, we agreed to issue 252,500 shares of our common stock to each of 5X Partners principals, Larry D. Ingwersen and Rod Johnson (individually).

Subsequent to September 30, 2009

In April 2009, we initiated an offering reflecting the sale of 12% convertible note that evidenced a 24-month maturity date secured against the Pharaoh Vault with an option to convert principal and accrued interest at to $0.35 per share along with warrant coverage at $0.50 per share. On October 2, 2009, we closed this convertible note offering.

Also see Part II, Item 5, below, which describes compensation granted to Roy A. Bauer, our Chairman and CEO, which included shares of our common stock that are restricted securities, among other compensation.

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

Item 3. Defaults Upon Senior Securities.

After implementation of our Modification Proposal (discussed in our Plan of Operation above in Part I, Item 2) and further discussed in Note 3 to our consolidated financial statements above, the following reflects the total amount of convertible notes that were outstanding, the remaining principal and accrued interest outstanding from those convertible note holders that did not convert or extend their convertible notes as of November 14, 2009.

Total

Due Date

Total

Total

Principal &

For

Principal

Acc. Interest

Accrued

Principal &

Balance of

on

Interest on

Accrued

Total of

Conv. Notes

Conv. Notes

Conv. Notes

Interest on

Convertible

Outstanding

Outstanding

Outstanding

Convertible

Notes Sold at

as of

as of

as of

Notes at

12/31/2008

11/14/2009

11/14/2009

11/14/2009

11/14/2009

1st Qtr 2007

$ 401,050

$ 60,000

$ 19,620

$ 79,620

Sep-08

2nd Qtr 2007

$ 707,500

$ 225,000

$ 67,973

$ 292,973

Dec-08

3rd Qtr 2007

$ 1,165,000

$ 105,000

$ 28,062

$ 133,062

Mar-09

4th Qtr 2007

$ 926,000

$ 140,000

$ 34,992

$ 174,992

Jun-09

1st Qtr 2008

$ 808,500

$ 15,000

$ 3,060

$ 18,060

Sep-09

2nd Qtr 2008

$ 945,500

$ 98,000

$ 17,976

$ 115,976

Dec-09

3rd Qtr 2008

$ 546,450

$ 65,000

$ 10,163

$ 75,163

Mar-10

$ 5,500,000

$ 708,000

$ 181,846

$ 889,846

Based on the analysis detailed above, we are subject to currently due principal and accrued interest of $889,845.

Relative to the matured convertible notes detailed above, we have not entered into any formal payment schedules, and we continue to negotiate alternative payment arrangements.

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

We held our annual meeting of shareholders on October 15, 2009, at which three of our directors were elected for the coming year, with two other directors continuing. Our shareholders voted for, against and abstained in the voting for each director who was nominated as follows:

	For	Against	Abstain
Roy A. Bauer	26,226,323	70,284	452,569
Karen Gilles Larson	26,033,718		

70,284

244,974

Kedar Belhe

25,983,518

70,284

244,974

Item 5. Other Information.

Currently pending is the extension of a $250,000 convertible note held by a former Board member. This convertible note matured on May 20, 2009, and we have been in discussions with this convertible note holder regarding acceptable terms that may be associated with the extension of this convertible note.

During the three months ended June 30, 2009, a $250,000 12% convertible note held by a shareholder with a maturity date of April 20, 2009, was extended to October 20, 2009. In return for the nine month extension of this convertible note, the shareholder released a Board member s personal guarantee of this note and received 125,000 warrants reflecting at an exercise of $0.50 per warrant. At this time, we have not received official approval from this shareholder to further extend this convertible note.

On July 31, 2009, Jonathan S. Miner and Pamela J. Miner resigned as directors and from their respective positions on our Compensation and Governance Committees. There were no disagreements between Mr. and Mrs. Miner and us regarding these resignations.

On July 13, 2009, we announced that as mentioned in our Annual Report for the year ended December 31, 2008, we were evaluating strategic alternatives within the portfolio of our business, including the divesting of our Pharaoh

Vault business. Although we had made a concerted effort toward that end, we could not reach agreement on key terms of an Asset Purchase Agreement with a potential purchaser, and we were unsuccessful in that effort.

On September 16, 2009, we announced the appointment of two new members to the Board of Directors. Benno Sand and Rick Rickenbach were appointed effective September 16, 2009. Mr. Sand was also appointed Chair of the Audit Committee.

On October 30, 2009, our Board of Directors approved the following compensation package for our Chairman and CEO, Roy A. Bauer, with Mr. Bauer abstaining from the vote:

Base Salary:

$175,000 per year;

Salary from February 9, 2009, through September 30, 2009, of $ 109,375.05, to be paid in shares of our common stock that are restricted securities as defined in Rule 144 of the Securities and Exchange Commission at $0.20 per share, equal to 546,875 shares; and

Commencing October 1, 2009, salary payable monthly as follows: half to be paid in cash ($7,291.67) per month and half to be paid in grants of shares of our common stock that are also restricted securities at $0.20 per share or 36,458 shares per month.

Other Compensation:

Signing Bonus: 500,000 five year warrants to acquire 500,000 shares of our common stock that are also restricted securities at $0.20 per share, effective February 9, 2009; and

A one-time performance bonus of $50,000 earned if Mr. Bauer is our CEO on December 31, 2009, and to be paid in cash during the first quarter of 2010 as recognition for 2009 performance and commitment to us and our shareholders.

Performance Incentives:

For the commercial launch of our Pyramid product no later than March 31, 2010: 250,000 five year warrants to acquire 250,000 of shares of our common stock that are also restricted securities at $0.35 per share;

For raising a minimum of $3 million of capital no later than June 30, 2010: 250,000 five year warrants to acquire 250,000 shares of our common stock that are also restricted securities at the price of $0.50 per share; and

For building management capabilities and implementing an orderly CEO transition plan (criteria to be defined) prior to December 31, 2010: 250,000 five year warrants to acquire 250,000 shares of our common stock that are also restricted securities at $0.50 per share.

Item 6. Exhibits.

Exhibit No.	**Identification of Exhibit**	
3.1	Initial Certificate of Incorporation filed March 31, 2006.	Exhibit to our Form 10
3.2	Bylaws.	Exhibit to our Form 10
3.3	Certificate of Amendment regarding the name change to Digitiliti, inc. and the Recapitalization.	Exhibit to our Form 10
3.4	Certificate Correction regarding the name change to Digitiliti, Inc.	Exhibit to our Form 10
3.5	Amended and Restated Certificate of Incorporation filed May 13, 2008.	

Exhibit to our Form 10

10.1

Stock Purchase Agreement between Storage and our former principal shareholders under which Storage acquired a controlling interest in us.

Exhibit to our Form 10

10.2

Agreement and Plan of Merger between us, Themescapes and Bulldog under which we became a holding company.

Exhibit to our Form 10

10.3

Agreement and Plan of Merger, as amended, between us, Cyclone Acquisition and Storage under which Storage became our wholly-owned subsidiary.

Exhibit to our Form 10

10.4

XO Communications Contract.

Exhibit to our Form 10

10.5

FRM Associates Lease, as amended.

Exhibit to our Form 10

10.6

EBC Minneapolis, Inc. Sublease Agreement.

Exhibit to our Form 10

10.7

Upper Corner Venture, LLC Lease Agreement.

Exhibit to our Form 10

10.8

M2 Consulting Agreement of May 2006, with Addendums.

Exhibit to our Form 10

10.9

M2 Consulting Agreement of April 2008.

Exhibit to our Form 10

10.10

5X Partners Corporate Development Services Agreement with Addendums.

Exhibit to our Form 10

10.11

StorageSwitch Consulting Services Agreement.

Exhibit to our Form 10

10.12

StorageSwitch Non-Compete Agreement.

Exhibit to our Form 10

10.13

StorageSwitch Technology Purchase Agreement.

Exhibit to our Form 10

10.14

Vision to Practice, Inc. Development Services Agreement.

Exhibit to our Form 10

10.15

Form of 12% Convertible Note.

Exhibit to our Form 10/A-2

10.16

Form of A Warrant for 12% Convertible Note Offering.

Exhibit to our Form 10/A-2

10.17

Form of B Warrant for 12% Convertible Note Offering.

Exhibit to our Form 10/A-2

10.18

Letter Agreement with M2 of June, 2008.

Exhibit to our Form 10/A-2

16.1

Letter of Auditors regarding termination.

Exhibit to our Form 10/A-2

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Subsidiaries.

Exhibit to our Form 10

31.1	302 Certification of CEO, Roy A. Bauer	
31.2	302 Certification of CFO, William McDonald	
32	906 Certification	
99.1	Digitiliti, Inc. Stock Option Plan.	Exhibit to our Form 10

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized

Digitiliti, Inc.

Date:

November 13, 2009

By:

/s/Roy A. Bauer

Roy A. Bauer, President, CEO and Director

Date:

November 13, 2009

By:

/s/William McDonald

William McDonald, CFO

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o such agreements are currently outstanding, management intends to continue monitoring the interest rate environment and may enter into such transactions in the future if deemed advantageous.

Stock Split

On May 1, 2002, the Company s board of directors approved a 3-for-2 stock split of the Company s common shares in the form of a 50% stock dividend. Accordingly, shareholders of record on May 15, 2002 received an additional common share for every two shares they held. The additional shares were distributed on May 29, 2002. All share and per share amounts in this annual report have been restated to reflect the stock split.

Legal Contingencies

In November 2002, a lawsuit was filed in the United States District Court, Middle District of Tennessee, Nashville Division, on behalf of three plaintiffs alleging various wage and hour violations by the Company of the Fair Labor Standards Act of 1938. The plaintiffs attorneys are seeking collective-action status on this complaint. In October 2003, the presiding judge denied the Company s request to enforce the arbitration agreements signed by the plaintiffs and also ordered the Company to turn over certain employee addresses to the plaintiffs attorneys. The Company has appealed this decision. As part of the appeal process, the presiding judge stayed the order regarding the employee addresses. Due to the evolving nature of this case, the potential impact to the Company s financial results cannot be estimated at this time. Accordingly, no accrual for a loss contingency has been made in the accompanying consolidated financial statements.

In addition, from time to time, the Company is involved in various legal claims and litigation arising in the normal course of business. Based on currently-known legal actions, management believes that, as a result of its legal defenses and insurance arrangements, none of these other actions should have a material adverse effect on the Company s business or financial condition, taken as a whole.

New Accounting Pronouncements

The following recent accounting pronouncements could potentially impact the Company s financial results.

The Financial Accounting Standards Board (FASB) issued Statement of Accounting Standards (SFAS) No. 143, Accounting for Asset Retirement Obligations in June 2001. SFAS 143 applies to legal obligations associated with the retirement of certain tangible long-lived assets. This statement is effective for fiscal years beginning after June 15, 2002. Accordingly, the Company adopted this statement on January 2, 2003. The adoption of SFAS 143 has not had a material impact on the Company s financial statements.

In July 2002, the FASB issued SFAS No. 146, Accounting for Obligations Associated with Disposal Activities, which addresses financial reporting and accounting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). SFAS 146 requires that a liability be recognized for such costs only when the liability is incurred, which is in contrast to EITF 94-3, which requires the recognition of a liability upon the commitment to an exit plan. The statement is effective for exit or disposal activities that are initiated after December 31, 2002 and has not materially affected the Company s financial statements.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, which amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company has adopted the disclosure provision of this statement.

In November 2002, the FASB issued Interpretation No. 45 (FIN 45), Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. FIN 45 addresses the requirements for financial statement disclosures to be made by a guarantor about its obligations under certain guarantees and clarifies that a guarantor is required to recognize a liability upon issuing a guarantee for the fair value of the obligation. The Company will apply FIN 45 to any guarantees issued or modified after December 31, 2002. The impact to the Company s financial results has been immaterial. The Company had no material guarantees at December 31, 2003.

On May 15, 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity. The Statement requires issuers to classify as liabilities (or assets in some circumstances) three classes of freestanding financial instruments that embody obligations for the issuer. Generally, the Statement is effective for financial instruments entered into or modified after May 31, 2003 and is otherwise effective at the beginning of the first interim period beginning after June 15, 2003. The Company adopted the provisions of the Statement on July 3, 2003. The Company did not have any financial instruments within the scope of SFAS 150 at any time during 2003.

In December 2003, the FASB revised Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities, which was originally issued in January 2003, to provide guidance regarding issues arising from the implementation of FIN 46. This interpretation addresses the consolidation by business enterprises of variable interest entities, as defined in the interpretation, and sets forth additional disclosure regarding such interests. FIN 46 applies immediately to variable interest entities created, or in which the Company obtains an interest, after January 31, 2003, and became effective as of December 31, 2003 for all variable interest entities held by the Company prior to that date. Management has evaluated the impact of FIN 46 and does not expect it will have a material effect on the Company s consolidated financial statements.

Impact of Inflation

The Company s operating costs that may be affected by inflation consist principally of food, payroll and utility costs. A significant number of the Company s restaurant team members are paid at the Federal minimum wage and accordingly, legislated changes to the minimum wage affect the Company s payroll costs. Although no minimum wage increases have been signed into law, legislation proposing to increase the minimum wage by $1.50 to $6.65 per hour was introduced in the U.S. Senate in early 2003. Although the proposed legislation was not passed in 2003, it is likely that Congress will consider the issue in 2004. The Company is typically able to increase menu prices to cover most of the payroll rate increases.

The Company considers its current price structure to be very competitive. This factor, among others, is considered by the Company when passing cost increases on to its customers. Sales prices were increased by 2.8% in 2003 and 3.9% in 2002.

Forward-Looking Information

In accordance with the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, the Company cautions that the statements in this annual report and elsewhere that are forward-looking involve risks and uncertainties that may impact the Company s actual results of operations. All statements other than statements of historical fact that address activities, events or developments that the Company expects or anticipates will or may occur in the future, including such things as Company plans or strategies, deadlines for completing projects, expected financial results, expected regulatory environment and other such matters, are forward-looking statements. The words estimates , plans , anticipates , expects , intends , believes and similar expressions are intended to identify forward-looking statements. All forward-looking information reflects the Company s best judgment based on current information. However, there can be no assurance that other factors will not affect the accuracy of such information. While it is not possible to identify all relevant factors, the following could cause actual results to differ materially from expectations: general economic conditions including consumer confidence levels; competition; developments affecting the public s perception of buffet-style restaurants; real estate availability; food and labor supply costs; food and labor availability; an adverse food safety event; weather fluctuations; interest rate fluctuations; stock market conditions; political environment (including acts of terrorism and wars); and other risks and factors described from time to time in the Company s reports filed with the Securities and Exchange Commission, including this Form 10-K. The ability of the Company to open new restaurants depends upon a number of factors, including its ability to find suitable locations and negotiate acceptable land acquisition and construction contracts, its ability to attract and retain sufficient numbers of restaurant managers and team members, and the availability of reasonably priced capital. The extent of the Company s stock repurchase program during 2004 and future years depends upon the financial performance of the Company s restaurants, the investment required to open new restaurants, share price, the availability of reasonably priced capital, the financial covenants contained in the Company s loan agreements that govern both the senior notes and the revolving credit facility, and the maximum debt and share repurchase levels authorized by the Company s Board of Directors.

Item 7A. ***Quantitative and Qualitative Disclosure About Market Risk***

The Company s exposure to market risk relates primarily to changes in interest rates. On January 28, 2000, the Company obtained a $200 million revolving credit facility with several banks due in 2005, bearing interest at various floating interest rates plus a variable spread currently set at 1.375%. At the same time, a separate transaction involved the private placement of $75 million of senior notes due in 2008 with principal payments commencing in 2005, bearing interest at 9.02%. On July 25, 2003, the Company completed a private placement of $100 million of its 4.65% senior notes due 2013 with principal payments beginning in 2007, bearing interest at 4.65%. In connection with this transaction, the revolving credit facility s credit limit was permanently reduced from $200 million to $100 million. All loans are secured by the stock of the Company s wholly-owned subsidiaries.

While the Company has entered into derivative financial instrument agreements in the past, there were no such agreements outstanding during the year ended December 31, 2003. The Company has never entered into financial instrument agreements for trading or speculative purposes.

The following table presents information regarding the Company s outstanding long-term debt based on total outstanding debt balances as of December 31, 2003. The contractually required principal repayments and their related average interest rates by maturity date are presented in the table. For the variable rate debt, average interest rate is based on the two-month London Interbank Offered Rate (LIBOR) at December 31, 2003 plus the current applicable margin of 1.375%. The applicable margin is subject to increase up to a maximum of 1.675% or decrease to a minimum of 0.875% in future years depending upon changes to the Company s ratio of funded debt to EBITDA. The fair value of the variable rate debt approximates its carrying amount at December 31, 2003 due to the variable rate provisions of the related debt instruments. During 2003, the variable rate debt had an average interest rate of 2.8%. The fair value of the fixed rate debt is based on borrowing rates available to the Company for notes with similar terms and average maturities at December 31, 2003.

	As of December 31, 2003 Expected Maturity Dates							
Liabilities (dollars in millions)	**2004**	**2005**	**2006**	**2007**	**2008**	**There-after**	**Total**	**Fair Value**
Long-term debt:								
Variable rate		$21.0					21.0	21.0
Average interest rate	2.5%	2.5%					2.5%	
Fixed rate 2000 senior notes		$18.8	18.8	18.7	18.7		75.0	86.3
Average interest rate	9.0%	9.0%	9.0%	9.0%	9.0%		9.0%	
Fixed rate 2003 senior notes				$14.3	14.3	71.4	100.0	97.7
Average interest rate	4.7%	4.7%	4.7%	4.7%	4.7%	4.7%	4.7%	

Item 8. ***Financial Statements and Supplementary Data***

Ryan s Family Steak Houses, Inc. and Subsidiaries
Index to Consolidated Financial Statements

RYAN S FAMILY STEAK HOUSES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF EARNINGS

	Year Ended		
	December 31, 2003	**January 1, 2003**	**January 2, 2002**
	(In thousands, except earnings per share)		
Restaurant sales	$805,009	773,817	745,163
Cost of sales:			
Food and beverage	283,535	275,674	270,155
Payroll and benefits	253,152	241,420	226,950
Depreciation	32,503	30,226	30,238
Other restaurant expenses	112,872	104,337	101,406
Total cost of sales	682,062	651,657	628,749
General and administrative expenses	42,022	38,034	38,447
Interest expense	10,216	9,302	11,687
Royalties from franchised restaurants	(1,503)	(1,663)	(1,281)
Other income, net	(2,709)	(2,486)	(2,824)
Earnings before income taxes	74,921	78,973	70,385
Income taxes	25,098	28,588	25,339
Net earnings	$ 49,823	50,385	45,046
Earnings per share:			
Basic	$ 1.18	1.15	0.98
Diluted	1.14	1.11	0.95
Weighted-average shares:			
Basic	42,210	43,680	45,881
Diluted	43,754	45,518	47,519

See accompanying notes to consolidated financial statements.

RYAN S FAMILY STEAK HOUSES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	December 31, 2003	January 1, 2003
	(In thousands)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 8,617	2,654
Receivables	4,293	5,010
Inventories	5,648	5,119
Prepaid expenses	1,758	1,266
Income taxes receivable		2,739
Deferred income taxes	5,150	4,676
Total current assets	25,466	21,464
Property and equipment:		
Land and improvements	154,528	144,859
Buildings	449,561	413,700
Equipment	252,611	231,244
Construction in progress	25,789	29,245
	882,489	819,048
Less accumulated depreciation	264,339	234,627
Net property and equipment	618,150	584,421
Other assets	8,073	7,194
Total assets	$ 651,689	613,079
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	6,580	8,670
Income taxes payable	1,288	
Accrued liabilities	42,590	37,974
Total current liabilities	50,458	46,644
Long-term debt	196,000	202,000
Deferred income taxes	42,824	39,375
Other long-term liabilities	5,467	4,579
Total liabilities	294,749	292,598
Shareholders equity:		
Common stock of $1.00 par value; authorized 100,000,000 shares; issued 41,843,000 in 2003 and 42,745,000 in 2002	41,843	42,745
Additional paid-in capital	1,412	2,066
Retained earnings	313,685	275,670
Total shareholders equity	356,940	320,481

Commitments and contingencies		
Total liabilities and shareholders equity	$651,689	613,079

See accompanying notes to consolidated financial statements.

RYAN S FAMILY STEAK HOUSES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended		
	December 31, 2003	**January 1, 2003**	**January 2, 2002**
		(In thousands)	
Cash flows from operating activities:			
Net earnings	$ 49,823	50,385	45,046
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	34,445	31,644	31,956
Gain on sale of property and equipment	(150)	(28)	(518)
Tax benefit from exercise of stock options	1,412	1,784	3,195
Deferred income taxes	2,975	8,328	549
Decrease (increase) in:			
Receivables	717	(204)	(1,175)
Inventories	(529)	(28)	(6)
Prepaid expenses	(492)	(450)	4
Income taxes receivable	2,739	(2,739)	
Other assets	(1,130)	(528)	(59)
Increase (decrease) in:			
Accounts payable	(2,090)	(2,532)	2,179
Income taxes payable	1,288	(3,238)	(25)
Accrued liabilities	4,616	(629)	2,817
Other long-term liabilities	888	666	981
Net cash provided by operating activities	94,512	82,431	84,944
Cash flows from investing activities:			
Proceeds from sale of property and equipment	9,240	5,467	6,179
Capital expenditures	(76,853)	(74,125)	(51,982)
Net cash used in investing activities	(67,613)	(68,658)	(45,803)
Cash flows from financing activities:			
Proceeds from issuance of senior notes	100,000		
Debt issuance costs	(160)		
Net proceeds from (repayment of) revolving credit facility	(106,000)	24,000	(14,000)
Proceeds from stock options exercised	3,688	3,508	8,406
Purchase of common stock	(18,464)	(51,950)	(22,322)
Net cash used in financing activities	(20,936)	(24,442)	(27,916)
Net increase (decrease) in cash and cash equivalents	5,963	(10,669)	11,225
Cash and cash equivalents beginning of period	2,654	13,323	2,098
Cash and cash equivalents end of period	$ 8,617	2,654	13,323
Supplemental disclosure			
Cash paid during the year for:			
Interest, net of amount capitalized	$ 9,914	8,794	11,783
Income taxes	17,262	24,784	21,786

See accompanying notes to consolidated financial statements.

RYAN S FAMILY STEAK HOUSES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Description of Business and Summary of Significant Accounting Policies

Ryan s Family Steak Houses, Inc. operates a chain of 334 Company-owned restaurants (as of December 31, 2003) located principally in the southern and midwestern United States and receives franchise royalties from an unrelated third-party franchisee that operates 18 restaurants (as of December 31, 2003) in Florida. The Company was organized in 1977, opened its first restaurant in 1978 and completed its initial public offering in 1982.

Consolidation. The consolidated financial statements include the financial statements of Ryan s Family Steak Houses, Inc. and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

Fiscal Year. The Company s fiscal year ends on the Wednesday nearest December 31, resulting in years of either 52 or 53 weeks. Each of the years ended December 31, 2003, January 1, 2003 and January 2, 2002 consists of 52 weeks.

Restaurant Sales. Restaurant sales include food and beverage sales and are net of applicable state and local sales taxes. Restaurant sales are recognized upon delivery of services. Proceeds from the sale of gift certificates are deferred and recognized as revenue as they are redeemed.

Franchise Royalties. Franchise royalties, which are based on a percentage of monthly sales, are recognized as income on the accrual basis. In the event that the franchisee experiences payment difficulties or, in management s opinion, may be susceptible to such difficulties, franchise royalties may be recognized as income on the cash basis.

Other Income. Other income consists principally of cash receipts from vending machines located in the Company s restaurants, management s estimate of abandoned gift certificates, the net gain on sale of assets not subject to impairment and sales tax filing discounts.

Cash and Cash Equivalents. Cash and cash equivalents include cash and short-term investments with initial maturities of three months or less that are stated at cost which approximates market value.

Inventories. Inventories consist of menu ingredients and restaurant supplies and are stated at the lower of cost or market. Cost is determined using the first-in, first-out method.

Property and Equipment. Property and equipment are stated at cost. Depreciation is calculated principally on the straight-line method over the following estimated useful lives: buildings and land improvements 25 to 39 years and equipment 3 to 20 years. Buildings and land improvements on leased property are amortized straight-line over the shorter of the lease term or estimated useful life of the asset.

The Company s long-lived assets, which consist principally of restaurant properties, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If an asset is considered to be impaired, an impairment loss is recognized equal to the amount by which the carrying amount of the asset exceeds its fair value. Assets to be sold are reported at the lower of carrying amount or fair value less costs to sell.

Other Assets. Other assets consist principally of long-term receivables, cash surrender values of life insurance policies, unamortized debt issuance costs and a long-term prepayment of land rent.

Derivative Financial Instruments. The Company has used derivative financial instruments in the past to reduce its exposure to interest rate fluctuations. The Company does not enter into financial instrument agreements for trading or speculative purposes. There were no derivative financial instrument agreements outstanding during the periods presented.

Self-Insurance Liabilities. The Company self-insures a significant portion of expected losses under its workers compensation, general liability and team member medical programs. Accrued liabilities have been recorded based on the Company s estimates of the ultimate costs to settle reported claims and claims that have been incurred but not reported.

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RYAN S FAMILY STEAK HOUSES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Income Taxes. Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Stock Split. On May 1, 2002, the Company s board of directors approved a 3-for-2 stock split of the Company s common shares in the form of a 50% stock dividend. Shareholders of record on May 15, 2002 received an additional common share for every two shares they held. The additional shares were distributed on May 29, 2002. All share and per share amounts in the accompanying financial statements have been restated to reflect the stock split.

Stock Options. As allowed by Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, the Company accounts for its stock option plans in accordance with the intrinsic value provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. As such, compensation expense is recorded on the date of grant only if the current market price of the underlying stock exceeds the exercise price. No compensation cost has been recognized for stock-based compensation in consolidated net earnings for the periods presented, as all options granted under the Company s stock option plans had exercise prices equal to the market value of the underlying common stock on the date of the grant. Had the Company determined compensation cost based on the fair value recognition provisions of SFAS No. 123, the Company s net earnings and earnings per share would have been reduced to the pro forma amounts indicated in the following table:

	2003	**2002**	**2001**
	(In thousands, except earnings per share)		
Net earnings, as reported	$49,823	50,385	45,046
Less total stock-based compensation expense determined under fair value based method, net of related tax effects	(1,486)	(1,472)	(1,791)
Pro forma net earnings	$48,337	48,913	43,255
Earnings per share:			
Basic:			
As reported	$ 1.18	1.15	0.98
Pro forma	1.15	1.12	0.94
Diluted:			
As reported	1.14	1.11	0.95
Pro forma	1.10	1.07	0.91

Earnings Per Share. Basic earnings per share (EPS) excludes dilution and is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS includes common stock equivalents which arise from the hypothetical exercise of outstanding stock options using the treasury stock method.

Use of Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications. Certain prior year amounts in the accompanying consolidated financial statements have been reclassified to conform to the 2003 presentation. These reclassifications did not affect either the prior years net earnings or shareholders equity.

RYAN S FAMILY STEAK HOUSES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Income Taxes

Income tax expense for the years ended December 31, 2003, January 1, 2003 and January 2, 2002, consists of:

	2003	2002	2001
		(In thousands)	
Current:			
U.S. Federal	$20,853	18,069	22,452
State and local	1,270	2,191	2,338
Total current	22,123	20,260	24,790
Deferred:			
U.S. Federal	3,909	7,673	496
State and local	(934)	655	53
Total deferred	2,975	8,328	549
Total income taxes	$25,098	28,588	25,339

Income taxes differ from the amounts computed by applying the U.S. Federal statutory corporate rate of 35 percent to earnings before income taxes as follows:

	2003	2002	2001
		(In thousands)	
Tax at Federal statutory rate	$26,222	27,641	24,635
Increase (decrease) in taxes due to:			
State income taxes, net of Federal income tax benefit	218	1,850	1,554
Federal tax credits	(2,413)	(1,697)	(1,397)
Other	1,071	794	547
Total income taxes	$25,098	28,588	25,339

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2003 and January 1, 2003 are presented in the following table:

	2003	2002
	(In thousands)	
Deferred tax assets:		
Self-insurance liabilities	$ 4,550	4,044
Deferred compensation	2,214	1,871
Other	599	632

Total gross deferred tax assets	7,363	6,547
Less valuation allowance		
Net deferred tax assets	7,363	6,547
Deferred tax liabilities:		
Building and equipment	(45,037)	(41,246)
Total gross deferred tax liabilities	(45,037)	(41,246)
Net deferred taxes	$ (37,674)	(34,699)

The Company did not establish a valuation allowance for deferred tax assets as of December 31, 2003 or January 1, 2003. In assessing the realizability of deferred tax assets, management considers whether it is more

RYAN S FAMILY STEAK HOUSES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment and, accordingly, believes it is more likely than not that the results of future operations will generate sufficient taxable income to realize the benefits of these deductible differences at December 31, 2003.

Note 3. Long-Term Debt

Long-term debt at December 31, 2003 and January 1, 2003 consists of the following:

	2003	2002
	(In thousands)	
Revolving credit facility with banks due January 2005, with weighted average interest of 2.56% at December 31, 2003; secured by the common stock of the Company s wholly-owned subsidiaries	$ 21,000	127,000
Senior notes payable bearing interest at 9.02%; payable in annual installments of $18,750,000 commencing January 2005, final installment due January 2008; secured by the common stock of the Company s wholly-owned subsidiaries	75,000	75,000
Senior notes payable bearing interest at 4.65%; payable in annual installments of $14,285,714 commencing July 2007, final installment due July 2013; secured by the common stock of the Company s wholly-owned subsidiaries	100,000	
	196,000	202,000
Less current installments		
Total long-term debt	$196,000	202,000

The revolving credit facility is a $100 million facility with $68 million of available borrowings at December 31, 2003 and bears interest at various floating interest rates plus a variable spread that ranges from 0.875% to 1.625%. Interest is paid at least quarterly and is generally based on the London Interbank Offered Rate. Unused fees ranging from 0.225% to 0.375% of the average unused portion of the facility are also paid quarterly. The variable spread and the unused fee rate were 1.375% and 0.325%, respectively, at December 31, 2003. Both percentages are based on the ratio of funded debt to EBITDA and are subject to adjustment quarterly. The facility was reduced in July 2003 from $200 million to $100 million in connection with the issuance of the 4.65% senior notes. The revolving credit facility also includes a $20 million subfacility for letters of credit of which approximately $10 million was outstanding at December 31, 2003. The Company uses letters of credit principally for self-insurance purposes.

Interest payments related to the senior notes are made semiannually for the 9.02% notes and quarterly for the 4.65% notes. Both of the senior note agreements allow the Company to make either partial or total prepayments of principal, subject to a specified make-whole premium.

The loan agreements contain minimum net worth requirements and maximum leverage ratios as well as restrictions on future stock repurchases, dividends, capital expenditures, investments and sales of assets. As of December 31, 2003, the Company was in compliance with all covenants under the loan agreements and exceeded the most restrictive minimum net worth requirement by $45.7 million.

The aggregate amount of installments due on long-term debt for each of the following years subsequent to December 31, 2003 are as follows: $0 in 2004; $39.8 million in 2005; $18.8 million in 2006; $33.0 million in 2007; $33.0 million in 2008; and thereafter, $71.4 million.

The fair value of the revolving credit facility approximates its carrying amount as of December 31, 2003 and January 1, 2003 due to its variable interest rate provisions. Based on the borrowing rates available to the

RYAN S FAMILY STEAK HOUSES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Company for notes with similar terms and average maturities, the fair and book values of the 9.02% and the 4.65% senior notes at December 31, 2003 follow:

	Fair Value	Book Value
	(In thousands)	
9.02% senior notes	$86,300	75,000
4.65% senior notes	97,700	100,000

Note 4. Interest Cost

The Company capitalizes interest cost as a component of the cost of new restaurant construction. A summary of interest cost incurred follows:

	2003	2002	2001
		(In thousands)	
Interest cost capitalized	$ 1,676	2,031	2,813
Interest cost charged to income	10,216	9,302	11,687
Total interest cost incurred	$11,892	11,333	14,500

Note 5. Leases

The Company leases 17 restaurant sites under noncancelable operating leases with initial terms that expire over the next 1 to 10 years. The Company is also a party to one noncancelable operating lease for a restaurant building and its underlying land with an initial term that expires in 18 years. These leases contain renewal options for periods ranging from 10 to 30 years and require the Company to pay all executory costs such as property taxes, utilities and insurance. Rental payments are based on contractual amounts as set forth in the lease agreements and do not include any contingent rentals. The Company also leases dishwashing equipment at certain restaurants under agreements with five-year terms that are cancelable by the Company after the first 12 months. Total rental expense for operating leases amounted to $2,455,000 in 2003, $2,488,000 in 2002 and $2,133,000 in 2001. Future lease payments under the noncancelable operating leases as of December 31, are:

	(In thousands)
Year End:	
2004	$1,330
2005	1,134
2006	1,078
2007	948
2008	728
Later years, through 2021	3,705
Future lease payments	$8,923

RYAN S FAMILY STEAK HOUSES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 6. Accrued Liabilities

Accrued liabilities consist of the following:

	2003	2002
	(In thousands)	
Self-insurance liabilities	$12,932	11,261
Accrued compensation	10,938	9,646
Accrued taxes (other than income)	7,976	7,107
Accrued interest	3,879	3,577
Outstanding gift certificates	3,134	2,677
Accrued team member benefits	1,028	1,100
Accrued utility costs	734	918
Other accrued expenses	1,969	1,688
Total accrued liabilities	$42,590	37,974

Note 7. Shareholders Equity

The components of shareholders equity are as follows:

	$1 Par Value Common Stock	Additional Paid-in Capital	Retained Earnings
		(In thousands)	
Balances at January 3, 2001	$46,788		235,641
Net earnings			45,046
Issuance of common stock under Stock Option Plans	1,659	6,747	
Tax benefit from exercise of nonqualified stock options		3,195	
Purchases of common stock	(2,631)	(4,900)	(14,791)
Balances at January 2, 2002	45,816	5,042	265,896
Net earnings			50,385
Issuance of common stock under Stock Option Plans	645	2,863	
Tax benefit from exercise of nonqualified stock options		1,784	
Purchases of common stock	(3,716)	(7,623)	(40,611)
Balances at January 1, 2003	42,745	2,066	275,670
Net earnings			49,823
Issuance of common stock under Stock Option Plans	614	3,074	
Tax benefit from exercise of nonqualified stock options		1,412	
Purchases of common stock	(1,516)	(5,140)	(11,808)
Balances at December 31, 2003	$41,843	1,412	313,685

The Company s Board of Directors has authorized the repurchase of up to 55 million shares of the Company s common stock through December 2004. At December 31, 2003, approximately 43.2 million shares

RYAN S FAMILY STEAK HOUSES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

had been purchased at an aggregate cost of $314.6 million since the beginning of the program in March 1996. Future repurchase transactions will be made from time to time on the open market or in privately negotiated transactions in accordance with applicable securities regulations, depending on market conditions, share price and other factors.

On January 26, 1995, the Board of Directors adopted a Shareholder Rights Agreement (the Agreement) and declared a dividend of one Common Stock Purchase Right (a Right) for each outstanding share of common stock to shareholders of record on February 10, 1995. Such Rights only become exercisable ten business days after (i) a public announcement that a person or group, except for certain exempt persons specified in the Agreement, (an Acquiring Person) has acquired beneficial ownership of 15% or more of the Company s common stock; or (ii) a person or group commences or publicly announces its intention to commence a tender or exchange offer for an amount of the Company s common stock that would result in the ownership by such person or group of 15% or more of the common stock.

Each Right may initially be exercised to acquire a one-half share of the Company s common stock at an exercise price of $16.67, subject to adjustment. Thereafter, upon the occurrence of certain events specified in the Agreement (for example, if the Company is the surviving corporation of a merger with an Acquiring Person), the Rights entitle holders other than the Acquiring Person to acquire upon exercise common stock having a market value of twice the exercise price of the Rights. Alternatively, upon the occurrence of certain other events specified in the Agreement (for example, if the Company is acquired in a merger or other business combination transaction in which the Company is not the surviving corporation), the Rights would entitle holders other than the Acquiring Person to acquire upon exercise common stock of the acquiring company having a market value of twice the exercise price of the Rights.

The Rights may be redeemed by the Company at a redemption price of $.001 per Right at any time prior to the tenth business day following public announcement that a 15% position has been acquired and before the final expiration date of the Rights. After the redemption period has expired, the Company s right of redemption may be reinstalled under certain circumstances outlined in the Agreement. The Rights will expire on February 10, 2005.

Note 8. Team Member Retirement Plans

The Company maintains a defined contribution retirement plan, which covers all team members who have at least one year of service and have attained 21 years of age. Participating team members may contribute from 1% to 15% of their compensation to the plan with the first 6% of compensation matched by the Company at a 40% rate. The Company s match for participants with 20 or more years of service increases to 100%. All plan assets are invested in a nationally recognized family of mutual funds. Retirement plan expense, including administrative costs, amounted to $1,597,000 in 2003, $1,585,000 in 2002 and $1,439,000 in 2001.

Officers, certain key executives and certain corporate and restaurant-level managers may also participate in one of two nonqualified deferred compensation plans maintained by the Company. These plans provide benefits to the participants or their designated beneficiaries at specified future dates or upon the termination of employment or death. Subject to plan limitations, participants can defer a substantial portion of their compensation and receive a matching contribution comparable to the Company s defined contribution retirement plan. Participant deferrals and any related Company contributions are credited to the participants deferred compensation accounts. Participants can select from a variety of investment options, and investment earnings are credited to their accounts. The Company informally funds its liability to the participants through the use of Company-owned life insurance contracts. The Company has the right to amend or terminate the plans. The amount of expense related to the deferred compensation plans was $315,000 in 2003, $404,000 in 2002 and $209,000 in 2001. Outstanding balances under the plans amounted to $3,614,000 at December 31, 2003 and $2,505,000 at January 1, 2003 and are included in other long-term liabilities in the accompanying balance sheets.

RYAN S FAMILY STEAK HOUSES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 9. Stock Option Plan

In 2002, the Company s shareholders approved a stock option plan (Plan) pursuant to which the Company s Board of Directors may grant options to officers and team members. The Plan authorized grants of options to purchase up to 3,600,000 shares of authorized but unissued common stock. Under the terms of the Plan, which expires in 2012, a committee of non-employee directors has the authority to determine the eligibility, tax treatment, term, vesting period and exercise price. The Plan provides for a maximum ten-year life for 900,000 of the option shares and a maximum seven-year life for the remaining 2,700,000 option shares. Officer grants have vesting periods that generally do not exceed six months. Options granted to other team members typically vest pro-rata over four years. In addition, the Plan states that the exercise price of an option cannot be less than the fair market value, based on the closing market price, of the Company s common stock on the day of the grant. The Plan also provides for option grants to Board members at a fixed amount of 5,000 shares per director granted annually on October 31 with an exercise price equal to that day s closing market price. Options granted to Board members have vesting periods that generally do not exceed six months. At December 31, 2003, there were 2,652,000 shares available for grant under the Plan and another 481,000 shares available for grant under a predecessor plan. Options granted under the predecessor plan have terms generally similar to the current Plan, except that all options under the predecessor plan have a maximum ten-year life.

A summary of the status of the Company s current and predecessor stock option plans as of December 31, 2003, January 1, 2003 and January 2, 2002 and changes during the years ended on those dates is presented below:

	2003		2002		2001	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
	(Shares in thousands)					
Outstanding at beginning of year	4,592	$ 8.10	4,728	$ 7.41	5,564	$ 5.78
Granted	731	12.72	773	10.68	1,266	11.67
Exercised	(614)	6.85	(645)	5.95	(1,802)	5.61
Forfeited	(295)	8.31	(264)	8.43	(300)	6.07
Outstanding at end of year	4,414	9.01	4,592	8.10	4,728	7.41
Exercisable at year-end	2,851		2,792		2,709	

The following table summarizes information about stock options outstanding at December 31, 2003:

	Options Outstanding			Options Exercisable	
		Weighted-Average			
Range of Exercise Prices	Number Outstanding at 12/31/03	Remaining Contractual Life	Exercise Price	Number Exercisable at 12/31/03	Weighted-Average Exercise Price
	(Shares in thousands)				
$4 to $6	1,187	4.9 years	$ 5.04	1,048	$ 5.03
$6 to $9	868	5.5	7.02	868	7.02
$9 to $11	674	6.7	10.37	332	10.30

$11 to $18	1,685	7.8	12.30	603	12.03
$4 to $18	4,414	6.4	9.01	2,851	7.73

RYAN S FAMILY STEAK HOUSES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The per share weighted-average fair values of stock options issued during 2003, 2002 and 2001 were $3.41, $3.82 and $3.88, respectively. The fair value of each option grant was estimated using the Black-Scholes option-pricing model based on the following weighted-average assumptions:

	2003	2002	2001
Risk-free interest rate	3.3%	3.3%	4.0%
Expected life (years)	5.1	5.2	5.2
Expected volatility	.22	.34	.29
Expected dividend yield	0%	0%	0%

Note 10. Earnings Per Share

Basic and diluted earnings per share (EPS) are calculated as follows:

		2003	2002	2001
		(In thousands, except earnings per share)		
Net earnings	a	$49,823	50,385	45,046
Weighted-average common shares	b	42,210	43,680	45,881
Stock options		1,544	1,838	1,638
Adjusted weighted-average common shares	c	43,754	45,518	47,519
Basic EPS	a/b	$ 1.18	1.15	0.98
Diluted EPS	a/c	1.14	1.11	0.95

In order to prevent antidilution, outstanding stock options to purchase 3,000 shares in 2003 and 1.1 million shares of common stock in 2002 were not included in the computation of diluted EPS. No such antidilutive stock options were outstanding in 2001.

Note 11. Quarterly Consolidated Financial Data (Unaudited)

Quarterly consolidated financial results for 2003 and 2002 are summarized as follows:

	Quarter				
	First	Second	Third	Fourth	Total Year
	(In thousands, except earnings per share)				
2003:					
Restaurant sales	$193,192	208,504	205,686	197,627	805,009
Restaurant operating profit(a)	29,831	34,201	29,733	29,182	122,947
Net earnings	12,098	14,329	10,997	12,399	49,823
Earnings per share:					
Basic	$ 0.28	0.34	0.26	0.30	1.18
Diluted	0.28	0.33	0.25	0.28	1.14

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RYAN S FAMILY STEAK HOUSES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Quarter				
	First	Second	Third	Fourth	Total Year
	(In thousands, except earnings per share)				
2002:					
Restaurant sales	$193,570	201,027	194,115	185,105	773,817
Restaurant operating profit(a)	30,882	35,155	29,190	26,933	122,160
Net earnings	13,421	15,426	11,527	10,011	50,385
Earnings per share:					
Basic	$ 0.30	0.35	0.27	0.23	1.15
Diluted	0.28	0.34	0.26	0.23	1.11

(a) Restaurant operating profit is calculated as restaurant sales less cost of sales.

Note 12. Disclosures About the Fair Value of Financial Instruments

The Company s significant financial instruments are cash and cash equivalents, receivables, notes payable, accounts payable, accrued liabilities and long-term debt. Except for long-term debt, the fair values of these financial instruments approximate their carrying values due to their short maturities. The fair value of the long-term debt is discussed in Note 3.

Note 13. Legal Contingencies

In November 2002, a lawsuit was filed in the United States District Court, Middle District of Tennessee, Nashville Division, on behalf of three plaintiffs alleging various wage and hour violations by the Company of the Fair Labor Standards Act of 1938. The plaintiffs attorneys are seeking collective-action status on this complaint. In October 2003, the presiding judge denied the Company s request to enforce the arbitration agreements signed by the plaintiffs and also ordered the Company to turn over certain employee addresses to the plaintiffs attorneys. The Company has appealed this decision. As part of the appeal process, the presiding judge stayed the order regarding the employee addresses. Due to the evolving nature of this case, the potential impact to the Company s financial results cannot be estimated at this time. Accordingly, no accrual for a loss contingency has been made in the accompanying consolidated financial statements.

In addition, from time to time, the Company is involved in various legal claims and litigation arising in the normal course of business. Based on currently-known legal actions, management believes that, as a result of its legal defenses and insurance arrangements, none of these other actions should have a material adverse effect on the Company s business or financial condition, taken as a whole.

Independent Auditors Report

The Board of Directors and Shareholders

Ryan s Family Steak Houses, Inc.:

We have audited the accompanying consolidated balance sheets of Ryan s Family Steak Houses, Inc. and subsidiaries as of December 31, 2003 and January 1, 2003 and the related consolidated statements of earnings and cash flows for each of the years in the three-year period ended December 31, 2003. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our 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 Ryan s Family Steak Houses, Inc. and subsidiaries as of December 31, 2003 and January 1, 2003, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

Greenville, South Carolina
January 30, 2004

Item 9. ***Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

None.

Item 9A. ***Controls and Procedures***

Under the supervision and with the participation of the Company s management, including its principal executive officer and principal financial officer, the Company conducted an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures, as defined in rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report (the Evaluation Date). Based on this evaluation, the Company s principal executive officer and principal financial officer concluded as of the Evaluation Date that the Company s disclosure controls and procedures were effective such that the information relating to the Company, including its consolidated subsidiaries, required to be disclosed in its Securities and Exchange Commission (SEC) reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to the Company s management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

During the fourth quarter of 2003, the Company did not make any changes in its internal controls over financial reporting that have materially affected, or are reasonably likely to affect, those controls.

PART III

Item 10. ***Directors and Executive Officers of the Registrant***

The information required under this item is incorporated by reference to the Ryan s Family Steak Houses, Inc. Proxy Statement for the Annual Meeting of Shareholders to be held May 5, 2004 under the headings Election of Directors , Executive Officers and Section 16(a) Beneficial Ownership Reporting Compliance.

Item 11. ***Executive Compensation***

The information required under this item is incorporated by reference to the Ryan s Family Steak Houses, Inc. Proxy Statement for the Annual Meeting of Shareholders to be held May 5, 2004 under the headings Election of Directors Compensation of Directors , Executive Compensation and Other Information , Report of the Compensation Committee and Performance Graph.

Item 12. ***Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

The information required under this item is incorporated by reference to the Ryan s Family Steak Houses, Inc. Proxy Statement for the Annual Meeting of Shareholders to be held May 5, 2004 under the headings Election of Directors , Certain Beneficial Owners of Common Stock and Executive Officers.

Item 13. ***Certain Relationships and Related Transactions***

The information required under this item is incorporated by reference to the Ryan s Family Steak Houses, Inc. Proxy Statement for the Annual Meeting of Shareholders to be held May 5, 2004 under the headings Election of Directors and Executive Compensation and Other Information Deferred Compensation Salary Continuation Agreement.

Item 14. ***Principal Accountant Fees & Services***

The information required under this item is incorporated by reference to the Ryan s Family Steak Houses, Inc. Proxy Statement for the Annual Meeting of Shareholders to be held May 5, 2004 under the headings Ratification of Appointment of Independent Auditors Fees Paid to Independent Auditors.

PART IV

Item 15. ***Exhibits, Financial Statement Schedules and Reports on Form 8-K***

(a) 1-2 The Company s consolidated financial statements are listed in the accompanying Index to Consolidated Financial Statements on page 20.

(a) 3 Exhibits (numbered in accordance with Item 601 of Regulation S-K):

Exhibit #	Description
3.1	Articles of Incorporation of the Company, as amended through April 24, 1986: Incorporated by reference to Exhibit 4(a) to the Registration Statement of the Company filed with the SEC on Form S-3 (Commission file no. 33-7245) (the Form S-3).
3.1.1	Articles of Amendment to the Articles of Incorporation, dated April 22, 1987: Incorporated by reference to Exhibit 3.2 to the Annual Report on Form 10-K for the period ended January 1, 1992 (Commission file no. 0-10943) (the 1991 10-K).
3.1.2	Articles of Amendment to the Articles of Incorporation, dated May 25, 1989: Incorporated by reference to Exhibit 4.3 to the Registration Statement of the Company filed with the SEC on Form S-8 (Commission file no. 33-53834).
3.2	Bylaws of the Company: Incorporated by reference to Exhibit 4(b) to the Form S-3.
3.2.1	Amendment to By-Laws of the Company, dated October 25, 1990: Incorporated by reference to Exhibit 3.3 to the 1991 10-K.
3.2.2	Amendment to By-Laws of the Company, dated January 28, 1999: Incorporated by reference to Exhibit 3.2.2 to the Annual Report on Form 10-K for the period ended December 29, 1999 (Commission file no. 0-10943) (the 1999 10-K).
4.1	Specimen of Company common stock certificate: Incorporated by reference to Exhibit 4.1 to the 1991 10-K.
4.2	See Exhibits 3.1, 3.1.1, 3.1.2, 3.2, 3.2.1 and 3.2.2.
4.3	See Exhibit 10.21, 10.22, 10.22.1, 10.22.2, 10.22.3, 10.23, 10.23.1 and 10.24.
*10.1	Ryan s Family Steak Houses, Inc. 1987 Stock Option Plan: Incorporated by reference to Exhibit 4 to the Registration Statement of the Company filed with the SEC on Form S-8 (Commission file no. 33-15924).
*10.2	Ryan s Family Steak Houses, Inc. 1991 Stock Option Plan: Incorporated by reference to Exhibit 4.4 to the Registration Statement of the Company filed with the SEC on Form S-8 (Commission file no. 33-53834).
*10.3	Ryan s Family Steak Houses, Inc. 1998 Stock Option Plan: Incorporated by reference to Exhibit 99.1 to the Registration Statement of the Company filed with the SEC on Form S-8 (Commission file no. 333-67165).
*10.4	Ryan s Family Steak Houses, Inc. 2002 Stock Option Plan, as approved at the Special Meeting of Shareholders held on July 22, 2002: Incorporated by reference to Exhibit 10.4 to the Annual Report on Form 10-K for the period ended January 1, 2003 (Commission file no. 0-10943) (the 2002 10-K).
*10.5	Ryan s Employee Retirement Savings Plan, dated March 1, 1992: Incorporated by reference to Exhibit 10.4 to the 1991 10-K.
*10.6	Salary Continuation Agreement, dated April 22, 1987, between the Company and Alvin A. McCall, Jr.; as amended on October 26, 1989: Incorporated by reference to Exhibit 10.5 to the 1991 10-K.
*10.7	Deferred Compensation Salary Continuation Agreement, dated April 22, 1987, between the Company and Charles D. Way: Incorporated by reference to Exhibit 10.6 to the 1991 10-K.
10.8	Agreement and Plan of Restructuring: Incorporated by reference to Exhibit A to the Proxy Statement of the Company, dated March 25, 1993, filed with respect to the Annual Meeting of Shareholders to be held on April 28, 1993 (Commission file no. 0-10943).

Exhibit #	Description
*10.9	Split Dollar Agreement by and between the Company and Charles D. Way dated September 1, 1993: Incorporated by reference to Exhibit 10.8 to the Annual Report on Form 10-K for the period ended December 29, 1993 (Commission file no. 0-10943) (the 1993 10-K).
*10.10	Split Dollar Agreement by and between the Company and G. Edwin McCranie dated November 12, 1993: Incorporated by reference to Exhibit 10.9 to the 1993 10-K.
*10.11	Split Dollar Agreement by and between the Company and James R. Hart dated August 8, 1993: Incorporated by reference to Exhibit 10.11 to the 1993 10-K.
*10.12	Split Dollar Agreement by and between the Company and Fred T. Grant, Jr. dated November 12, 1993: Incorporated by reference to Exhibit 10.12 to the 1993 10-K.
*10.13	Split Dollar Agreement by and between the Company and Alan E. Shaw dated November 12, 1993: Incorporated by reference to Exhibit 10.13 to the 1993 10-K.
*10.14	Split Dollar Agreement by and between the Company and Morgan A. Graham dated November 12, 1993: Incorporated by reference to Exhibit 10.15 to the Annual Report on Form 10-K for the period ended December 31, 1997 (Commission file no. 0-10943) (the 1997 10-K).
*10.15	Split Dollar Agreement by and between the Company and Janet J. Gleitz dated November 12, 1993: Incorporated by reference to Exhibit 10.16 to the 1997 10-K.
*10.16	Split Dollar Agreement by and between the Company and Ilene T. Turbow dated November 12, 1995: Incorporated by reference to Exhibit 10.17 to the 1997 10-K.
*10.17	Deferred Compensation Plan by and between the Company and Morgan A. Graham dated November 1, 1997: Incorporated by reference to Exhibit 10.18 to the 1997 10-K.
*10.18	Deferred Compensation Plan by and between the Company and Janet J. Gleitz dated November 1, 1997: Incorporated by reference to Exhibit 10.19 to the 1997 10-K.
*10.19	Deferred Compensation Plan by and between the Company and Ilene T. Turbow dated November 1, 1997: Incorporated by reference to Exhibit 10.20 to the 1997 10-K.
*10.20	Executive Bonus Plan, commencing in fiscal year 1998: Incorporated by reference to Exhibit 10.23 to the 1997 10-K.
10.21	Franchise Agreement between Ryan s Family Steak Houses, Inc. (later assigned to Ryan s Properties, Inc.) and Family Steak Houses of Florida, Inc. dated September 16, 1987: Incorporated by reference to Exhibit 10.21 to the Annual Report on Form 10-K for the period ended January 2, 2002 (Commission file no. 0-10943) (the 2001 10-K).
10.21.1	Amendment dated as of May 29, 1992 to the Franchise Agreement referred to at Exhibit 10.21: Incorporated by reference to Exhibit 10.21.1 to the 2001 10-K.
10.21.2	Agreement dated July 11, 1994 and amended on October 17, 1994 to the Franchise Agreement referred to at Exhibit 10.21: Incorporated by reference to Exhibit 10.15 to the Annual Report on Form 10-K for the period ended December 28, 1994 (Commission file no. 0-10943).
10.21.3	Amendment dated as of October 3, 1996 to the Franchise Agreement referred to at Exhibit 10.21: Incorporated by reference to Exhibit 10.22.1 to the 1999 10-K.
10.21.4	Amendment dated as of August 31, 1999 to the Franchise Agreement referred to at Exhibit 10.21: Incorporated by reference to Exhibit 10.22.2 to the 1999 10-K.
10.21.5	Amendment dated as of January 30, 2002 to the Franchise Agreement referred to at Exhibit 10.21: Incorporated by reference to Exhibit 10.21.5 to the 2001 10-K.
10.21.6	Amendment dated as of December 17, 2003 to the Franchise Agreement referred to at Exhibit 10.21.
10.22	Ryan s Family Steak Houses, Inc. and Equiserve Trust Company, N.A., as Rights Agent, Amended and Restated Shareholder Rights Agreement dated as of October 16, 2000: Incorporated by reference to Exhibit 4.1 to the Quarterly Report on Form 10-Q for the period ended September 27, 2000 (Commission file no. 0-10943).
10.23	Credit Agreement dated as of January 28, 2000 among Ryan s Family Steak Houses, Inc. (the Borrower), the domestic subsidiaries of the Borrower, as Guarantors, Bank of America, N.A., as Administrative Agent, First Union National Bank, as Syndication Agent, Wachovia Bank, N.A., as Documentation Agent, SunTrust Bank, Atlanta, as Senior Managing Agent, and certain other banks signatory thereto: Incorporated by reference to Exhibit 10.24 to the 1999 10-K.

Exhibit #	Description
10.23.1	First Amendment dated as of November 9, 2001 to the Credit Agreement referred to at Exhibit 10.23: Incorporated by reference to Exhibit 10.23.1 to the 2001 10-K.
10.23.2	Second Amendment dated as of November 15, 2002 to the Credit Agreement referred to at Exhibit 10.23: Incorporated by reference to Exhibit 10.23.2 to the 2002 10-K.
10.23.3	Third Amendment dated as of July 25, 2003 to the Credit Agreement referred to at Exhibit 10.23: Incorporated by reference to Exhibit 10.1 to the Quarterly Report on Form 10-Q for the period ended July 2, 2003 (Commission file no. 0-10943) (the July 2003 10-Q).
10.24	Note Purchase Agreement between Ryan s Family Steak Houses, Inc. and various lenders for $75,000,000 of 9.02% Senior Notes due January 28, 2008: Incorporated by reference to Exhibit 10.25 to the 1999 10-K.
10.24.1	First Amendment dated as of July 25, 2003 to the Note Purchase Agreement referred to at Exhibit 10.24: Incorporated by reference to Exhibit 10.2 to the July 2003 10-Q.
10.25	Note Purchase Agreement between Ryan s Family Steak Houses, Inc. and various lenders for $100,000,000 of 4.65% Senior Notes due July 25, 2013: Incorporated by reference to Exhibit 10.3 to the July 2003 10-Q.
*10.26	Form of Split-Dollar Life Insurance Agreement by and between the Company and each of Messrs. Way, McCranie, Graham, Grant, Hart and Shaw and Ms. Gleitz and Ms. Turbow: Incorporated by reference to Exhibit 10.26 to the 1999 10-K.
*10.27	Deferred Compensation Plan, effective as of August 1, 1999: Incorporated by reference to Exhibit 10.27 to the 1999 10-K.
*10.28	Form of Employment, Noncompetition and Severance Agreement by and between the Company and each of Messrs. Way, McCranie, Grant, Graham, and Hart and Ms. Gleitz and Ms. Turbow: Incorporated by reference to Exhibit 10.28 to the Annual Report on Form 10-K for the period ended January 3, 2001 (Commission file no. 0-10943).
21.1	Subsidiaries of the Company.
23.1	Consent of Independent Auditors.
31.1	Section 302 Certification of Chief Executive Officer
31.2	Section 302 Certification of Chief Financial Officer
32.1	Section 906 Certification of Chief Executive Officer
32.2	Section 906 Certification of Chief Financial Officer

* This is a management contract or compensatory plan or arrangement.

Filed with this Form 10-K.

(b) (i) On October 22, 2003, the Company filed a report on Form 8-K regarding the press release on the Company s financial results as of and for the quarter and nine months ended October 1, 2003. (ii) On December 17, 2003, the Company filed a report on Form 8-K regarding an amendment to the franchise agreement with Family Steak Houses of Florida, Inc. (FSH) that terminates FSH s franchise rights by no later than June 30, 2005.

(c) The response to this portion of Item 15 is submitted as a separate section of this report.

(d) The response to this portion of Item 15 is submitted as a separate section of this report.

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.

RYAN S FAMILY STEAK HOUSES, INC.

By: /s/ FRED T. GRANT, JR.

Fred T. Grant, Jr.
Senior Vice President Finance, Treasurer and Assistant Secretary (Principal Financial and Accounting Officer)

March 15, 2004

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

Signature	Title	Date
/s/ CHARLES D. WAY Charles D. Way	Chairman, President and Chief Executive Officer	March 15, 2004
/s/ G. EDWIN MCCRANIE G. Edwin McCranie	Director and Executive Vice President	March 15, 2004
/s/ JAMES D. COCKMAN James D. Cockman	Director	March 15, 2004
/s/ BARRY L. EDWARDS Barry L. Edwards	Director	March 15, 2004
/s/ BRIAN S. MACKENZIE Brian S. MacKenzie	Director	March 15, 2004
/s/ HAROLD K. ROBERTS, JR. Harold K. Roberts, Jr.	Director	March 15, 2004
/s/ JAMES M. SHOEMAKER, JR. James M. Shoemaker, Jr.	Director	March 15, 2004
/s/ FRED T. GRANT, JR. Fred T. Grant, Jr.	Senior Vice President Finance, Treasurer and Assistant Secretary (Principal Financial and Accounting Officer)	March 15, 2004

Ryan s continued to gain more of the market in 2003 with a total of 334 company-owned and 18 franchised restaurants.

OFFICERS

Charles D. Way
Chairman, President
and Chief Executive Officer

G. Edwin McCranie
Executive Vice President

Fred T. Grant, Jr.
Senior Vice President-Finance
and Chief Financial Officer

Alan Shaw
Senior Vice President-Operations

Janet J. Gleitz
Corporate Secretary

Morgan A. Graham
Vice President-Construction

James R. Hart
Vice President-Human Resources

Richard D. Sieradzki
Vice President-Accounting and
Corporate Controller

Edward R. Tallon, Sr.
Vice President-Internal Audit
and Loss Prevention

Ilene T. Turbow
Vice President-Marketing

William R. Dalton
Regional Vice President

Michael Rick Kirk
Regional Vice President

William J. O Brien
Regional Vice President

DIRECTORS

Charles D. Way
Chairman, President

and Chief Executive Officer

G. Edwin McCranie
Executive Vice President

James D. Cockman
Investor

Barry L. Edwards
Executive Vice President
and Chief Financial Officer
SourceCorp, Inc.

Brian S. MacKenzie
Senior Vice President-Sales
and Marketing
International Surface
Preparation Corporation

Harold K. Roberts, Jr.
President and Chief Executive Officer
Statewide Title, Inc.

James M. Shoemaker, Jr.
Member
Wyche, Burgess, Freeman & Parham, P.A.

MISSION STATEMENT
To be an innovative, profitable, growth company, committed to customer satisfaction and building sales by always providing high quality food at affordable prices with friendly service in clean and pleasant surroundings. We Strive:

To put people first customers and team members.

To attract and maintain a strong team of individuals recognized as standouts in each area of focus.

To promote safety, responsibility and a high level of ethics in our workplace.

To be environmentally aware and work to preserve our natural resources.

To utilize materials and services that provide the best cost/value ratio without sacrificing quality.

To enhance long-term shareholder wealth.

CORPORATE INFORMATION

Corporate Office
Ryan s Family Steak Houses, Inc.
405 Lancaster Avenue (29650)
Post Office Box 100
Greer, South Carolina 29652
(864) 879-1000

General Counsel
Wyche, Burgess, Freeman & Parham, P.A.
Greenville, South Carolina

Transfer Agent
American Stock Transfer & Trust Company
59 Maiden Lane
New York, New York 10038
(877) 777-0800
www.amstock.com

Independent Auditors
KPMG LLP
Greenville, South Carolina

Form 10-K
A copy of the Company s annual report on Form 10-K for fiscal 2003, as filed with the Securities and Exchange Commission, may be obtained without charge by writing to the Corporate Secretary at the Company s corporate office.

Annual Meeting
The annual meeting will be held at the Greenville/ Spartanburg Airport Marriott, Greenville, South Carolina, on May 5, 2004, at 11:00 a.m. All shareholders are cordially invited to attend.

Common Stock Data
The Company s common stock trades on The Nasdaq Stock Market® under the symbol RYAN. The Company has never paid cash dividends on its common stock and does not expect to pay such dividends in the foreseeable future.

Financial Information
In order to provide Ryan s shareholders and prospective investors with timely and accurate information, quarterly financial information, Securities and Exchange Commission filings and news releases can be obtained on the internet at www.ryansinc.com.

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