FY2023 - Appendix 4E & Preliminary Financial Report

29 February 2024

1. Reporting period

Name of Entity:	Nightingale Intelligent Systems, Inc. (the **Company**)
ARBN:	659 369 221
Reporting period:	For the year ended 31 December 2023
Previous reporting period:	For the year ended 31 December 2022

This Appendix 4E is prepared in US Dollars under US GAAP and is unaudited.

2. Results for announcement to the market

	FY2023 (unaudited)	FY2022 (audited)	Up / Down
Revenue from ordinary activities	1,742,912	2,144,054	Down 19%
Loss from ordinary activities after tax attributable to members	(2,774,761)	(4,079,488)	Down 32%
Net loss for the period attributable to members	(2,507,920)	(5,973,794)	Down 58%

Dividends

The Company does not propose to pay any dividends in relation to the current financial period. No dividends were paid in the preceding financial period. The Company does not operate any dividend reinvestment plans.

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3. Net tangible assets

	FY2023 (cents)	FY2022 (cents)
Net tangible assets per security	0.01	0.02

Note: Net tangible assets include $385,659 and $538,462 of Right-of-Use Assets (net) in accordance with ASU 2016-02, Topic 842, respectively for FY2023 and FY2022. The Company's securities include US shares of common stock and Australian CDIs representing underlying shares of common stock. US shares of common stock are convertible into CDIs on a 1:1 basis.

4. Commentary on preliminary financial results

The Company designs, develops, builds, deploys, and supports autonomous robotic aerial security technologies. The Company's revenue is generated from contractual arrangements for the sale of drone systems which include the drone and base equipment, deployment of the drone system, and maintenance and support agreements. The Company also leases its equipment to customers under bundled lease subscription arrangements, which typically include the equipment, software, maintenance services, and training for which the customer pays a single negotiated fixed minimum monthly payment for all elements over the contractual lease term.

The Company's CHESS Depository Interests (**CDIs**) over shares of common stock are quoted on the ASX. One CDI represents one fully paid share of common stock in the Company. All net losses are attributable to U.S. shareholders and Australian CDI holders on an equal basis.

Although unaudited revenues decreased in 2023 over 2022 (audited), the Company's revenue outlook for 2024 is solid with new contracts being awarded in late 2023 that have not yet been deployed or recognized as revenue in 2023. Additional contracts have been awarded in 2024 and further contracts are expected to be awarded in the current financial year. The sales pipeline encompasses the Company's core customer sectors of industrial/commercial, law enforcement and defense, and the board believes that the Company's "land and expand" strategy under which the Company provides its products to an initial customer location and, with successful deployment, then sells to further locations of that customer is gaining traction with customers. The Company will continue both to sell and lease its products.

The net loss for the current year is $2.508M (FY2022 $5.974M). Most of the decrease in current year net loss arises from less operating expenses due to cost-constraint measures in salaries, contracted professional fees, and material and supplies, and less non-cash stock-based compensation expense. Loss from operations in the current year is $2.775M (FY2022 $4.079M).

The Company continues to closely monitor its working capital to ensure it has adequate funds to meet its business plans. The Company expects to incur additional losses in the future and will need to raise additional capital to fully implement its business plan. The Company may raise additional capital through the issuance of equity securities, debt financing or other sources in order to further implement its business plan. However, if such financing is not available when needed and at adequate levels, the Company will need to re-evaluate its operating plans.

5. Control gained or lost over entities

During the current financial period, the Company dissolved its only subsidiary, the wholly owned Nightingale (UK) Operations Ltd on May 16, 2023. The subsidiary was a dormant non-trading entity.

6. Associates and joint venture entities

The Company had no investments in associates or joint ventures during the current financial period.

7. Accounting standards and audit

The Company's financial statements are prepared under US GAAP and are audited under Australian Accounting Standards.

This preliminary financial report is based on financial statements which are in the process of being independently audited by Grant Thornton. The Directors believe it is likely that Grant Thornton will issue an unqualified opinion, with a note relating to going concern. However, the Directors' belief is subject to Grant Thornton completing their audit work and forming their own independent view

Signed by:

Jack Wu
Executive Director and Chief Executive Officer

Nightingale Intelligent Systems, Inc.

Preliminary Financial Statements as of and for the
Years Ended December 31, 2023 and 2022
Unaudited and Condensed

NIGHTINGALE INTELLIGENT SYSTEMS, INC.
PRELIMINARY BALANCE SHEETS
AS OF DECEMBER 31, 2023 AND 2022

	December 31,	
	2023 (unaudited)	**2022 (audited)**
Assets		
Current assets		
Cash and cash equivalents	$ 811,472	$ 1,441,248
Accounts receivable, net of allowance for doubtful accounts ($244,694 at December 31, 2023 and $158,150 at December 31, 2022)	57,766	224,361
Inventory, net	165,159	203,301
Prepaid expenses and other current assets	176,844	84,132
Total current assets	1,211,241	1,953,042
Operating lease right-of-use asset	385,659	538,462
Leased assets, net	70,220	108,930
Property and equipment, net	3,914	33,086
Other assets	22,664	23,407
Total assets	$ 1,693,698	$ 2,656,927
Liabilities, and Stockholders' Equity (Deficit)		
Current liabilities		
Accounts payable	$ 517,174	$ 720,824
Accrued expenses	103,346	73,624
Deferred revenue	1,767,214	573,566
Operating lease liability, current	164,789	164,626
Total current liabilities	2,552,523	1,532,640
Loan payable	150,000	150,000
Loans from officers and directors	497,906	—
Operating lease liability, non-current	216,586	412,966
Total liabilities	3,417,015	2,095,606
Stockholders' Equity (Deficit):		
Common stock, $0.00001 par value; 250,000,000 and 90,433,860 shares authorized at December 31, 2023 and 2022, respectively; 133,222,854 shares issued and outstanding at December 31, 2023 and 2022	17,418,009	17,418,009
Additional paid-in capital	14,655,465	14,432,183
Accumulated deficit	(33,796,791)	(31,288,871)
Total stockholders' equity (deficit)	(1,723,317)	561,321
Total liabilities and stockholders' equity (deficit)	$ 1,693,698	$ 2,656,927

See accompanying condensed notes to unaudited financial statements.

NIGHTINGALE INTELLIGENT SYSTEMS, INC.
PRELIMINARY STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31, 2023 AND 2022

	Years Ended December 31,	
	2023 (unaudited)	2022 (audited)
Revenue	$ 1,742,912	$ 2,144,054
Cost of revenue	836,648	1,626,110
Gross profit	906,264	517,944
Operating expenses:		
Research and development	1,780,128	2,299,710
Sales and marketing	233,498	235,203
General and administrative	1,667,399	2,062,519
Total operating expenses	3,681,025	4,597,432
Loss from operations	(2,774,761)	(4,079,488)
Other income (expense), net		
Interest expense, net	(15,196)	(1,765,673)
Other income (expense), net	282,037	(128,633)
Total other income (expense), net	266,841	(1,894,306)
Net loss	$ (2,507,920)	$ (5,973,794)
Net loss per share - basic and diluted	$ (0.02)	$ (0.18)
Weighted average shares of common stock - basic and diluted	133,222,854	33,952,429

See accompanying condensed notes to unaudited financial statements.

NIGHTINGALE INTELLIGENT SYSTEMS, INC.
PRELIMINARY STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIT)
FOR THE YEAR ENDED DECEMBER 31, 2023 AND 2022

	Convertible Preferred Stock		Common Stock		Additional Paid-In Capital	Accumulated Deficit	Total Stockholders' Equity (Deficit)
	Shares	Amount	Shares	Amount			
Balances at December 31, 2021	27,039,077	$ 12,709,219	21,570,999	$ 173	$ 10,259,243	$ (25,315,077)	$ (15,055,661)
Issuance of common stock upon conversion of Series Seed, Series A, Series B, Series B-1 and Series C convertible preferred stock	(27,039,077)	(12,709,219)	27,039,068	11,113,155	1,596,064	—	12,709,219
Issuance of common stock from initial public offering, net of offering costs	—	—	22,727,273	2,183,332	—	—	2,183,332
Issuance of common stock upon conversion of convertible notes	—	—	49,882,676	4,121,229	—	—	4,121,229
Conversion of derivative liability	—	—	—	—	2,094,520	—	2,094,520
Issuance of common stock upon exercise of Series C stock warrants	—	—	12,002,838	120	119,913	—	120,033
Stock-based compensation expense	—	—	—	—	362,443	—	362,443
Net loss	—	—	—	—	—	(5,973,794)	(5,973,794)
Balances at December 31, 2022	—	—	133,222,854	$ 17,418,009	$ 14,432,183	$ (31,288,871)	$ 561,321
Stock-based compensation (unaudited)	—	—	—	—	222,432	—	222,432
Proceeds from exercise of stock options (unaudited)	—	—	—	—	850	—	850
Net loss (unaudited)	—	—	—	—	—	(2,507,920)	(2,507,920)
Balances at December 31, 2023 (unaudited)	—	$ —	133,222,854	$ 17,418,009	$ 14,655,465	$ (33,796,791)	$ (1,723,317)

See accompanying condensed notes to unaudited financial statements.

NIGHTINGALE INTELLIGENT SYSTEMS, INC.
PRELIMINARY STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2023 AND 2022

	Years Ended December 31,	
	2023 (unaudited)	**2022 (audited)**
Cash flows from operating activities:		
Net loss	$ (2,507,920)	$ (5,973,794)
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock-based compensation expense	222,432	362,443
Reduction of operating lease right of use asset	152,803	174,636
Credit loss expense	49,813	—
Depreciation and amortization	51,082	168,263
Loss on sale of fixed assets	1,800	—
Foreign exchange gain	(18,507)	(1,924)
Loss on change in fair value of derivative liability	—	138,962
Amortization of debt discount	—	665,496
Amortization of debt issuance costs	—	123,437
Loss on release of convertible notes, net	—	749,556
Changes in operating assets and liabilities:		
Accounts receivable	116,782	537,315
Inventories	38,142	(98,782)
Prepaid expenses and other current assets	(92,712)	127,627
Other assets	743	22,596
Accounts payable	(203,650)	302,608
Accrued expenses	29,722	(2,038)
Accrued interest	—	213,346
Deferred revenue	1,193,648	(319,508)
Operating lease liability	(196,217)	(135,506)
Net cash used in operating activities	(1,162,039)	(2,945,267)
Cash flows from investing activity:		
Proceeds on sale of fixed assets	15,000	—
Net cash provided by investing activity	15,000	—
Cash flows from financing activities:		
Net proceeds from loan	497,906	—
Proceeds from exercise of stock options	850	—
Proceeds from issuance of common stock	—	3,379,464
Net proceeds from convertible notes	—	654,012
Proceeds from Economic Injury Disaster Loan	—	150,000
Proceeds from issuance of promissory note	—	120,033
Offering costs paid	—	(803,378)
Payment for redemption of convertible notes	—	(342,719)
Net cash provided by financing activities	498,756	3,157,412
Effects of foreign exchange rate on cash and cash equivalents	18,507	(24,534)
(Decrease)/Increase in cash and cash equivalents	**(629,776)**	**187,971**
Cash and cash equivalents, beginning of period	**1,441,248**	**1,253,277**
Cash and cash equivalents, end of period	**$ 811,472**	**$ 1,441,248**

See accompanying condensed notes to unaudited financial statements.

	For the Years Ended December 31,	
	2023 (unaudited)	**2022 (audited)**
Supplemental disclosure of non-cash investing and financing activities:		
Reclassification of deferred offering costs	$ —	$ 869,121
Deferred offering cost included in accounts payable	$ —	$ 285,902
ROU assets obtained for operating lease liabilities	$ —	$ 713,098
Conversion of convertible notes and accrued liabilities	$ —	$ 4,121,229
Conversion of derivative liability	$ —	$ 2,094,520
Conversion of Series Seed, Series A, Series B, Series B-1 and Series C convertible preferred stock	$ —	$ 12,709,219

NOTE 1: DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

Nightingale Intelligent Systems, Inc. ("Nightingale" or the "Company") was incorporated under the laws of the State of Delaware on June 13, 2014, as Nightingale Autonomous Systems, Inc. In October 2017, the Company changed its name from Nightingale Autonomous Solutions, Inc. to Nightingale Intelligent Systems, Inc.

The Company designs, develops, builds, deploys, and supports autonomous robotic aerial security technologies that protect critical infrastructure for Fortune 500-type companies. The autonomous perimeter security system features networked base stations and mission-ready drones which can be airborne in less than 30 seconds. The system is driven by the Company's Mission Control software (Mission Manager), which equips security teams with a real-time decision support system to help keep their facilities safe. The Company focuses on Enterprise, Defense, and Emergency Response market segments linked to critical infrastructure locations (e.g. utilities, pharmaceutical facilities and laboratories, military facilities, data centers). The majority of the Company's business activities occur in the United States (US) but the Company has also made sales in Europe (EU), Australia, Saudi Arabia, and Brazil.

On November 16, 2022, the Company (trading under the ticker code "NGL") was successfully admitted to the Official List of Australian Securities Exchange (ASX) via an Initial Public Offering and listing on the ASX (IPO). The Company raised, on a gross basis, AUD $5,000,000 or approximately USD $3.4 million through issuance of 22,727,273 shares at an issue price of AUD $0.22 per share. The Company's shares of common stock trade on the ASX by way of CHESS Depositary Interests (CDIs).

On May 16, 2023, Nightingale (UK) Operations Ltd, a dormant subsidiary of the Company, was dissolved.

<u>Basis of Presentation</u>

The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the US (US GAAP), which require management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Unless otherwise noted, dollar amounts in these financial statements are shown in US dollars.

<u>Liquidity/Going Concern</u>

The financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. In order to continue its operations, the Company must be awarded contracts from customers, raise additional equity or debt financings and achieve profitable operations. Although management has historically been successful in raising capital, there can be no assurance that the Company will be able to obtain additional equity or debt financing on terms acceptable to the Company, or at all. The failure to obtain sufficient funds on acceptable terms when needed could have a material adverse effect on the Company's business, financial position, results of operations, and future cash flows. The Company completed an IPO of its common stock on November 18, 2022. Upon the closing of the IPO, on specified terms, the Company's outstanding convertible preferred stock and most convertible debt automatically converted into shares of common stock. The Company expects to achieve additional liquidity from operations, and through funding from other capital sources including through the sale of equity, debt financings or other capital sources including collaborations with other companies or other strategic transactions. However, the Company may be unable to raise additional funds or enter into such agreements or arrangements when needed on acceptable terms, or at all.

Since its inception, the Company has incurred significant operating losses and negative cash flows from operations primarily as a result of significant research and development activities related to the development and continued improvement of the Company's Mission Manager Software, drone units and base stations. The Company has funded these activities to date primarily through the issuance of convertible preferred stock and debt. The Company must among other things respond to competitive developments, attract, retain and motivate qualified personnel. Although the Company has generated revenue from product sales to date, the Company has not yet been able to achieve profitability and will continue to incur significant research and development and other expenses related to its ongoing operations. Cash and cash equivalents on hand was $0.8 million and $1.4 million at December 31, 2023 and 2022, respectively. The Company has incurred net losses of $2.5 million and $6.0 million for the period ended December 31, 2023 and 2022, had an accumulated deficit of $33.8 million as of December 31, 2023 and working capital deficit of $1.3 million.

The financial statements are in the process of being independently audited by Grant Thornton. The Directors believe it is likely that Grant Thornton will issue an unqualified opinion, with a note relating to going concern. However, the Directors' belief is subject to Grant Thornton completing their audit work and forming their own independent view.

NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Comprehensive Loss

Comprehensive loss includes all changes in equity during a period from non-owner sources. Through December 31, 2023, there are no components of comprehensive loss which are not included in net loss; therefore, a separate statement of comprehensive loss has not been presented. The Company does not have any significant foreign currency translation adjustments as a component of other comprehensive loss through December 31, 2023.

Use of Estimates

The preparation of the financial statements in conformity with U.S. GAAP requires the Company's management to make judgments, assumptions, and estimates that affect the amounts reported in its financial statements and the accompanying notes. The most significant estimates in the Company's financial statements relate to revenue recognition, determination of the cost and deriving the useful lives of the Company's drone units and base stations, assessing assets for impairment, ability to realize deferred tax assets, fair value measurements, valuation of financial instruments, valuation of stock options and warrants, and contingencies.

These estimates and assumptions are based on current facts, historical experience and various other factors believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the recording of revenues and expenses that are not readily apparent from other sources. Actual results could differ from those estimates.

Financial Instruments – Recognition and Derecognition

Financial assets and financial liabilities are recognized when the Company becomes party to the contractual provisions of the instrument. Financial assets and financial liabilities are initially measured at fair value. Transaction costs that are directly attributable (other than financial assets or liabilities at fair value through profit or loss) are added to or deducted from the fair value as appropriate on initial recognition.

Equity instruments are any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Equity instruments are recognized as proceeds received net of issue costs.

Financial assets
The Company's financial instruments include cash and cash equivalents, accounts receivable, accounts payable, accrued expenses, and loans. The recorded carrying amounts of cash and cash equivalents, accounts receivable, accounts payable, and accrued liabilities approximates their fair value due to the short-term nature of these instruments. Loans are initially recorded at fair value of the consideration received net of issue costs, and subsequently measured at amortized cost using the effective interest method.

Financial assets and financial liabilities are recognized when the Company becomes a party to the contractual provisions of the financial instrument. Financial assets are derecognized when the contractual rights to the cash flows from the financial asset expire, or when the financial asset and substantially all the risks and rewards are transferred. A financial liability is derecognized when it is extinguished, discharged, canceled or expires.

Fair Value Measurements

The Company accounts for fair value measurements under Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurements and Disclosures*, which establishes a framework for measuring fair value and requires disclosures about fair value measurements by establishing a hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to Level 1 measurements and lowest priority to Level 3 measurements. The three levels of the fair value hierarchy are described below:

- Level 1 – Observable inputs such as quoted prices in active markets
- Level 2 – Inputs other than quoted market prices in active markets that are observable, either directly or indirectly in active markets

- Level 3 – Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The estimated fair value of financial instruments disclosed in the financial statements have been determined by using available market information and appropriate valuation methodologies. In certain cases where there is limited activity or less transparency around inputs to valuation these financial instruments are classified as Level 3.

Cash Equivalents

The Company considers all highly liquid investments purchased with an original maturity of three months or less from the date of purchase to be cash equivalents. The Company places its cash and cash equivalents in highly liquid instruments with financial institutions with high credit ratings.

Inflation Reduction Act of 2022

On August 16, 2022, the Inflation Reduction Act of 2022 (IRA) was signed into law. The IRA includes a 15% Corporate Alternative Minimum Tax (Corporate AMT) for tax years beginning after December 31, 2022. The Company does not expect the Corporate AMT to have a material impact on its financial statements. Additionally, the IRA imposes a 1% excise tax on net repurchases of stock by certain publicly traded corporations. The excise tax is imposed on the value of the net stock repurchased or treated as repurchased. No shares have been repurchased in 2023 to date.

Concentrations of Credit Risk and Significant Suppliers

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of cash and cash equivalents. Cash and cash equivalent deposits with financial institutions may occasionally exceed the limits of insurance on bank deposits. The Company has not experienced any losses on such accounts and management believes that the Company is not exposed to significant credit risk due to the financial position of the depository institution in which those accounts are held.

The Company is also subject to credit risk from its accounts receivable. The Company extends credit to customers in the normal course of business. Generally, the Company does not perform evaluations of customers' financial condition and does not require collateral or other security to support accounts receivable. Concentrations of credit risk with respect to accounts receivable exist to the full extent of amounts presented in the financial statements.

The Company is dependent on third-party manufacturers to supply products and services for its drones and base stations. In particular, the Company relies, and expects to continue to rely, on a small number of third-party manufacturers to manufacture and supply the inventory and other materials for its security services. These activities could be adversely affected by a significant interruption in the supply of these items.

Deferred Offering Costs

The Company capitalized certain legal, professional, accounting and other third-party fees that were directly associated with in-process financings as deferred offering costs until such financings are consummated. After consummation of the financing, these costs are recorded as a reduction of the proceeds received from the financing. If a planned financing is abandoned, the deferred offering costs are expensed as a charge to operating expenses in the statement of operations. All deferred offering costs related to the Company's IPO which closed in November 2022 have been recorded as a reduction of the IPO proceeds.

Accounts Receivable

Accounts receivables are derived from sales and rental of proprietary drones and base station assets along with access to its browser-based interface Mission Manager. The Company reviews its receivables for collectability based on historical loss patterns adjusted for existing conditions and further adjusted for the period of time that can reasonably be forecasted, aging of the receivables, and assessments of specific identifiable customer accounts considered at risk or uncollectible and provides allowances for potential credit losses, as needed. The Company also considers any changes to the financial condition of its customers and any other external market factors that could impact the collectability of the receivables in the determination of the allowance for doubtful accounts. The allowance for doubtful accounts was $244,694 and $158,150 as of December 31, 2023 and 2022, respectively. Additions to the allowance was $86,544 in 2023.

At December 31, 2023, the Company had two customers whose accounts receivable balance each totaled 10% or more of the Company's total accounts receivable (57% and 35%) compared with four such customers (39%, 20%, 14% and 13%) at December 31, 2022.

For the year ended December 31, 2023, the Company had two customers (21% and 29%) who individually accounted for 10% or more of the Company's total customer revenue compared with three customers (17%, 12%, and 10%) for the period ended December 31, 2022.

Inventory

Inventories are valued at the lower of cost or net realizable value and are determined using the average cost method. The Company's inventory consists of raw material components, finished drone units, and base stations. Finished drone units and base stations include materials, the majority of which are purchased from third-party suppliers. Only final assembly and testing is done by the Company. The Company has determined that presently labor and other direct and indirect costs of production are not material. The Company regularly assesses slow-moving, excess and obsolete inventory and will maintain balance sheet reserves in amounts required to reduce the recorded value of inventory to the lower of cost or net realizable value.

Equipment on Operating Leases

Equipment is recorded at cost and depreciated over the estimated useful lives. Equipment on operating leases is depreciated to estimated salvage value over the lease term. Depreciation is computed using the straight-line method. Significant improvements are capitalized, and repairs and maintenance are expensed. See Note 7 - *Inventories & Equipment on Operating Leases*.

Property and Equipment

Property and equipment are stated at cost and include computers, automobiles, leasehold improvements and machinery and equipment. Depreciation is computed using the straight-line method over the estimated useful lives of two to five years for computers, automobiles, machinery and equipment. Leasehold improvements are amortized using the straight-line method over the shorter of the remaining lease term or the estimated useful lives. Expenditures for repairs and maintenance, which do not extend the useful life of the property and equipment, are expensed as incurred and improvements and betterments are capitalized. Gains and losses associated with dispositions are reflected as a non-operating gain or loss in the statements of operations.

Intangible Assets

Intangible assets are stated at cost, net of accumulated amortization. Intangible assets are amortized using the straight-line method over the estimated useful life of 15 years.

Intangible assets include capitalized research and development costs and organization and start-up costs. Intangible assets are presented under other assets in the balance sheet.

Product Development Assets

Depreciation expense on product development assets is included in research and development expenses on the Company's statement of operations were approximately nil and $19,000 for the years ended December 31, 2023 and 2022, respectively.

Impairment of Long-Lived Assets

The Company assesses the impairment of long-lived assets whenever events or changes in circumstances indicate that their carrying value may not be recoverable from the estimated future cash flows expected to result from their use or eventual disposition. If estimates of future undiscounted net cash flows are insufficient to recover the carrying value of the assets, the Company will record an impairment loss in the amount by which the carrying value exceeds the fair value. If the assets are determined to be recoverable, but the useful lives are shorter than originally estimated, the Company will depreciate or amortize the net book value of the assets over the newly determined remaining useful lives. The Company had a $140,000 reserve recorded against certain early-generation drone units determined to be obsolete as of both December 31, 2023 and 2022. None of the Company's drone units, base stations or property and equipment was determined to be impaired as of December 31, 2023 and 2022.

Leases

The Company adopted ASU 2016-02, *Leases* (Topic 842) (ASU 2016-02), as of January 1, 2022, using the modified retrospective method. The Company had two leases as the lessee related to a building and vehicle lease. The lease terms for both leases expired prior to adoption of this new lease standard.

The Company determines if a contract is a lease or contains a lease at the inception of the contract and reassesses that conclusion if the contract is modified. All leases are assessed for classification as an operating lease or a finance lease. ROU assets represent the Company's right to use an underlying asset for the lease term and lease liabilities represent its obligation to make lease payments arising from the lease. The Company does not obtain and control its right to use the asset until the lease commencement date.

The Company's lease liabilities are recognized at the applicable lease commencement date based on the present value of the lease payments required to be paid over the lease term. As the Company's leases do not provide an implicit rate, the Company uses its incremental borrowing rate to discount the lease payments to present value. The estimated incremental borrowing rate is derived from information available at the lease commencement date. The Company's ROU assets also are recognized at the applicable lease commencement date. The ROU asset equals the carrying amount of the related lease liability, adjusted for any lease payments made prior to lease commencement and lease incentives provided by the lessor. Variable lease payments are expensed as incurred and do not factor into the measurement of the applicable ROU asset or lease liability.

The term of the Company's leases equals the non-cancellable period of the lease, including any rent-free periods provided by the lessor, and also includes options to renew or extend the lease (including by not terminating the lease) that the Company is reasonably certain to exercise. The Company establishes the term of each lease at lease commencement and reassesses that term in subsequent periods when one of the triggering events outlined in ASC Topic 842, *Leases* (ASC 842) occurs. Operating lease cost for lease payments is recognized on a straight-line basis over the lease term.

The Company's lease contracts often include lease and non-lease components. For all leases except telecommunications-related leases, the Company has elected the practical expedient offered by the standard to not separate the lease from non-lease components and accounts for them as a single lease component. The Company elected the package of practical expedients permitted under the transition guidance, which allows the Company to carry forward its historical lease classification, its assessment on whether a contract is or contains a lease, and its initial direct costs for any leases that existed prior to adoption of the new standard. The Company has elected, for all classes of underlying assets, not to recognize ROU assets and lease liabilities for leases with a term of twelve months or less. Lease cost for short-term leases is recognized on a straight-line basis over the lease term.

Deferred Revenue

When the Company is entitled to bill its customers and receive payment from its customers in advance of its obligation to provide services or transfer goods to its customers, the Company includes the amounts in deferred revenue on its balance sheet.

Revenue Recognition

The Company accounts for all revenue contracts in accordance with ASC Topic 606, *Revenue from Contracts with Customers* (ASC 606). A performance obligation is a promise in a contract to transfer distinct goods or services to a customer, and it is the unit of account in ASC 606. A contract's transaction price is allocated to each distinct performance obligation and revenue is recognized when each performance obligation under the terms of a contract is satisfied. For contracts with multiple performance obligations, the Company allocates the contract's transaction price to each performance obligation using observable standalone selling prices for similar products and services.

The substantial majority of the Company's revenue is generated pursuant to written contractual arrangements for drone systems which include the drone and base equipment, deployment of the drone system, and subscriptions for access to the Company's browser-based interface, Nightingale Security Mission Manager, through contracts that typically have 12-month terms and automatically renew upon payment for an additional 12-month term thereafter.

The Company's performance obligations are satisfied over time or at a point in time. Revenue for maintenance, repair, and upgrades (MRU), as well as lease subscription revenues, are recognized over the term of the contract which as stated above is generally 12 months, unless different terms are stated in the contract. For MRU, progress is measured via a time-based output method, which is days elapsed since the Company is standing ready to perform. The Company elected the right to invoice practical expedient under which, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date, such as time elapsed for maintenance, repair, and upgrade services, the entity may recognize revenue in the amount to which the entity has a right to invoice. Training and other time and material-based services are recognized over time using an output method based on days of training/services completed unless the training or other services require less than one month and are therefore recognized as training is completed.

For performance obligations that are not satisfied over time per the criteria above, revenue is recognized at the point in time at which each performance obligation is fully satisfied. The Company's drone and base product, which has embedded software, is composed of revenue recognized on contracts for the delivery of the drone, base, and spare parts. Revenue is recognized at the point in time when control transfers to the customer, which generally occurs when title and risk of loss have passed to the customer.

Application of the various accounting principles in U.S. GAAP related to the measurement and recognition of revenue requires the Company to make judgments and estimates including ASC 606 and ASC 842. Complex arrangements with nonstandard terms and conditions may require significant contract interpretation to determine the appropriate accounting. Specifically, the revenue related to the following areas involves significant judgments and estimates:

Lease Subscription Arrangements: The Company also leases its equipment direct to end customers under bundled lease subscription arrangements, which typically include the equipment, software, maintenance services, and training for which the customer pays a single negotiated fixed minimum monthly payment for all elements over the contractual lease term. Lease deliverables include the drone and base equipment and software as well as the deployment fee associated with the drone system, while the non-lease deliverables generally consist of the services, which include maintenance, repair, upgrades, and training. Sales made under bundled lease subscription arrangements comprise 18% or $313,974 and 17% or $355,109 of total sales revenue for the years ended December 31, 2023 and 2022, respectively. Revenues under these bundled lease subscription arrangements are allocated considering the relative standalone selling prices of the lease and non-lease deliverables included in the bundled arrangement.

Sales to Distributors and Resellers: The Company utilizes distributors and resellers to sell its products, supplies and parts to end-user customers. Sales to distributors and resellers are generally recognized as revenue when products are shipped to such distributors and resellers. Distributors and resellers may participate in various discount, rebate, price-support, cooperative marketing and other programs, and the Company records provisions and allowances for these programs as a reduction to revenue when the sales occur. The Company did not record estimates for sales returns and other discounts and allowances when the sales occurred for the years ended December 31, 2023 and 2022 as none was deemed needed as a result of the measurement of constraint of revenues. Total sales to distributors and resellers were $61,625 and $255,470 for the years ended December 31, 2023 and 2022, respectively.

Service Arrangements: Revenues associated with service arrangements – maintenance, repairs, and upgrades (or “MRU”), and software-as-a-service pertaining to Nightingale Security Mission Manager – are generally recognized over the term of the service period which is generally 12 months as the customer is typically invoiced for that usage at the beginning of the 12-month period.

Significant management judgments and estimates must be made and used in connection with the recognition of revenue in any accounting period. Material differences in the amount of revenue in any given period may result if these judgments or estimates prove to be incorrect or if management’s estimates change on the basis of development of the business or market conditions. Management judgments and estimates have been applied consistently and have been reliable historically. The Company believes that there are two key factors which impact the reliability of management’s estimates. The first of those key factors is that the terms of its contracts are typically for one year. The short-term nature of such contracts reduces the risk that material changes in accounting estimates will occur on the basis of market conditions or other factors. The second key factor is that it has numerous contracts in any given accounting period, which reduces the risk that any one change in an accounting estimate on one or several contracts would have a material impact on the Company’s financial statements.

Based on the nature of the contracts and consistent with prior practice, the Company recognizes revenue upon invoicing the customer for the large majority of its revenue. Additionally, the unit of accounting, that is, the identification of performance obligations, is consistent with prior revenue recognition practice. A significant portion of drone and base sales are either recorded as sales-type leases or through direct sales to customers or to distributors and resellers and these revenue streams are not impacted by the adoption of ASC 606. The only change of significance identified in adoption involves a change in the classification of certain revenues that were previously reported in service revenues. These revenues relate to certain analyst services performed in connection with the deployment of drone systems that are being considered part of the drone and base sale performance obligation. Accordingly, these revenues are reported as part of sales.

Deferred contract costs, which include incremental costs of obtaining a contract and costs to fulfill a contract and sales commissions on reseller arrangements, had been minimal under prior Company practices as most costs to obtain a contract and fulfill a contract were expensed as incurred. As a result of the contract cost guidance included in ASC 606 and ASC Topic 340-40 *Contracts with Customers*, the Company determined that any transition asset would be immaterial related to the incremental cost to obtain contracts as the adjustment would relate to the deferral of sales commissions paid to resellers in connection with the deployment of drone systems with post-sale service arrangements.

Revenue-based Taxes

Revenue-based taxes assessed by governmental authorities that are both imposed on and concurrent with specific revenue-producing transactions, and that are collected by the Company from a customer, are excluded from revenue. The primary revenue-based taxes are US sales taxes.

Shipping and Handling

Shipping and handling costs are accounted for as a fulfillment cost and are included in cost of revenue in the statements of operations.

Refer to Note 4 - *Revenue Recognition* for additional information regarding revenue recognition policies with respect to contract assets and liabilities as well as contract costs.

Warrants Issued in Connection with Financings

The Company generally accounts for warrants issued in connection with financings as a component of equity, unless there is a deemed possibility that it may have to settle the warrants in cash. For warrants issued with a deemed possibility of cash settlement, the Company records the fair value of the issued warrants as a liability at each reporting period and records changes in the estimated fair value as a non-cash gain or loss in the statement of operations.

Derivative Liabilities

The Company evaluates all of its agreements to determine if such instruments have derivatives or contain features that qualify as embedded derivatives. The Company accounts for certain redemption features that are associated with convertible notes as liabilities at fair value and adjusts the instruments to their fair value at the end of each reporting period. For derivative financial instruments that are accounted for as liabilities, the derivative instrument is initially recorded at its fair value and is then re-valued at each reporting date, with changes in the fair value reported in other income (expense), net in the statement of operations. Derivative instrument liabilities are classified in the balance sheet as current or non-current based on whether or not net-cash settlement of the derivative instrument could be required within 12 months of the balance sheet date.

Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with ASC Topic 718, *Compensation - Stock Compensation,* which requires that the estimated fair value on the date of grant be determined using the Black-Scholes option pricing model with the fair value recognized over the requisite service period of the awards, which is generally the option vesting period. Stock-based awards made to nonemployees are measured and recognized based on the estimated fair value on the vesting date and are re-measured at each reporting period. The Company's determination of the fair value of the stock-based awards on the date of grant, using the Black-Scholes option pricing model, is affected by the Company's value of its common stock as well as other assumptions regarding a number of highly complex and subjective variables. These variables include but are not limited to the Company's expected stock price volatility over the term of the awards, and actual and projected employee option exercise behaviors. Because there is insufficient historical information available to estimate the expected term of the stock-based awards, the Company adopted the simplified method of estimating the expected term of options granted by taking the average of the vesting term and the contractual term of the option.

For awards with graded vesting, the Company recognizes stock-based compensation expense over the service period using the straight-line method, based on shares ultimately expected to vest. The Company also elected to recognize forfeitures as they occur when calculating the stock-based compensation for equity awards.

Research & Development Costs

Research and development costs primarily consist of employee-related expenses, including salaries and benefits, share-based compensation expense, facilities costs, depreciation and other allocated expenses. Research and development costs are expensed as incurred.

Advertising Costs

Advertising costs are recorded in sales and marketing expense in the Company's statement of operations as incurred. Advertising expense were $1,070 and nil for the years ended December 31, 2023 and 2022.

Foreign Currency

The functional and presentation currency of the Company is the U.S. dollar. Transactions denominated in a currency other than the functional currency are recorded on the initial recognition at the exchange rate at the date of the transaction. After initial recognition, monetary assets and liabilities denominated in foreign currency are translated at the end of each reporting period into the functional currency at the exchange rate at that date. The cumulative translation adjustment is included in the accumulated other comprehensive income (loss) within the statement of stockholders' (deficit) equity. Exchange differences are included in general and administrative expenses in the statement of operations. Non-monetary assets and liabilities measured at cost are remeasured at the exchange rate at the date of the transaction.

Income Taxes

The Company uses the asset and liability method of accounting for income taxes as set forth in ASC Topic 740, *Income Taxes* (ASC 740). Under this method, deferred taxes are determined based on the temporary differences between the financial statement and tax basis of assets and liabilities using tax rates expected to be in effect during the years in which the basis differences reverse. A valuation allowance is recorded when it is unlikely that the deferred tax assets will not be realized. The Company assesses its income tax positions and records tax benefits for all years subject to examination based upon the Company’s evaluation of the facts, circumstances and information available at the reporting date. In accordance with ASC 740-10, for those tax positions where there is a greater than 50% likelihood that a tax benefit will be sustained, the Company’s policy will be to record the largest amount of tax benefit that is more likely than not to be realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. For those income tax positions where there is less than 50% likelihood that a tax benefit will be sustained, no tax benefit will be recognized in the financial statements.

Comprehensive Loss

Net loss was equal to comprehensive loss for the years ended December 31, 2023 and 2022.

Net Loss Per Share

Basic net loss per share is computed by dividing the net loss by the weighted average number of common shares outstanding for the period, without consideration for potentially dilutive securities. Diluted net loss per share is computed by dividing the net loss by the weighted average number of common shares and dilutive common stock equivalents outstanding for the period determined using the treasury-stock and if-converted methods. Dilutive common stock equivalents are comprised of convertible preferred stock, options outstanding under the Company’s stock option plan and outstanding common stock warrants. For all periods presented, there is no difference in the number of shares used to calculate basic and diluted shares outstanding as inclusion of the potentially dilutive securities would be anti-dilutive.

The table below presents a reconciliation of the numerator and denominator used to compute basic and diluted net loss per share for each class of common stock:

	December 31,	
	2023	**2022**
Basic and diluted net loss per share:		
Numerator:		
Net loss	2,507,920	5,973,794
Denominator:		
Weighted-average shares outstanding	133,222,854	33,952,429
Basic and diluted net loss per share	0.02	0.18

Recent Accounting Pronouncements - Adopted

In October 2023, the FASB issued ASU 2023-06, *Codification Amendments in Response to the SEC's Disclosure Update and Simplification Initiative.* The update modifies the disclosure or presentation requirements of a variety of Topics in the Codification. Certain amendments represent clarifications to or technical corrections of the current requirements. These amendments align the requirements in the ASC to the removal of certain disclosure requirements set out in Regulation S-X and Regulation S-K, announced by the SEC. The effective date for each amended topic in the ASC is two years after the date on which the SEC's removal of the related disclosure requirement from Regulation S-X or Regulation S-K becomes effective. Early adoption is prohibited. The company does not expect that the application of this standard will have an impact on the Company's financial statements and disclosures since the Company is already applying applicable SEC rules and regulations. The disclosures are aligned with ASU 2023-06.

In September 2022, the FASB issued ASU 2022-04, *Disclosure of Supplier Finance Programs,* to enhance transparency about an entity's use of supplier finance programs. Under ASU 2022-04, the buyer in a supplier finance program is required to disclose information about the key terms of the program, outstanding confirmed amounts as of the end of the period, a roll forward of such amounts during each annual period, and a description of where in the financial statements outstanding amounts are presented. ASU 2022-04 is effective for all entities for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years, except for the disclosure of roll forward information, which is effective for fiscal years beginning after December 15, 2023. The Company had no existing supplier finance program as of December 31, 2023.

In January 2021, the FASB issued ASU 2021-01, *Reference Rate Reform* (Topic 848), which clarifies that certain optional expedients and exceptions in Topic 848 for contract modifications and hedge accounting apply to derivatives that are affected by the discounting transition of LIBOR. As of the report date, the Company had no outstanding loan that uses LIBOR as a reference rate.

In February 2016, the FASB issued ASU 2016-02 that requires companies to generally recognize on the balance sheet operating and financing lease liabilities and corresponding right-of-use assets. In June 2020, the FASB issued ASU No. 2020-05 which deferred the effective date for private companies until fiscal years beginning after December 15, 2021. The Company adopted ASU 2016-02 effective January 1, 2022 on a modified retrospective basis. The adoption of the standard resulted in the recognition of additional lease liabilities and right-of-use assets of $0.7 million.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses: Measurement of Credit Losses on Financial Instruments ("ASU 2016-13"). ASU 2016-13 replaces the incurred loss impairment methodology in current U.S. GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. In May 2019, the FASB issued ASU 2019-05, Financial Instruments – Credit Losses to allow entities to irrevocably elect the fair value option for certain financial assets previously measured at amortized cost upon adoption of the new credit losses standard. The new effective dates and transition align with those of ASU 2016-13. The Company adopted ASU 2016-13 effective January 1, 2022 and it did not have a material impact on the Company's financial position, results of operations or disclosures.

In August 2020, the FASB issued ASU 2020-06, Debt – Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging – Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity ("ASU 2020-06"). The new guidance, among other things, simplifies the accounting for certain financial instruments with characteristics of liabilities and equity, including convertible instruments, and amends existing earnings-per-share ("EPS") guidance by requiring that an entity use the if-converted method when calculating diluted EPS for convertible instruments. ASU 2020-06 is effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years, with early adoption permitted for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. The Company adopted the new guidance effective January 1, 2022 and it did not have a material impact on the Company's financial position, results of operations or disclosures.

Recent Accounting Pronouncements – Not Yet Adopted

In December 2023, the FASB issued ASU 2023-09, *Income Taxes (Topic 740): Improvements to Income Tax Disclosure*s. The amendments in ASU 2023-09 require greater disaggregation of income tax disclosures related to the income tax rate reconciliation and income taxes paid. This will result in additional disclosures. For entities other than public business entities, ASU 2023-09 is effective for annual periods beginning after December 15, 2025 and early adoption is permitted. The Company has elected not to early adopt but will monitor the effects of the added disclosures in income tax rate reconciliation and income taxes paid.

In December 2023, the FASB issued ASU 2023-08, *Intangibles – Goodwill and others- Crypto Assets*, which addresses the accounting and disclosure requirements for certain crypto assets. The new guidance requires entities to subsequently measure certain crypto assets at fair value, with changes in fair value recorded in net income in each reporting period. In addition, entities are required to provide additional disclosures about the holdings of certain crypto assets. For all entities, the ASU's amendments are effective for fiscal years beginning after December 15, 2024, including interim periods within those years. As of December 31, 2023, the Company has no crypto assets that would be affected by this update.

In November 2023, the FASB issued ASU 2023-07, *Segment Reporting—Improvements to Reportable Segment Disclosures*. ASU 2023-07 introduced additional disclosures requiring public entities to disclose multiple measures of segment profit or loss, disclosure of significant segment expenses, and qualitative disclosure of other segment items. The ASU is only for public entities. No effect on the Company is foreseen.

In August 2023, the FASB issued ASU 2023-04, *Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 121*. The update amends paragraph 405-10-05-2 and adds Section 405-10-S99. Paragraph 405-10-05-2 amends the wording for identifying the specific standard with respect to certain liabilities, while Section 405-10-S99 deals with the Accounting for Obligations to Safeguard Crypto Assets an Entity Holds for Its Platform Users. As of December 31, 2023, the Company has no crypto assets that would be affected by this update.

In July 2023, the FASB issued the ASU 2023-03, *Presentation of Financial Statements (Topic 205), Income Statement—Reporting Comprehensive Income (Topic 220), Distinguishing Liabilities from Equity (Topic 480), Equity (Topic 505), and Compensation—Stock Compensation (Topic 718)*. The update amends or supersedes various SEC paragraphs within the Codification to conform to past SEC announcements and guidance issued by the SEC. The ASU does not provide any new guidance, so there is no transition or effective date associated with it.

In March 2023, the FASB issued ASU 2023-02, which expands the proportional amortization method to account for investments in all tax credit structures. That accounting method was previously allowed only for low-income housing tax credit (LIHTC) investments, but now is available, by election, to all community development tax credit investment reporting that meet five conditions. The ASU has no impact on the Company.

In March 2023, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2023-01, *Leases (Topic 842): Common Control Arrangements*. The ASU addresses the following issues: that the terms and conditions to be considered when classifying and accounting for leases between entities under common control; and accounting for leasehold improvements in leases between entities under common control. The ASU has no impact on the Company.

In October 2021, the FASB issued ASU 2021-08, *Accounting for Contract Assets and Contract Liabilities from Contracts with Customers,* which requires that an entity (acquirer) recognize, and measure contract assets and contract liabilities acquired in a business combination in accordance with ASC 606. For private entities, the amendments are effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted. The Company elected not to early adopt ASU 2021-08 and has no impact on the Company.

NOTE 3: INITAL PUBLIC OFFERING

On November 16, 2022, the Company (trading under the ticker code “NGL”) was successfully admitted to the Official List of Australian Securities Exchange via an Initial Public Offering “IPO”. The Company’s shares of common stock and quoted options will be settled in the form of CDIs at a ratio of 1:1. The Company raised, on a gross basis, AUD $5,000,000 or approximately USD $3.4 million through issuance of 22,727,273 shares at an issue price of AUD $0.22 per share and 11,363,610 options with an exercise price of AUD $0.35 and expiring on or before September 16, 2025.

As part of the IPO, the Company converted all their 2020 and 2021 Convertible Notes into Common Shares. The Company converted a portion of their 2022 Convertible Notes into Common Shares. See Note 13 – *Debt Obligations.*

The Company incurred IPO related expenses consisting of underwriters’ commissions, discounts and issuance costs totaling approximately USD $1.1 million.

NOTE 4: REVENUE RECOGNITION

Revenues are disaggregated by major product lines and sales channels are as follows:

	December 31, 2023	December 31, 2022
Major product and services lines		
Drone and Base Equipment	$ 1,497,893	$ 1,407,825
Maintenance Agreements (1)	181,287	171,836
Deployment (2)	64,900	90,000
Other (3)	125,819	119,824
Lease subscription arrangements (4)	313,974	355,109
Revenue Discounts	(440,961)	—
Total Revenues	$ 1,742,912	$ 2,144,054
Sales channels:		
Customer direct sales	$ 1,428,938	$ 1,533,475
Direct equipment lease (4)	313,974	355,109
Distributors & resellers (5)	—	255,470
Total Revenues	$ 1,742,912	$ 2,144,054

(1) Includes revenues from MRU agreements on sold equipment as well as revenues associated with maintenance service agreements sold through resellers.
(2) Primarily includes revenues from deployment of drone systems.
(3) Primarily includes revenues from training, consulting services, and miscellaneous hardware sales.
(4) Primarily reflects sales through bundled lease subscription arrangements.
(5) Primarily reflects sales through two-tier distribution channels.

Revenues disaggregated by point-in-time and over-time are as follows:

	December 31, 2023	December 31, 2022
Recognition:		
Point-in-time	$ 1,247,651	$ 1,617,109
Over-time	495,261	526,945
Total Revenues	$ 1,742,912	$ 2,144,054

Contract assets and liabilities: Company contract assets are generally not material, which are primarily related to costs of deployment to install drone and base systems. Company contract liabilities, which represent billings in excess of revenue recognized, are primarily related to advanced billings and were $1.9 million and $0.6 million at December 31, 2023 and December 31, 2022, respectively. The majority of the balance at December 31, 2023 will be amortized to revenue over approximately the next 12 months. See below for the roll forward of contract liabilities.

	December 31, 2023	December 31, 2022
Beginning of the period – December 31	$ 573,566	$ 893,074
Payments in advance	2,308,731	895,142
Revenue recognized on contract	(1,115,083)	(1,214,650)
End of the period – December 31	$ 1,767,214	$ 573,566

Backlog: Backlog is defined as remaining unsatisfied performance obligations under firm orders for which work has not been performed. Generally, 90-100% of backlog will be recognized as revenue during the following fiscal year. Because of possible future changes in delivery schedules and/or cancellations of orders, backlog at any particular date is not necessarily representative of actual sales to be expected for any succeeding period, and actual sales for the year may not meet or exceed the backlog represented. Backlog is typically due to maintenance, repairs, and upgrades. As revenues are recognized over time, the backlog and related contract liability decrease.

NOTE 5: OTHER INCOME/EXPENSE, NET

In July 2023, the Company received the proceeds of Earned Retention Credit (ERC) payroll tax refund claims it had filed with the US Internal Revenue Service earlier in 2023. The ERC program was a COVID-19 cost relief program for companies that retained employees during the COVID-19 pandemic. The Company received approximately $0.4 million, net of fees. This is included in other income (expense), net in the statements of operations.

NOTE 6: ACCOUNTS RECEIVABLES, NET

Accounts receivables, net consisted of the following:

	December 31,	
	2023	2022
Accounts receivable	$ 302,459	$ 382,511
Less: allowance for credit losses	(244,694)	(158,150)
Accounts receivables, net	$ 57,766	$ 224,361

The following table shows a roll forward of the allowance for credit losses on accounts receivables:

	December 31,	
	2023	2022
Beginning balance	$ 158,150	$ 158,150
Provision for credit losses	86,544	–
Ending balance	$ 244,694	$ 158,150

NOTE 7: INVENTORY AND EQUIPMENT ON OPERATING LEASES

Inventory consisted of the following at December 31, 2023 and 2022:

	December 31,	
	2023	2022
Raw material components	$ 102,892	$ 105,885
Finished drones	18,952	61,911
Finished base stations	43,315	35,505
Inventory	$ 165,159	$ 203,301

<u>Equipment on Operating Lease</u>

Equipment on operating leases and similar arrangements consists of Company equipment rented to customers and depreciated to estimated salvage value at the end of the lease term.

Equipment on operating leases and the related accumulated depreciation at December 31, 2023 and 2022 were as follows:

	December 31,	
	2023	2022
Equipment on lease	$ 695,537	$ 695,537
Accumulated depreciation	625,317	586,607
Drones and base stations, net	$ 70,220	$ 108,930

NOTE 8: ACCRUED EXPENSES

A summary of the components of accrued expenses is as follows:

	December 31, 2023	December 31, 2022
Accrued finance fee	$ 55,000	—
Accrued interest	25,291	—
Accrued payroll	7,275	$ 51,897
Accrued patent fee	5,500	—
Accrued insurance	4,258	20,475
Accrued professional fees	3,878	—
Other accrued liabilities	2,144	1,252
	$ 103,346	$ 73,624

NOTE 9: FAIR VALUE MEASUREMENTS

The following tables set forth by level, within the fair value hierarchy, the financial assets and liabilities that are measured at fair value on a recurring basis at December 31, 2023 and 2022:

	Carrying Amount	Fair Value Measurements at December 31, 2023 using:		
Assets:		Level 1	Level 2	Level 3
Money market funds	$ 650,056	$ 650,056	$ —	$ —
	$ 650,056	$ 650,056	$ —	$ —

	Carrying Amount	Fair Value Measurements at December 31, 2022 using:		
Assets:		Level 1	Level 2	Level 3
Money market funds	$ 24,042	$ 24,042	$ —	$ —
	$ 24,042	$ 24,042	$ —	$ —

The change in the fair value of derivative liabilities for the years ended December 31, 2023 and 2022 are summarized below:

	December 31, 2023	December 31, 2022
Fair value as of beginning of period - December 31	$ —	$ 1,906,429
Derivative liability upon issuance of 2022 Convertible Notes	—	50,128
Change in fair value on 2020 Notes	—	357,226
Change in fair value on 2021 Notes	—	(232,920)
Change in fair value on 2022 Notes	—	14,656
Conversion of derivative liability	—	(2,094,520)
Release of remaining derivative liability	—	(999)
Fair value as of December 31, 2022	—	—
Change in fair value on 2022 Notes	—	—
Change in fair value on 2023 Notes	—	—
Fair value as of end of period – December 31	$ —	$ —

For the years ended December 31, 2023 and 2022, the recorded gain/(loss) on change in fair value of derivative warrants amounted to nil and $0.1 million, respectively, in the statements of operations.

The derivative liabilities in the table above related to the 2021, 2022 and 2023 convertible notes represent the fair value of the redemption-like contingent conversion feature. The Company calculated the fair value of the derivative liability using a probability weighted discounted cash flow analysis. The inputs used to determine the estimated fair value of the derivative were based primarily on the probability of an underlying event occurring that would trigger the embedded derivative and the timing of such event. The Company's derivative liability is measured at fair value on a recurring basis and is classified as a Level 3 liability (see Note 13 – *Debt Obligations*).

NOTE 10: PROPERTY AND EQUIPMENT

Property and equipment, leasehold improvements and software, as of December 31, 2023 and 2022 are as follows:

	December 31, 2023	December 31, 2022
Computer equipment	$ 20,337	$ 20,337
Machinery and equipment	6,493	6,493
Automobiles	16,124	49,723
Leasehold improvements	69,431	69,432
	112,385	145,985
Accumulated depreciation	(108,471)	(112,899)
Property and equipment, net	$ 3,914	$ 33,086

Depreciation and amortization expense on property and equipment included in general and administrative expenses amounted to approximately $9,012 and $5,000 in 2023 and 2022, respectively. Depreciation and amortization expense of property and equipment relating to cost of services, research and development and sales and marketing were insignificant for all periods presented.

NOTE 11: OTHER ASSETS

Other assets consisted of the following at December 31:

	December 31, 2023	December 31, 2022
Intangible assets, net	$ 5,201	$ 5,944
Rent deposits	17,463	17,463
	$ 22,664	$ 23,407

Intangible assets, net consisted of the following at December 31:

	December 31, 2023	December 31, 2022
Capitalized research and development costs	$ 614,408	$ 614,408
Organization and start-up costs	11,145	11,145
	625,553	625,553
Accumulated amortization	(620,352)	(619,609)
Intangible assets, net	$ 5,201	$ 5,944

Amortization expense amounted to $743 and $1,115 for the years ended December 31, 2023 and 2022, respectively.

The Company's estimated future intangible assets amortization expense is as follows:

	Amounts
Years Ending December 31:	
2024	743
2025	743
2026	743
2027	743
Thereafter	2,229
	$ 5,201

NOTE 12: LOANS FROM OFFICERS AND DIRECTORS

The Company entered into note agreements with certain of its officers on May 24, 2023 amounting to $30,000 and $150,000, and with certain of its Board of Director members on June 19, 2023 amounting to $250,000 and $150,000. The loans were payable in full including accrued fees on or before August 30, 2023. The loans are secured by the Earned Retention Credit refund claim filed by the Company with the Internal Revenue Service (IRS) and the Company's accounts receivables. The Company reserves the right to fully or partially prepay the loans prior to maturity with no penalty.

On August 25, 2023, $550,000 of the loans were amended to change the repayment date to no later than November 30, 2023 and a note for $30,000 was repaid with interest. No other provisions of the note agreements were amended. On November 30, 2023, the loans were further amended to change the repayment date of the notes and accrued interest to no later than May 31, 2025. A finance fee of $55,000, in consideration for extending the repayment date, is due no later than May 31, 2024. No other interest is due. The amendments were accounted for as a debt modification and resulted in a new discount rate of 12.55%.

NOTE 13: DEBT OBLIGATIONS

<u>Small Business Administration Loan</u>

In November 2021, the Company entered into a Loan Authorization Agreement with the U.S. Small Business Administration (US SBA) in which the Company would receive a loan for $150,000 (the "promissory note"). The promissory note would bear interest at 3.5% per annum with installment payments, including principal and interest, of $731 per month, to begin twelve months from the date of the promissory note. The principal and interest will be payable over thirty years from the date of the promissory note. The proceeds from the promissory note were received in March 2022.

Effective March 2022, the SBA provided additional deferment of principal and interest payments for existing COVID Economic Injury Disaster Loan (EIDL) program borrowers for a total of 30 months deferment from inception. Hence, the installment payments of $731 will begin on September 16, 2024.

NOTE 14: STOCKHOLDERS' EQUITY (DEFICIT)

As of December 31, 2023, the Company was authorized to issue one class of stock with a $0.00001 par value consisting of common stock totaling 250,000,000 shares. All Preferred Stock was converted to common shares in connection with the Company's IPO in 2022.

As of both December 31, 2023 and 2022 respectively, 133,222,854 shares of Common Stock were issued and outstanding. The Company has reserved 25,000,000 shares of its common stock pursuant to the 2014 Stock Plan (2014 Plan) as of December 31, 2023. A total of 5,930,927 stock options are outstanding under the 2014 Plan as of December 31, 2023 and 2022, respectively.

NOTE 15: STOCK-BASED COMPENSATION

<u>Stock Options</u>

In November 2014, the Board of Directors adopted the 2014 Equity Incentive Plan (the "2014 Plan") allowing for the issuance of shares of common stock through grants of options or the direct award or sale of shares. The 2014 Plan provides for the granting of stock awards such as incentive stock options, non-statutory stock options, and restricted share unit awards to employees, directors and outside consultants as determined by the Board of Directors. The Plan, as last amended in June 2022, allows for the issuance of 25,000,000 shares of Company common stock.

The Board may grant stock options under the 2014 Plan at a price of not less than 100% of the fair market value of the Company's common stock on the date the option is granted. The option exercise price generally may not be less than the underlying stock's fair market value at the date of grant and generally have a term of ten years. Incentive stock options granted to employees who, on the date of grant, own stock representing more than 10% of the voting power of all of the Company's classes of stock, are granted at an exercise price of not less than 110% of the fair market value of the Company's common stock. The maximum term of incentive stock options granted to employees who, on the date of grant, own stock having more than 10% of the voting power of all the Company's classes of stock, may not exceed five years. The Board of Directors also determines the terms and conditions of awards, including the vesting schedule and any forfeiture provisions. Options granted under the 2014 Plan may vest upon the passage of time, generally four years, or upon the attainment of certain performance criteria established by the Board of Directors. The Company may from time-to-time grant options to purchase common stock to nonemployees for advisory and consulting services. At each measurement date, the Company will remeasure the fair value of these stock options using the Black-Scholes option pricing model and recognize the expense ratably over the vesting period of each stock option award.

The Company measures employee stock-based awards at grant-date fair value and recognizes employee compensation expense on a straight-line basis over the vesting period of the award. Determining the appropriate fair value of stock-based awards requires the input of subjective assumptions, including the fair value of the Company's common stock, and for stock options, the expected life of the option, and expected stock price volatility. The Company used the Black-Scholes option pricing model to value its stock option awards. The assumptions used in calculating the fair value of stock-based awards represent management's best estimates and involve inherent uncertainties and the application of management's judgment. As a result, if factors change and management uses different assumptions, stock-based compensation expense could be materially different for future awards.

The expected life of the stock options was estimated using the "simplified method," which is based on the midpoint between the vesting start date and the end of the contractual term, as the Company has limited historical information to develop reasonable expectations about future exercise patterns and employment duration for its stock options grants. The simplified method is based on the average of the vesting tranches and the contractual life of each grant. For stock price volatility, the Company uses comparable public companies as a basis for its expected volatility to calculate the fair value of options grants. The risk-free interest rate is based on U.S. Treasury notes with a term approximating the expected life of the option. The estimation of the number of stock awards that will ultimately vest requires judgment, and to the extent actual results or updated estimates differ from the Company's current estimates, such amounts are recognized as an adjustment in the period in which estimates are revised.

The Company recognized employee stock-based compensation expense for the years ended December 31, 2023 and 2022, respectively, which was calculated based upon awards ultimately expected to vest, and thus, this expense was reduced for estimated forfeitures. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.
Stock-based compensation is included in the statements of operations in cost of revenue, general and administrative, research and development, or sales and marketing expenses, depending on the nature of the services provided.

Stock-based compensation expense recorded to operations for stock options was as follows:

	December 31, 2023	December 31, 2022
Cost of revenue	$ (6,944)	$ 4,104
General and administrative	122,117	194,878
Research and development	95,240	163,461
	$ 210,413	$ 362,443

Restricted Stock Units

In 2022, the Company's Board of Directors approved the creation of Restricted Stock Units ("RSU's") to be awarded to its CEO and its CTO. A total of 7,000,000 RSU's were issued with the CEO and CTO each receiving 3,500,000 RSUs. Each RSU has the right to convert to one share of the Company's common stock. The RSU's were issued subject to, and in conjunction with, the Company's IPO on November 18, 2022. The RSU's were issued as Class A and Class B RSU's – a total of 3,500,000 RSU's of each class. The Class A RSU's vested in two tranches upon the Company achieving certain revenue target thresholds for the period from January 1, 2022 to June 1, 2023. The Class B RSU's vest upon the Company achieving Beyond Visual Line of Sight ("BVLOS") certification from the FAA, and the Company achieving a certain revenue threshold within 18 months of receiving the BVLOS certification. The Class B RSU's expire 18 months after BVLOS certification is received. The Class A RSU's are not transferable and do not entitle the holder to any voting rights until such time as the Class B RSU's vest and the holder is issued common shares in exchange for the RSU's.

Similar to its accounting for stock options, the Company measures RSU awards at grant-date fair value and recognizes employee compensation expense on a straight-line basis over the vesting period of the award. Determining the appropriate fair value of stock-based awards requires the input of subjective assumptions, including the fair value of the Company's common stock, and for stock options, the expected life of the option, and expected stock price volatility. The Company used the Black-Scholes option pricing model to value its stock option awards. The assumptions used in calculating the fair value of stock-based awards represent management's best estimates and involve inherent uncertainties and the application of management's judgment. As a result, if factors change and management uses different assumptions, stock-based compensation expense could be materially different for future awards.

NOTE 16: EMPLOYEE BENEFIT PLAN

The Company has a 401(k) retirement plan (the 401(k) Plan) administered by a third party in which all eligible employees can participate. The Company has made no matching contributions.

NOTE 17: INCOME TAXES

Domestic and foreign components of loss before provision for income taxes for the years ended December 31, 2023 and 2022 are as follows:

	December 31, 2023	December 31, 2022
United States	$ 2,507,920	$ 5,973,794
Loss before income taxes	$ 2,507,920	$ 5,973,794

Deferred tax assets and deferred tax liabilities are recognized based on temporary differences between the financial reporting and tax basis of assets and liabilities using statutory rates. A valuation allowance is recorded against deferred tax assets if it is more likely than not that some or all of the deferred tax assets will not be realized. Due to the uncertainty surrounding the realization of the favorable tax attributes in future tax returns, we have recorded fall valuation allowance against our otherwise recognizable net deferred tax assets.

Net operating loss and tax credit carryforwards

The utilization of NOLs and tax credit carryforwards to offset future taxable income may be subject to an annual limitation as a result of ownership changes that have occurred previously or may occur in the future. Under Sections 382 and 383 of the Internal Revenue Code (IRC) a corporation that undergoes an ownership change may be subject to limitations on its ability to utilize its pre-change NOLs and other tax attributes otherwise available to offset future taxable income and/or tax liability. An ownership change is defined as a cumulative change of 50% or more in the ownership positions of certain stockholders during a rolling three-year period. The Company has not completed a formal study to determine if any ownership changes within the meaning of IRC Section 382 and 383 have occurred. If an ownership change has occurred, the Company's ability to use its NOLs or tax credit carryforwards may be restricted, which could require the Company to pay federal or state income taxes earlier than would be required if such limitations were not in effect.

Effective for tax years beginning after December 31, 2021, taxpayers are required to capitalize any expenses incurred that are considered incidental to R&E activities under IRC Section 174. While taxpayers historically had the option of deducting these expenses under IRC Section 174, the December 2017 Tax Cuts and Jobs Act mandates capitalization and amortization of R&E expenses for tax years beginning after December 31, 2021. Expenses incurred in connection with R&E activities in the US must be amortized over a 5-year period if incurred, and R&E expenses incurred outside the US must be amortized over a 15-year period. R&E activities are broader in scope than qualified research activities considered under IRC Section 41 (relating to the research tax credit). For the year ended December 31, 2022, the Company performed an analysis based on available guidance and determined that it will continue to be in a loss position even after the required capitalization and amortization of its R&E expenses. The Company will continue to monitor this issue for future developments, but it does not expect R&E capitalization and amortization to require it to pay cash taxes now or in the near future.

NOTE 18: LEASE OBLIGATIONS

Effective December 2017, the Company entered into a facility lease agreement for manufacturing space located in Newark, California. The lease term commenced May 1, 2018 and expired on June 30, 2021 at which time the lease was amended with a new expiration date of February 14, 2022 and was further amended such that the expiration date of the new lease is now February 14, 2026. Monthly lease obligations under the amended agreement include base rent starting at $13,339 per month plus 26.2% of common area operating costs, subject to actual expenses. The base rent was contractually escalated to $13,801 per month beginning December 15, 2020 and to $14,216 per month beginning December 15, 2021.

Operating lease cost totaled $166,984 and $214,078 for the years ended December 31, 2023 and 2022, respectively. The amounts are included in general and administrative expenses in the statements of operations.

As of December 31, 2023 and 2022, operating lease ROU asset amounted to $385,659 and $538,462, respectively. Weighted average remaining lease term is 2.62 years. Weighted average discount rate is 6.25%.

Operating cash flow used from operating activities amounted to $111,860 and $174,016 for the period ended December 31, 2023 and 2022, respectively. ROU assets obtained in exchange for operating lease liabilities amounted to nil and $713,098 for the years ended December 31, 2023 and 2022, respectively.

To calculate the ROU assets and lease liabilities, the Company uses the discount rate implicit in lease agreements when available. When the implicit discount rates are not readily determinable, the Company uses its incremental borrowing rate. The Company determines the incremental borrowing rate using the interest rates from the Company's secured borrowings after taking into consideration the nature of the debt, such as borrowings collateralized by the exact building in the lease, and payment structure, including frequency and number of payments in the agreement.

Maturities of operating lease liabilities as of December 31, 2023 are as follows:

For the period ending:	
2024	183,524
2025	205,993
2026	17,463
Thereafter	—
Total lease payments	406,980
Less: imputed interest	25,605
Less: lease liabilities, current	164,789
Lease liabilities, non-current	$ 216,586

NOTE 19: COMMITMENTS AND CONTINGENCIES

In the normal course of business, the Company enters into contracts that contain various representations and provide for general indemnifications. The Company's exposure under these agreements is unknown because any claims that may be made against the Company in the future have not yet been made. To date, the Company has not paid any claims or been required to defend any action related to its indemnification obligations and, accordingly, the Company believes that the fair value of these indemnification obligations is minimal and has not accrued any amounts for these obligations.

From time to time, the Company is subject to claims and assessments in the ordinary course of business. The Company is not currently a party to any litigation matters that, individually or in the aggregate, are expected to have a material adverse effect on the Company's business, financial condition, results of operations, or cash flows.

NOTE 20: SUBSEQUENT EVENTS

Convertible Note Purchase Agreement

In February 2024, the Company entered into a Convertible Note Purchase Agreement. The principal amount of the offering is $250,000 with a face amount of $1 per convertible note and an interest of 15% per annum. This will mature two (2) years from the date of issue. The principal amount, along with all accrued and unpaid interest on the convertible notes, becomes due and payable on the maturity date. Interest on the convertible notes can be paid, at the Company's discretion, either in cash or in the form of the Company's CDIs. The proceeds are utilized for general corporate purposes.

The convertible notes have no voting rights; they will also not carry any entitlement to participate in future issuances of securities by the Company and are not transferable without the prior written consent of the Company. The convertible notes are not listed on the ASX, and are unsecured.

With 30 days' prior written notice to the holder, the Company may, before or at the maturity date, choose to redeem, proportionately, all or some of the convertible notes held by the holder. Upon reaching the maturity date, the Company holds the discretion to compel the holder to convert some or all of the outstanding principal, as well as accrued and unpaid interest, on the convertible notes into CDIs (Conversion CDIs) at the conversion price. The Company shall apply for the Conversion CDIs to be traded on ASX promptly after issue.