BRAVO FOODS INTERNATIONAL CORP
Form 10QSB/A
October 03, 2006

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

AMENDMENT NO. 1 TO FORM 10Q-SB
QUARTERLY OR TRANSITIONAL REPORT

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

For the Quarterly Period Ended March 31, 2006

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

Commission File Number 000-25039

BRAVO! FOODS INTERNATIONAL CORP.
(Exact name of registrant as specified in its amended charter)

Delaware	62-1681831
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

11300 US Highway 1, North Palm Beach, Florida 33408 USA
(Address of principal executive offices)

(561) 625-1411
Registrant's telephone number

(Former name, former address and former fiscal year if changed since last report)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934, during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes |X| No |_| Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes |_| No |X|

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY
PROCEEDINGS DURING THE PRECEDING FIVE YEARS

Check whether the registrant filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 after the distribution of securities under a plan confirmed by a court. Yes |_| No |_|

APPLICABLE ONLY TO CORPORATE ISSUERS

The number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date is as follows:

Date	Class	Shares Outstanding
September 25, 2006	Common Stock	195,018,001
	Preferred Stock	456,840

Transitional Small Business Disclosure Format (Check One) YES [ ] NO [x]

BRAVO! FOODS INTERNATIONAL CORP. AND SUBSIDIARY

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DOCUMENTS INCORPORATED BY REFERENCE: See Exhibits

EXPLANATORY NOTE

We are filing this Amendment No. 1 to our Quarterly Report on Form 10-QSB for the quarterly period ended March 31, 2006 to reflect the restatement of our consolidated financial statements for the periods ended March 31, 2006 and 2005. As more fully described in Note 10 to the consolidated financial statements, included herein, we have restated our consolidated financial statements to (i) properly account for certain derivative financial instruments embedded in our notes payable, convertible notes payable and redeemable preferred stock, (ii) properly account for other derivative financial instruments (principally warrants) that were issued in connection with our financing and other business arrangements, (iii) reclassify and properly account for redeemable preferred stock and (iv) certain other matters more fully described in Note 10. We have also restated Management's Discussion and Analysis and our Evaluation of Disclosure Controls and Procedures, also included herein, to give effect to the restated financial information.

FORWARD-LOOKING STATEMENTS

Statements that are not historical facts, including statements about our prospects and strategies and our expectations about growth contained in this report are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements represent our present expectations or beliefs concerning future events. We caution that such forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among other things, the uncertainty as to our future profitability; the uncertainty as to whether our new business model can be implemented successfully; the accuracy of our performance projections; and our ability to obtain financing on acceptable terms to finance our operations until we become profitable.

BRAVO! FOODS INTERNATIONAL CORP. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS

	March 31, 2006 (Unaudited (Restated
Assets	
Current assets:	
Cash and cash equivalents	$ 609,7
Accounts receivable, net of allowances for doubtful accounts of $364,941 and $350,000 at 2006 and 2005, respectively	1,537,8
Inventories	3,043,9
Prepaid expenses	1,947,9
Total current assets	7,139,4
Furniture and equipment, net	514,9
Intangible assets, net	17,881,6
Other assets	20,9
Total assets	$ 25,556,9
Liabilities, Redeemable Preferred Stock and Stockholders' Deficit	
Current liabilities:	
Accounts payable	$ 7,997,2
Accrued liabilities	4,387,1
Current maturities of notes payable	992,9
Convertible debt	1,023,8
Derivative liabilities	30,556,9
Total current liabilities	44,958,2
Notes payable, less current maturities	109,7
Total liabilities	45,068,0

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BRAVO! FOODS INTERNATIONAL CORP. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS

	March 31, 2006 (Unaudited (Restated
Commitments and contingencies (Note 9)	
Redeemable preferred stock:	
Series F convertible, par value $0.001 per share, 200,000 shares designated, Convertible Preferred Stock, stated value $10.00 per share, 5,248 shares issued and outstanding	52,4
Series H convertible, par value $0.001 per share, 350,000 shares designated, 7% Cumulative Convertible Preferred Stock, stated value $10.00 per share, 64,500 shares issued and outstanding	427,4
Series J, par value $0.001 per share, 500,000 shares designated, 8% Cumulative Convertible Preferred Stock, stated value $10.00 per share, 200,000 shares issued and outstanding	1,007,9
Series K, par value $0.001 per share, 500,000 shares designated, 8% Cumulative Convertible Preferred Stock, stated value $10.00 per share, 95,000 shares issued and outstanding	803,6
Total redeemable preferred stock	2,291,5
Stockholders' deficit:	
Preferred stock, 5,000,000 shares authorized	
Series B Preferred, par value $0.001 per share, 1,260,000 shares designated, 9% Convertible Preferred Stock, stated value $1.00 per share, 107,440 shares issued and outstanding	107,4
Common stock, par value $0.001 per share, 300,000,000 shares authorized, 185,753,753 and 184,253,753 shares issued and outstanding	185,7
Additional paid-in capital	97,675,1
Common stock subscription receivable	(10,0
Accumulated deficit	(119,729,4
Cumulative translation adjustment	(31,4
Total stockholders' deficit	(21,802,6
Total liabilities, redeemable preferred stock and stockholders' deficit	$ 25,556,9

See accompanying notes.

BRAVO! FOODS INTERNATIONAL CORP. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

	Three Months Ended March 31, 2006 (Unaudited) (Restated)	Three Months Ended March 31, 2005 (Unaudited) (Restated)
Revenues	$ 3,561,215	$ 897,770
Product costs	(2,946,460)	(677,663)
Shipping costs	(393,452)	(138,450)
Gross margin	221,303	81,657
Operating expenses:		
Selling	2,843,098	485,031
General and administrative	1,768,203	758,254
Product development	115,963	69,024
Loss from operations	(4,505,961)	(1,230,652)
Other income (expense)		
Derivative income, net	4,949,188	1,471,743
Interest expense, net	(34,007)	(894,161)
Liquidated damages	(685,887)	
Income (loss) before income taxes	(276,667)	(653,070)
Provision for income taxes	-	
Net loss	(276,667)	(653,070)
Preferred stock dividends and accretion	(258,783)	(271,115)
Loss applicable to common stockholders	$ (535,450)	$ (924,185)
Loss per common share:		
Basic	$ (0.00)	$ 0.02
Diluted	$ (0.00)	$ 0.02
Weighted average common shares outstanding	184,253,753	59,618,018
Comprehensive loss:		
Net loss	$ (276,667)	$ (653,070)
Foreign currency translation	(690)	(8,023)
Comprehensive loss	$ (277,357)	$ (661,093)

See accompanying notes.

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BRAVO! FOODS INTERNATIONAL CORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS

Three Months Ended March 31

	2006	2005
	(Unaudited) (Restated)	(Unaudited) (Restated)
Cash Flows from Operating Activities:		
Net income (loss)	$ (276,667)	$ (653,070)
Adjustments to net loss		
Depreciation and amortization	896,505	234,005
Stock issuance for compensation	--	57,500
Bad debt expense	14,941	--
Derivative income	(4,949,188)	(1,471,743)
Amortization of debt discount	11,076	772,181
Stock option expense for consultants	347,566	--
Employee options issued for compensation	111,592	--
Stock option expense for consultants	--	30,000
Loss on disposal of fixed assets	1,999	--
Changes in operating assets & liabilities:		
Accounts receivable	1,596,042	16,844
Inventories	(2,652,769)	6,982
Prepaid expenses and other assets	(980,325)	(118,713)
Accounts payable and accrued expenses	1,668,557	397,710
Net cash used in operating activities	(4,210,671)	(728,304)
Cash Flows from Investing Activities		
Licenses, finance and trademark costs	(163,536)	(371,649)
Purchases of equipment	(249,910)	(11,625)
Net cash used in investing activities	(413,446)	(383,274)
Cash Flows provided by financing activities:		
Proceeds from conversion of warrants	150,000	--
Proceeds from convertible notes payable	169,323	1,150,000
Payment of dividends	(11,257)	--
Payment of notes payable	(4,317)	--
Registration costs for financing	(17,143)	(26,728)
Net cash provided by financing activities	286,606	1,123,272
Effect of changes in exchange rates on cash	(690)	(8,023)
Net (decrease) increase in cash and cash equivalents	(4,338,201)	3,671
Cash and cash equivalent, beginning of period	4,947,986	113,888
Cash and cash equivalent, ending of period	$ 609,785	$ 117,559

See accompanying notes.

BRAVO! FOODS INTERNATIONAL CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

Note 1 -Nature of Business, Basis of Presentation and Liquidity and Management's Plans

Nature of Business:

We are engaged in the sale of flavored milk products and flavor ingredients in the United States, the United Kingdom and the Middle East, and we are establishing an infrastructure to conduct business in Canada.

Basis of Presentation:

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10QSB, Item 310(b) of Regulation S-B and Article 10 (01)(c) of Regulation S-X. Accordingly, the accompanying financial statements do not include all the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included in the accompanying financial statements. Operating results for the three-month period ending March 31, 2006 are not necessarily indicative of the results that may be expected for the year ended December 31, 2006.

As more fully described in Note 10, we have restated our balance sheets as of March 31, 2006 and our statements of operations and cash flows for the three months ended March 31, 2006 and 2005 for errors related to the accounting for derivative instruments arising from certain of our financing transactions and certain other matters. We have also made certain reclassifications to the March 31, 2006 and December 31, 2005 balance sheets and statements of operations and cash flows for the three months ended March 31, 2006 to conform to presentations and classifications in the current period. The consolidated balance sheet at December 31, 2005, is audited.

Liquidity and Management's Plans:

As reflected in the accompanying consolidated financial statements, we have incurred operating losses and negative cash flow from operations and have a working capital deficiency of $37,818,789 as of March 31, 2006. In addition, we are delinquent on certain of our debt agreements at March 31, 2006, and we have experienced delays in filing our financial statements and registration statements due to errors in our historical accounting that have been corrected (See Note 10). Our inability to make these filings is resulting in our recognition of penalties payable to the investors, and these penalties will continue until we can complete our filings and register the common shares into which the investors' financial instruments are convertible. Finally, our revenues are significantly concentrated with one major customer. The loss of this customer or curtailment in business with this customer could have a material adverse affect on our business. These conditions raise substantial doubt about our ability to continue as a going concern.

We have been dependent upon our ability to successfully complete financings as we execute our business model and plans. Although our liquid reserves have been substantially depleted as of March 31, 2006, we completed a $30.0 million convertible note financing in July 2006 that is expected to fulfill our liquidity requirements through the end of 2006. However, $15.0 million of this financing is being held in escrow, pending approval by our shareholders of an increase in our authorized shares of common stock. We were

BRAVO! FOODS INTERNATIONAL CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

in default on this instrument due to the delay in filing our quarterly financial report for the quarterly period ended June 30, 2006. As a result, an event of default has occurred under the terms of the Notes, and the interest rate on the Notes, payable quarterly, was increased from 9% to 14% per annum. Pursuant to the terms of the Notes, upon the occurrence of an event of default, holders of the Notes may, upon written notice to the Company, each require the Company to redeem all or any portion of their Notes at a default redemption price calculated pursuant to the terms of the Notes. On August 31, 2006, we entered into an Amendment Agreement with the holders of the Notes to amend the Notes in certain respects as consideration for the holders' release of the Company's default resulting from its delay in the filing of this quarterly report. See Item 3 of Part II of this report, entitled "Default on Senior Securities", for a description of the terms of the Amendment Agreement.

We plan to increase our sales, improve our gross profit margins, augment our international business and, if necessary, obtain additional financing. Ultimately, our ability to continue is dependent upon the achievement of profitable operations. There is no assurance that further funding will be available at acceptable terms, if at all, or that we will be able to achieve profitability.

The accompanying financial statements do not reflect any adjustments that may result from the outcome of this uncertainty.

Note 2. - Summary of Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Among the more significant estimates included in our financial statements are the following:

- Estimating future bad debts on accounts receivable that are carried at net realizable values.
- Estimating our reserve for unsalable and obsolete inventories that are carried at lower of cost or market.
- Estimating the fair value of our financial instruments that are required to be carried at fair value.
- Estimating the recoverability of our long-lived assets.

We use all available information and appropriate techniques to develop our estimates. However, actual results could differ from our estimates.

Business Segment and Geographic Information

We operate in one dominant industry segment that we have defined as the single serve flavored milk industry. While our international business is expected to grow in the future, it currently contributes less than 10% of our revenues, and we have no physical assets outside of the United States.

Revenue Recognition

Our revenues are derived from the sale of branded milk products to customers in the United States of America, Great Britain and the Middle East. For the period ended March 31, 2006, our revenues were

geographically dispersed 98% and 2% between the United States of America and internationally, respectively. We currently have one customer in the United States that provided 71% and 0% of our revenue during the three months ended March 31, 2006 and 2005, respectively.

Revenues are recognized pursuant to formal revenue arrangements with our customers, at contracted prices, when our product is delivered to their premises and collectibility is reasonably assured. We extend merchantability warranties to our customers on our products, but otherwise do not afford our customers with rights of return. Warranty costs have historically been insignificant.

Our revenue arrangements often provide for industry-standard slotting fees where we make cash payments to the respective customer to obtain rights to place our products on their retail shelves for a stipulated period of time. We also engage in other promotional discount programs in order to enhance our sales activities. We believe our participation in these arrangements is essential to ensuring continued volume and revenue growth in the competitive marketplace. These payments, discounts and allowances are recorded as reductions to our reported revenue. Unamortized slotting fees are recorded in prepaid expenses.

Principles of Consolidation

Our consolidated financial statements include the accounts of Bravo! Foods International Corp. (the "Company"), and its wholly-owned subsidiary Bravo! Brands (UK) Ltd. All material intercompany balances and transactions have been eliminated.

Shipping and Handling Costs

Shipping and handling costs incurred to deliver products to our customers are included as a component of cost of sales. These costs amounted to approximately $393,452 and $138,450 for the three months ended March 31, 2006 and 2005, respectively.

Cash and Cash Equivalents

We consider all highly liquid investments purchased with a remaining maturity of three months or less to be cash equivalents.

Accounts Receivable

Our accounts receivable are exposed to credit risk. During the normal course of business, we extend unsecured credit to our customers with normal and traditional trade terms. Typically credit terms require payments to be made by the thirtieth day following the sale. We regularly evaluate and monitor the creditworthiness of each customer. We provide an allowance for doubtful accounts based on our continuing evaluation of our customers' credit risk and our overall collection history. As of March 31, 2006 and December 31, 2005, the allowance of doubtful accounts aggregated approximately $365,000 and $350,000, respectively.

In addition, our accounts receivable are concentrated with one customer who represents 54% and 34% of our gross accounts receivable balances at March 31, 2006 and December 31, 2005, respectively. Approximately, 6% of our gross accounts receivable at March 31, 2006 are due from international customers.

Inventories

Inventories, which consist primarily of finished goods, is stated at the lower of cost on the first in, first-out method or market. Our inventories at March 31, 2006 have substantially increased from levels at December 31, 2005 because we are building inventories to support our contractual arrangement with a significant customer. Further, our inventories are perishable. Accordingly, we estimate and record lower-of-cost or market and unsalable-inventory reserves based upon a combination of our historical experience and on a specific identification basis. During the three months ended March 31, 2006, we did not provide for unsalable inventories.

In November 2004, the FASB issued Financial Accounting Standard No. 151, Inventory Costs, an amendment of ARB No. 43 Chapter 4 ("FAS 151"), which clarifies that inventory costs that are "abnormal" are required to be charged to expense as incurred as opposed to being capitalized into inventory as a product cost. FAS 151 provides examples of "abnormal" costs to include costs of idle facilities, excess freight and handling costs and spoilage. FAS 151 became effective for our fiscal year beginning January 1, 2006. The adoption of FAS No. 151 did not have a material effect on our consolidated financial statements.

Furniture and Equipment

Furniture and equipment are stated at cost. Depreciation is computed using the straight-line method over a period of seven years for furniture and five years for equipment. Maintenance, repairs and minor renewals are charged directly to expenses as incurred. Additions and betterments to property and equipment are capitalized. When assets are disposed of, the related cost and accumulated depreciation thereon are removed from the accounts, and any resulting gain or loss is included in the statement of operations.

Intangible Assets

Our intangible assets as of March 31, 2006 and December 31, 2005 consist of our distribution agreement with Coca-Cola Enterprises ("CCE"), our manufacturing agreement with Jasper Products, Inc. and licenses and trademark costs, with estimated lives of ten years, five years and one-to-five years, respectively. The following table illustrates information about our intangible assets:

	March 31, 2006	December 31, 2005

Distribution agreement	$15,960,531	$15,960,531
Manufacturing agreement	2,700,000	2,700,000
Licenses and trademarks	586,482	1,370,958
Less accumulated amortization	(1,365,366)	(1,437,929)
	$17,881,647	$18,593,560

Amortization expense amounted to $848,500 and $61,849 for the three months ended March 31, 2006 and March 31, 2005, respectively.

Estimated future amortization of our intangible assets is as follows as of March 31, 2006:

Nine months ended December 31, 2006	$1,837,171
Year ended:	
December 31, 2007	$2,367,947

December 31, 2008	$2,356,342
December 31, 2009	$2,355,844
December 31, 2010	$2,203,289
December 31, 2011	$1,767,591

Impairment of Long-Lived Assets

We evaluate the carrying value and recoverability of our long-lived assets when circumstances warrant such evaluation by applying the provisions of Financial Accounting Standard No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets ("FAS 144"). FAS 144 requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable through the estimated undiscounted cash flows expected to result from the use and eventual disposition of the assets. Whenever any such impairment exists, an impairment loss will be recognized for the amount by which the carrying value exceeds the fair value.

Financial Instruments

Financial instruments, as defined in Financial Accounting Standard No. 107 Disclosures about Fair Value of Financial Instruments ("FAS 107"), consist of cash, evidence of ownership in an entity and contracts that both (i) impose on one entity a contractual obligation to deliver cash or another financial instrument to a second entity, or to exchange other financial instruments on potentially unfavorable terms with the second entity, and (ii) conveys to that second entity a contractual right (a) to receive cash or another financial instrument from the first entity, or (b) to exchange other financial instruments on potentially favorable terms with the first entity. Accordingly, our financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable, accrued liabilities, notes payable, derivative financial instruments, convertible debt and redeemable preferred stock that we have concluded is more akin to debt than equity.

We carry cash and cash equivalents, accounts receivable, accounts payable, and accrued liabilities at historical costs; their respective estimated fair values approximate carrying values due to their current nature. We also carry notes payable, convertible debt and redeemable preferred stock at historical cost; however, fair values of debt instruments and redeemable preferred stock are estimated for disclosure purposes (below) based upon the present value of the estimated cash flows at market interest rates applicable to similar instruments.

As of March 31, 2006 and December 31, 2005, estimated fair values and respective carrying values of our notes payable, convertible debt and redeemable preferred stock are as follows:

Instrument	Note	Fair Value 2006	Carrying Value 2006	Fair Value 2005	Carr
$750,000 Note Payable	4(a)	$ 750,000	$ 750,000	$ 750,000	$
$187,743 Note Payable	4(b)	187,743	187,743	187,743	
Other Notes Payable	4(c)	165,007	165,007	--	
$200,000 Convertible Note	5(a)	200,000	196,569	190,000	
$15,000 Convertible Note	5(b)	14,200	3,031	13,300	
$600,000 Convertible Note	5(c)	668,000	600,000	668,000	
$6,250 Convertible Note	5(e)	6,250	6,219	6,375	

$25,000 Convertible Note	5(f)	25,500	30,278	25,500	
$187,760 Convertible Note	5(g)	187,760	187,760	187,600	
Series F Preferred Stock	6(d)	49,000	52,480	46,000	
Series H Preferred Stock	6(a)	557,000	427,479	525,000	
Series J Preferred Stock	6(b)	1,781,000	1,007,927	1,731,000	
Series K Preferred Stock	6(c)	927,000	803,688	881,000	

Derivative financial instruments, as defined in Financial Accounting Standard No. 133, Accounting for Derivative Financial Instruments and Hedging Activities ("FAS 133"), consist of financial instruments or other contracts that contain a notional amount and one or more underlying (e.g. interest rate, security price or other variable), require no initial net investment and permit net settlement. Derivative financial instruments may be free-standing or embedded in other financial instruments. Further, derivative financial instrument are initially, and subsequently, measured at fair value and recorded as liabilities or, in rare instances, assets.

We generally do not use derivative financial instruments to hedge exposures to cash-flow, market or foreign-currency risks. However, we have entered into certain other financial instruments and contracts, such as debt financing and common stock arrangements, redeemable preferred stock arrangements, and freestanding warrants with features that are either (i) not afforded equity classification, (ii) embody risks not clearly and closely related to host contracts, or (iii) may be net-cash settled by the counterparty. As required by FAS 133, these instruments are required to be carried as derivative liabilities, at fair value, in our financial statements.

The following table summarizes the components of derivative liabilities as of March 31, 2006 and December 31, 2005:

	Note	2006	
Compound derivative financial instruments that have been bifurcated from the following financing arrangements:			
$400,000 Convertible Note Financing	5(a)	$ (1,258,200)	$ (1
$2,300,000 Convertible Note Financing	5(b)	(4,219)	
$600,000 Convertible Note Financing	5(c)	(286,200)	
$693,000 Convertible Note Financing	5(e)	(42,656)	
$660,000 Convertible Note Financing	5(f)	(146,250)	
$1,080,000 Convertible Note Financing	5(g)	(549,808)	
Series F Preferred Stock Financing	6(d)	(20,329)	
Series H Preferred Stock Financing	6(a)	(396,362)	
Series J Preferred Stock Financing	6(b)	(4,704,000)	(5
Series K Preferred Stock Financing	6(c)	(209,338)	
Freestanding derivative contracts arising from financing and other business arrangements:			
Warrants issued with $693,000 Convertible Notes	5(e)	--	
Warrants issued with Series H Preferred Stock	6(a)	(936,205)	(1
Warrants issued with Series F Preferred Stock	6(d)	(505,231)	
Warrants issued with Series D Preferred Stock	6(d)	(366,147)	
Other warrants	8(b)	(21,132,012)	(24
Total derivative liabilities		$(30,556,957)	$(35

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See the notes referenced in the table for details of the origination and accounting for these derivative financial instruments. We estimate fair values of derivative financial instruments using various techniques (and combinations thereof) that are considered to be consistent with the objective measuring fair values. In selecting the appropriate technique, we consider, among other factors, the nature of the instrument, the market risks that it embodies and the expected means of settlement. For less complex derivative instruments, such as free-standing warrants, we generally use the Black-Scholes-Merton option valuation technique because it embodies all of the requisite assumptions (including trading volatility, estimated terms and risk free rates) necessary to fair value these instruments. For complex derivative instruments, such as embedded conversion options, we generally use the Flexible Monte Carlo valuation technique because it embodies all of the requisite assumptions (including credit risk, interest-rate risk and exercise/conversion behaviors) that are necessary to fair value these more complex instruments. For forward contracts that contingently require net-cash settlement as the principal means of settlement, we project and discount future cash flows applying probability-weightage to multiple possible outcomes. Estimating fair values of derivative financial instruments requires the development of significant and subjective estimates that may, and are likely to, change over the duration of the instrument with related changes in internal and external market factors. In addition, option-based techniques are highly volatile and sensitive to changes in our trading market price which has a high-historical volatility. Since derivative financial instruments are initially and subsequently carried at fair values, our income will reflect the volatility in these estimate and assumption changes.

The following table summarizes the effects on our income (loss) associated with changes in the fair values of our derivative financial instruments for the three months ended March 31, 2006 and 2005:

Derivative income (expense):	2006	2005
Convertible note and warrant financings	$ (50,904)	$ 582,675
Preferred stock and warrant financings	1,331,015	816,751
Other warrants and derivative contracts	3,699,077	72,317
	$4,949,188	$1,471,743

Our derivative liabilities as of March 31, 2006 and 2005 and our derivative income during each of the quarters ended March 31, 2006 and 2005 were significant to our financial statements. During the quarter ended March 31, 2006, the trading price of our common stock decreased from $0.59 at December 31, 2005 to $0.55 at March 31, 2006. During the quarter ended March 31, 2005, the trading price decreased from $0.17 at December 31, 2004 to $0.15 at March 31, 2005. The lower stock prices decreased the fair value of our derivative liabilities and, accordingly, we were required to adjust the derivatives to these lower values with credits to income.

The following table summarizes the number of common shares indexed to the derivative financial instruments as of March 31, 2006:

Financing or other contractual arrangement:	Note	Conversion Features	Warrants	Tot
$400,000 Convertible Note Financing	5(a)	4,000,000	--	4,000

$2,300,000 Convertible Note Financing	5(b)	120,000	2,000,000	2,120
$600,000 Convertible Note Financing	5(c)	4,100,000	--	4,100
$693,000 Convertible Note Financing	5(e)	63,542	--	63
$660,000 Convertible Note Financing	5(f)	250,000	1,500,000	1,750
$1,080,000 Convertible Note Financing	5(g)	1,924,540	--	1,924

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(UNAUDITED)

Series D Convertible Preferred Stock	6(d)	--	611,250	611
Series F Convertible Preferred Stock	6(d)	220,969	1,038,259	1,259
Series H Convertible Preferred Stock(a)	6(a)	--	4,387,500	4,387
Series J Convertible Preferred Stock	6(b)	20,000,000	--	20,000
Series K Convertible Preferred Stock(a)	6(c)	--	--	
Other warrants and contracts	8(b)	--	50,704,688	50,704
		30,679,051	60,241,697	90,920

(a) As more fully described in Notes 6(a) and 6(c) these instruments were afforded the conventional convertible exemption, which means we did not have to bifurcate the embedded conversion feature. However, we were required to bifurcate certain other embedded derivatives as discussed in the notes. Although the conversion features did not require derivative accounting, we are required to also consider the 990,905 and 9,500,000 common shares, respectively, into which these instruments are convertible in determining whether we have sufficient authorized and unissued common shares for all of our share-settled obligations.

We have entered into registration rights agreements with certain investors that require us to file a registration statement covering shares underlying a financing arrangement, become effective on the registration statement, maintain effectiveness and, in some instances, maintain the listing of the underlying shares. Certain of these registration rights agreements require our payment of liquidating damages to the investors in the event we do not achieve the requirements. We record estimated liquidated damages as liabilities and charges to our income when the liquidated damages are probable and estimable under Financial Accounting Standard No. 5, Accounting for Contingencies. During the three months ended March 31, 2006, we recorded liquidated damages expense of $685,887. These charges are significantly greater than the amounts we recorded in previous periods due to the fact that we now have incurred approximately $2.1 million of liquidated damages, and currently estimate that additional damages will accrue before we are able to cure our registration default.

Advertising and Promotion Costs

Advertising and promotion costs, which are included in selling expenses, are expensed as incurred and aggregated $1,243,908 and $138,722 for the three months ended March 31, 2006 and 2005, respectively.

Share-based payments

Effective January 1, 2005, we adopted the fair value recognition provisions of Financial Accounting Standards No. 123 Accounting for Stock-Based compensation ("FAS 123"). Effective January 1, 2006 we adopted Financial Accounting Standards No. 123(R), Share-Based Payments ("FAS123R"). Under the fair value method, we recognize compensation expense for all share-based payments granted after January 1, 2005, as well as all share-based payments granted prior to, but not yet vested, as of January 1, 2005, in accordance with FAS 123. Under the fair value recognition provisions of FAS 123R, we recognize share-based compensation expense, net of an estimated forfeiture rate, over the requisite service period of the award. Prior to the adoption of FAS 123 and FAS 123R, the Company accounted for share-based payments under Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees and the disclosure provisions of FAS 123. For further information regarding the adoption of SFAS No. 123R, see Note 7 to the consolidated financial statements.

Income Taxes

We account for income taxes using the liability method, which requires an entity to recognize deferred tax liabilities and assets. Deferred income taxes are recognized based on the differences between the tax bases of assets and liabilities and their reported amounts in the financial statements that will result in taxable or deductible amounts in future years. Further, the effects of enacted tax laws or rate changes are included as part of deferred tax expense or benefit in the period that covers the enactment date. A valuation allowance is recognized if it is more likely than not that some portion, or all, of a deferred tax asset will not be realized.

Loss Applicable to Common Shareholders

Our basic loss per common share is computed by dividing loss applicable to common stockholders by the weighted average number of common share outstanding during the reporting period. Diluted loss

applicable to common shareholders per common share is computed similar to basic loss per common share except that diluted loss per common share includes dilutive common stock equivalents, using the treasury stock method, and assumes that the convertible debt instruments were converted into common stock upon issuance, if dilutive. For the three months ended March 31, 2006 and 2005 potential common shares arising from our stock options, stock warrants, convertible debt and convertible preferred stock amounting to 81,913,744 and 129,857,869 shares, respectively, were not included in the computation of diluted earnings per share because their effect was antidilutive.

Note 3. Accrued liabilities

Accrued liabilities consist of the following as of March 31, 2006 and December 31, 2005:

	2006	2005

Liquidated damages due to late registration (a)	$ 989,637	$ 303,750
Investor relations liability	1,402,000	1,545,565
Production processor liability	61,544	182,814
Accrued payroll and related	511,017	636,757
Accrued interest	414,301	376,198
Discontinued products (b)	876,873	1,710,733
Other	131,815	116,460
	$4,387,187	$4,872,277

(a) Certain of our financing arrangements provide for penalties in the event of non-registration of securities underlying the financial instruments. Generally, these penalties are calculated as a percentage of the financing proceeds, usually between 1.0% and 3.0% each month. We record these liquidated damages when they are probable and estimable pursuant to FAS 5.

(b) During 2005, we discontinued certain product lines and, as a result, incurred certain penalties under purchase commitments with our manufacturing vendors. We accrued these penalties upon our decision to discontinue the products.

Note 4. Notes Payable

Notes payable consist of the following as of March 31, 2006 and December 31, 2005:

	2006	2005
$750,000 face value note payable, due September 3, 2004 (a)	$ 750,000	$ 750,000
$187,743 face value note payable, due December 31, 2005 (b)	187,743	187,743
Vehicle notes payable (c)	165,007	--
Total notes payable	1,102,750	937,743
Less current maturities	992,953	937,743
Long-term notes payable	$ 109,797	$ --

(a) On May 9, 2004 we received the proceeds of a $750,000 loan from Mid-Am Capital, payable September 3, 2004, with an interest rate of 8%. This loan is secured by a general security interest in all of our assets. Mid-Am has agreed to extend the note on a demand basis.

(b) In 1999, we issued a promissory note to assume existing debt owed by our then Chinese joint venture subsidiary to a supplier, International Paper. The face value of that unsecured note was $282,637 at an annual interest rate of 10.5%. The note originally required 23 monthly payments of $7,250 and a balloon payment of $159,862 due on July 15, 2000. During 2000, we negotiated an extension of this note to July 1, 2001. International Paper imposed a charge of $57,000 to renegotiate the note, which amount represents interest due through the extension date. The balance due on this note is $187,743 at March 31, 2006, all of which is delinquent. Although International Paper has not pursued collection of the note, it is possible that they could do so in the future and, if they do, such collection effort may have a significant adverse impact on the liquidity of the Company.

(c) In March 2006 we signed notes with GMAC for the purchase of eight vehicles. The initial principal balance was $169,323. The notes call for 36 monthly payments of $4,887, which includes principal and interest. The interest rate for seven of the notes is 1.9% with the other having a rate of 4.9%.

Note 5. Convertible Debt

Convertible debt carrying values consist of the following as of March 31, 2006 and December 31, 2005:

	2006	2005
$200,000 Convertible Note Payable, due November 2006 (a)	$ 196,569	$ 187,934
$15,000 Convertible Note Payable, due May 2007 (b)	3,030	1,620
$600,000 Convertible Note Payable, due December 2005 (c)	600,000	600,000
$6,250 Convertible Note Payable, due April 30, 2006 (e)	6,219	5,188
$25,000 Convertible Note Payable, due October 1, 2006 (f)	30,278	30,278
$187,760 Convertible Note Payable, due December 1, 2005 (g)	187,760	187,760
	$1,023,856	$1,012,780

(a) $400,000 Convertible Note Financing

On November 20, 2003, we issued $400,000 of 8.0% convertible notes payable, due November 20, 2005 plus warrants to purchase 14,000,000 shares of our common stock with a strike price ranging from $0.05 to $1.00 for a period of three years. The convertible notes had a face value outstanding of $200,000 on March 31, 2006 and December 31, 2005 following the modification of the underlying note agreement, extending the maturity date of the remaining balance to November 20, 2006. The convertible notes are convertible into a variable number of our common shares based upon a variable conversion price of the lower of $0.05 or 75% of the closing market price near the conversion date. The holder has the option to redeem the convertible notes payable for cash at 130% of the face value in the event of defaults and certain other contingent events, including events related to the common stock into which the instrument is convertible, registration and listing (and maintenance thereof) of our common stock and filing of reports with the Securities and Exchange Commission (the "Default Put"). In addition, we extended registration rights to the holder that required registration and continuing effectiveness thereof; we would be required to pay monthly liquidating damages of 2.0% for defaults under this provision.

In our evaluation of this instrument, we concluded that the conversion feature was not afforded the exemption as a conventional convertible instrument due to a variable conversion feature; and it did not otherwise meet the conditions for equity classification. Since equity classification is not available for the conversion feature, we were required to bifurcate the embedded conversion feature and carry it as a derivative liability, at fair value. We also concluded that the Default Put required bifurcation because, while puts on debt instruments are generally considered clearly and closely related to the host, the Default Put is indexed to certain events, noted above, that are not associated with debt instruments. We combined all embedded features that required bifurcation into one compound instrument that is carried as a

component of derivative liabilities. We also determined that the warrants did not meet the conditions for equity classification because, as noted above, share settlement and maintenance of an effective registration statement are not within our control. Therefore, the warrants are also required to be carried as a derivative liability, at fair value.

We estimated the fair value of the compound derivative on the inception dates, and subsequently, using the Monte Carlo Valuation technique, because that technique embodies all of the assumptions (including credit risk, interest risk, stock price volatility and conversion estimates) that are necessary to fair value complex derivative instruments. We estimated the fair value of the warrants on the inceptions dates, and subsequently, using the Black-Scholes-Merton Valuation technique, because that technique embodies all of the assumptions (including, volatility, expected terms, and risk free rates) that are necessary to fair value freestanding warrants. As a result of these estimates, our valuation model resulted in compound derivative balances associated with this financing arrangement of $1,258,200 and $1,311,000 as of March 31, 2006 and December 31, 2005, respectively. These amounts are included in Derivative Liabilities on our balance sheet. Warrants related to the financing were fully converted prior to December 31, 2005.

The following table illustrates fair value adjustments that we have recorded related to the derivative financial instruments associated with the $400,000 convertible note financing.

Derivative income (expense)	Three months ended March 31, 2006	Three months ended March 31, 2005
Compound derivative	$52,800	$238,800
Warrant derivative	$ --	$173,800

Changes in the fair value of the compound derivative and, therefore, derivative income (expense) related to the compound derivative is significantly affected by changes in our trading stock price and the credit risk associated with our financial instruments. The fair value of the warrant derivative is significantly affected by changes in our trading stock prices. Future changes in these underlying market conditions will have a continuing effect on derivative income (expense) associated with the remaining compound derivatives.

The aforementioned allocations to the compound and warrant derivatives resulted in the discount in the carrying value of the notes to zero. This discount, along with related deferred finance costs and future interest payments, are amortized through periodic charges to interest expense using the effective method. Interest expense during the three months ended March 31, 2006 and 2005 amounted to approximately $9,000 and $31,000, respectively.

As noted in the introductory paragraph of this section, the holders extended the notes one additional year to November 2006. This modification was accounted for as an extinguishment because the present value of the amended debt was significantly different than the present value immediately preceding the modification. As a result of the extinguishment, the existing debt carrying value was adjusted to fair value using projected cash flows at market rates for similar instruments. This extinguishment resulted in our recognition of a gain on extinguishment of $22,733 in the fourth fiscal quarter of our year ended December 31, 2005.

(b) $2,300,000 Convertible Note Financing:

On January 28, 2005, May 23, 2005 and August 18, 2005, we issued $1,150,000, $500,000 and $650,000, respectively of 8.0% convertible notes payable, due January 28, 2007 plus warrants to purchase 9,200,000, 4,000,000 and 5,200,000, respectively, shares of our common stock with a strike price of $0.129 for a period of five years. The convertible notes had a face value outstanding of $15,000 on March 31, 2006 and December 31, 2005 resulting from conversions to common stock. The convertible notes are convertible into a fixed number of our common shares based upon a conversion price of $0.125 with anti-dilution protection for sales of securities below the fixed conversion price. We have the option to redeem the convertible notes for cash at 120% of the face value. The holder has the option to redeem the convertible notes payable for cash at 120% of the face value in the event of defaults and certain other contingent events, including events related to the common stock into which the instrument is convertible, registration and listing (and maintenance thereof) of our common stock and filing of reports with the Securities and Exchange Commission (the "Default Put").

In our evaluation of this instrument, we concluded that the conversion feature was not afforded the exemption as a conventional convertible instrument due to the anti-dilution protection; and it did not otherwise meet the conditions for equity classification. Since equity classification is not available for the conversion feature, we were required to bifurcate the embedded conversion feature and carry it as a derivative liability, at fair value. We also concluded that the Default Put required bifurcation because, while puts on debt instruments are generally considered clearly and closely related to the host, the Default Put is indexed to certain events, noted above, that are not associated debt instruments. We combined all embedded features that required bifurcation into one compound instrument that is carried as a component of derivative liabilities. We also determined that the warrants did not meet the conditions for equity classification because these instruments did not meet all of the criteria necessary for equity classification. Therefore, the warrants are also required to be carried as a derivative liability, at fair value.

We estimated the fair value of the compound derivative on the inception dates, and subsequently, using the Monte Carlo Valuation technique, because that technique embodies all of the assumptions (including credit risk, interest risk, stock price volatility and conversion estimates) that are necessary to fair value complex derivative instruments. We estimated the fair value of the warrants on the inception dates, and subsequently, using the Black-Scholes-Merton Valuation technique, because that technique embodies all of the assumptions (including volatility, expected terms, and risk free rates) that are necessary to fair value freestanding warrants. As a result of these estimates, our valuation model resulted in compound derivative balances associated with this financing arrangement of $4,219 and $4,867 as of March 31, 2006 and December 31, 2005, respectively.

As of December 31, 2005 all warrants related to the financing had been converted.

The following table illustrates fair value adjustments that we have recorded related to the derivative financial instruments associated with the $2,300,000 convertible note financing:

Derivative income (expense)	Three months ended March 31, 2006	Three months ended March 31, 2005
Compound derivative	$648	$ 123,827
Warrant derivative	$ --	$(672,590)

Changes in the fair value of the compound derivative and, therefore, derivative income (expense) related to the compound derivative is significantly affected by changes in our trading stock price and the credit

risk associated with our financial instruments. The fair value of the warrant derivative is significantly affected by changes in our trading stock prices. Future changes in these underlying market conditions will have a continuing effect on derivative income (expense) associated with these instruments.

The aforementioned allocations to the compound and warrant derivatives resulted in the discount in the carrying value of the notes. This discount, along with related deferred finance costs and future interest payments, are amortized through periodic charges to interest expense using the effective method. Interest expense during the three months ended March 31, 2006 and 2005 amounted to approximately $6,000, respectively.

(c) $600,000 Convertible Note Financing:

On June 29, 2004, we issued $600,000 of 10.0% convertible notes payable, due December 31, 2005, plus warrants to purchase 2,000,000 and 5,000,000 shares of our common stock with strike prices of $0.25 and $2.00, respectively, for periods of five and two years, respectively. Net proceeds from this financing arrangement amounted to $500,000. As of March 31, 2006 and December 31, 2005, this debt is past due and the outstanding carrying value of $600,000 does not include $68,000 of capitalized interest, which is being reflected in accrued liabilities. The convertible notes are convertible into a fixed number of our common shares based upon a conversion price of $0.15 with anti-dilution protection for sales of securities below the fixed conversion price. We have the option to redeem the convertible notes for cash at 120% of the face value. The holder has the option to redeem the convertible notes payable for cash at 130% of the face value in the event of defaults and certain other contingent events, including events related to the common stock into which the instrument is convertible, registration and listing (and maintenance thereof) of our common stock and filing of reports with the Securities and Exchange Commission (the "Default Put"). In addition, we extended registration rights to the holder that required registration and continuing effectiveness thereof; we are required to pay monthly liquidating damages of 2.0% for defaults under this provision.

In our evaluation of this instrument, we concluded that the conversion feature was not afforded the exemption as a conventional convertible instrument due to the anti-dilution protection; and it did not otherwise meet the conditions for equity classification. Since equity classification is not available for the conversion feature, we were required to bifurcate the embedded conversion feature and carry it as a derivative liability, at fair value. We also concluded that the Default Put required bifurcation because, while puts on debt instruments are generally considered clearly and closely related to the host, the Default Put is indexed to certain events, noted above, that are not associated with debt instruments. We combined all embedded features that required bifurcation into one compound instrument that is carried as a component of derivative liabilities. We also determined that the warrants did not meet the conditions for equity classification because these instruments did not meet all of the criteria necessary for equity classification. Therefore, the warrants are also required to be carried as a derivative liability, at fair value.

We estimated the fair value of the compound derivative on the inception dates, and subsequently, using the Monte Carlo Valuation technique, because that technique embodies all of the assumptions (including credit risk, interest risk, stock price volatility and conversion estimates) that are necessary to fair value complex derivative instruments. We estimated the fair value of the warrants on the inceptions dates, and subsequently, using the Black-Scholes-Merton Valuation technique, because that technique embodies all of the assumptions (including, volatility, expected terms, and risk free rates) that are necessary to fair value freestanding warrants. As a result of these estimates, our valuation model resulted in compound derivative balances associated with this financing arrangement of $286,200 and $153,700 as of March 31,

2006 and December 31, 2005, respectively. These amounts are included in Derivative Liabilities on our balance sheet.

As of December 31, 2005 all warrants related to the financing had been converted.

The following table illustrates fair value adjustments that we have recorded related to the derivative financial instruments associated with the $600,000 convertible note financing:

Derivative income (expense)	Three months ended March 31, 2006	Three months ended March 31, 2005
Compound derivative	$(132,500)	$ 500
Warrant derivative	$ --	$153,500

Changes in the fair value of the compound derivative and, therefore, derivative income (expense) related to the compound derivative is significantly affected by changes in our trading stock price and the credit risk associated with our financial instruments. The fair value of the warrant derivative is significantly affected by changes in our trading stock prices. Future changes in these underlying market conditions will have a continuing effect on derivative income (expense) associated with these instruments.

The aforementioned allocations to the compound and warrant derivatives resulted in the discount in the carrying value of the notes. This discount, along with related deferred finance costs and future interest payments, are amortized through periodic charges to interest expense using the effective method. Interest expense during the three months ended March 31, 2006 and 2005 amounted to approximately $-0- and $117,000, respectively.

(d) $240,000 Convertible Note Financing:

On December 22, 2004, we issued $240,000 of 10.0% convertible notes payable, due April 30, 2006, plus warrants to purchase 800,000 shares of common stock at $0.15 for five years. Net proceeds from this financing arrangement amounted to $200,000. In June 2005 this debt was fully converted. The convertible notes were convertible into a fixed number of our common shares based upon a conversion price of $0.10 with anti-dilution protection for sales of securities below the fixed conversion price. We had the option to redeem the convertible notes for cash at 120% of the face value. The holder has the option to redeem the convertible notes payable for cash at 130% of the face value in the event of defaults and certain other contingent events, including events related to the common stock into which the instrument is convertible, registration and listing (and maintenance thereof) of our common stock and filing of reports with the Securities and Exchange Commission (the "Default Put"). In addition, we extended registration rights to the holder that required registration and continuing effectiveness thereof; we are required to pay monthly liquidating damages of 2.0% for defaults under this provision.

In our evaluation of this instrument, we concluded that the conversion feature was not afforded the exemption as a conventional convertible instrument due to the anti-dilution protection; and it did not otherwise meet the conditions for equity classification. Since equity classification is not available for the conversion feature, we were required to bifurcate the embedded conversion feature and carry it as a derivative liability, at fair value. We also concluded that the Default Put required bifurcation because, while puts on debt instruments are generally considered clearly and closely related to the host, the Default Put is indexed to certain events, noted above, that are not associated with debt instruments. We combined

all embedded features that required bifurcation into one compound instrument that is carried as a component of derivative liabilities. We also determined that the warrants did not meet the conditions for equity classification because these instruments did not meet all of the criteria necessary for equity classification. Therefore, the warrants are also required to be carried as a derivative liability, at fair value.

We estimated the fair value of the compound derivative on the inception dates, and subsequently, using the Monte Carlo Valuation technique, because that technique embodies all of the assumptions (including credit risk, interest risk, stock price volatility and conversion estimates) that are necessary to fair value complex derivative instruments. These amounts are included in Derivative Liabilities on our balance sheet. We estimated the fair value of the warrants on the inception dates, and subsequently, using the Black-Scholes-Merton Valuation technique, because that technique embodies all of the assumptions (including, volatility, expected terms, and risk free rates) that are necessary to fair value freestanding warrants.

As of December 31, 2005 all warrant liabilities related to the financing had been fully converted.

The following table illustrates fair value adjustments that we have recorded related to the derivative financial instruments associated with the $240,000 convertible note financing:

Derivative income (expense)	Three months ended March 31, 2006	Three months ended March 31, 2005
Compound derivative	$ --	$40,813
Warrant derivative	$ --	$16,240

Changes in the fair value of the compound derivative and, therefore, derivative income (expense) related to the compound derivative is significantly affected by changes in our trading stock price and the credit risk associated with our financial instruments. The fair value of the warrant derivative is significantly affected by changes in our trading stock prices. Future changes in these underlying market conditions will have a continuing effect on derivative income (expense) associated with the remaining compound derivative.

The aforementioned allocations to the compound and warrant derivatives resulted in the discount in the carrying value of the notes. This discount, along with related deferred finance costs and future interest payments, were amortized through periodic charges to interest expense using the effective method. Interest expense during the three months ended March 31, 2006 and 2005 amounted to approximately $-0- and $45,000, respectively.

(e) $693,000 Convertible Note Financing:

On October 29, 2004, we issued $693,000 of 10.0% convertible notes payable, due April 30, 2006, plus warrants to purchase 2,200,000 shares of common stock at $0.15 for five years. Net proceeds from this financing arrangement amounted to $550,000. At March 31, 2006 and December 31, 2005, this debt had an outstanding face value of $6,250. The convertible notes were convertible into a fixed number of our common shares based upon a conversion price of $0.10 with anti-dilution protection for sales of securities below the fixed conversion price. We had the option to redeem the convertible notes for cash at 120% of the face value. The holder has the option to redeem the convertible notes payable for cash at 130% of the face value in the event of defaults and certain other contingent events, including events related to the

common stock into which the instrument is convertible, registration and listing (and maintenance thereof) of our common stock and filing of reports with the Securities and Exchange Commission (the "Default Put"). In addition, we extended registration rights to the holder that required registration and continuing effectiveness thereof; we are required to pay monthly liquidating damages of 2.0% for defaults under this provision.

In our evaluation of this instrument, we concluded that the conversion feature was not afforded the exemption as a conventional convertible instrument due to the anti-dilution protection; and it did not otherwise meet the conditions for equity classification. Since equity classification is not available for the conversion feature, we were required to bifurcate the embedded conversion feature and carry it as a derivative liability, at fair value. We also concluded that the Default Put required bifurcation because, while puts on debt instruments are generally considered clearly and closely related to the host, the Default Put is indexed to certain events, noted above, that are not associated with debt instruments. We combined all embedded features that required bifurcation into one compound instrument that is carried as a component of derivative liabilities. We also determined that the warrants did not meet the conditions for equity classification because these instruments did not meet all of the criteria necessary for equity classification. Therefore, the warrants are also required to be carried as a derivative liability, at fair value.

We estimated the fair value of the compound derivative on the inception dates, and subsequently, using the Monte Carlo Valuation technique, because that technique embodies all of the assumptions (including credit risk, interest risk, stock price volatility and conversion estimates) that are necessary to fair value complex derivative instruments. We estimated the fair value of the warrants on the inception dates, and subsequently, using the Black-Scholes-Merton Valuation technique, because that technique embodies all of the assumptions (including, volatility, expected terms, and risk free rates) that are necessary to fair value freestanding warrants. As a result of these estimates, our valuation model resulted in compound derivative balances of $42,656 and $42,878 as of March 31, 2006 and December 31, 2005, respectively. Our value model resulted in a warrant derivative balance, arising from the convertible note financing, of $-0- and $924,120 as of March 31, 2006 and December 31, 2005, respectively. These amounts are included in Derivative Liabilities on our balance sheet.

The following table illustrates fair value adjustments that we have recorded related to the derivative financial instruments associated with the $693,000 convertible note financing:

Derivative income (expense)	Three months ended March 31, 2006	Three months ended March 31, 2005
Compound derivative	$221	$122,739
Warrant derivative	$ --	$ 34,510

Changes in the fair value of the compound derivative and, therefore, derivative income (expense) related to the compound derivative is significantly affected by changes in our trading stock price and the credit risk associated with our financial instruments. The fair value of the warrant derivative is significantly affected by changes in our trading stock prices. Future changes in these underlying market conditions will have a continuing effect on derivative income (expense) associated with the remaining compound instruments.

The aforementioned allocations to the compound and warrant derivatives resulted in the discount in the carrying value of the notes. This discount, along with related deferred finance costs and future interest

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payments, were amortized through periodic charges to interest expense using the effective method. Interest expense during the three months ended March 31, 2006 and 2005 amounted to approximately $1,000 and $110,000, respectively.

(f) $660,000 Convertible Note Financing:

On April 2, 2004, we issued $660,000 of 10.0% convertible notes payable, due October 1, 2005, plus warrants to purchase 3,000,000 shares of common stock at $0.15 for five years. Net proceeds from this financing arrangement amounted to $493,000. At March 31, 2006 and December 31, 2005, this debt had an outstanding face value of $25,000. The convertible notes were convertible into a fixed number of our common shares based upon a conversion price of $0.10 with anti-dilution protection for sales of securities below the fixed conversion price. We had the option to redeem the convertible notes for cash at 120% of the face value. The holder has the option to redeem the convertible notes payable for cash at 130% of the face value in the event of defaults and certain other contingent events, including events related to the common stock into which the instrument is convertible, registration and listing (and maintenance thereof) of our common stock and filing of reports with the Securities and Exchange Commission (the "Default Put"). In addition, we extended registration rights to the holder that required registration and continuing effectiveness thereof; we are required to pay monthly liquidating damages of 2.0% for defaults under this provision.

In our evaluation of this instrument, we concluded that the conversion feature was not afforded the exemption as a conventional convertible instrument due to the anti-dilution protection; and it did not otherwise meet the conditions for equity classification. Since equity classification is not available for the conversion feature, we were required to bifurcate the embedded conversion feature and carry it as a derivative liability, at fair value. We also concluded that the Default Put required bifurcation because, while puts on debt instruments are generally considered clearly and closely related to the host, the Default Put is indexed to certain events, noted above, that are not associated with debt instruments. We combined all embedded features that required bifurcation into one compound instrument that is carried as a component of derivative liabilities. We also determined that the warrants did not meet the conditions for equity classification because these instruments did not meet all of the criteria necessary for equity classification. Therefore, the warrants are also required to be carried as a derivative liability, at fair value.

We estimated the fair value of the compound derivative on the inception dates, and subsequently, using the Monte Carlo Valuation technique, because that technique embodies all of the assumptions (including credit risk, interest risk, stock price volatility and conversion estimates) that are necessary to fair value complex derivative instruments. We estimated the fair value of the warrants on the inception dates, and subsequently, using the Black-Scholes-Merton Valuation technique, because that technique embodies all of the assumptions (including, volatility, expected terms, and risk free rates) that are necessary to fair value freestanding warrants. As a result of these estimates, our valuation model resulted in compound derivative balances of $146,250 and $159,250 as of March 31, 2006 and December 31, 2005, respectively. This amount is included in Derivative Liabilities on our balance sheet.

As of June 30, 2005, all warrants related to the financing had been fully converted.

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The following table illustrates fair value adjustments that we have recorded related to the derivative financial instruments associated with the $660,000 convertible note financing:

Derivative income (expense)	Three months ended March 31, 2006	Three months ended March 31, 2005
Compound derivative	$13,000	$75,915
Warrant derivative	$ --	$61,800

Changes in the fair value of the compound derivative and, therefore, derivative income (expense) related to the compound derivative is significantly affected by changes in our trading stock price and the credit risk associated with our financial instruments. The fair value of the warrant derivative is significantly affected by changes in our trading stock prices. Future changes in these underlying market conditions will have a continuing effect on derivative income (expense) associated with the remaining compound instruments.

The aforementioned allocations to the compound and warrant derivatives resulted in the discount in the carrying value of the notes. This discount, along with related deferred finance costs and future interest payments, were amortized through periodic charges to interest expense using the effective method. Interest expense during the three months ended March 31, 2006 and 2005 amounted to approximately $-0- and $32,000, respectively.

(g) $1,008,000 Convertible Note Financing:

On June 29, 2004, we issued $1,008,000 of 10.0% convertible notes payable, due April 30, 2006, plus warrants to purchase 3,200,000 and 8,000,000 shares of our common stock at $0.25 and $2.00, respectively, for periods of five and two years, respectively. Net proceeds from this financing arrangement amounted to $679,000. At March 31, 2006 and December 31, 2005, this debt had an outstanding face value of $187,760. The convertible notes were convertible into a fixed number of our common shares based upon a conversion price of $0.15 with anti-dilution protection for sales of securities below the fixed conversion price. We had the option to redeem the convertible notes for cash at 120% of the face value. The holder has the option to redeem the convertible notes payable for cash at 130% of the face value in the event of defaults and certain other contingent events, including events related to the common stock into which the instrument is convertible, registration and listing (and maintenance thereof) of our common stock and filing of reports with the Securities and Exchange Commission (the "Default Put"). In addition, we extended registration rights to the holder that required registration and continuing effectiveness thereof; we are required to pay monthly liquidating damages of 2.0% for defaults under this provision.

In our evaluation of this instrument, we concluded that the conversion feature was not afforded the exemption as a conventional convertible instrument due to the anti-dilution protection; and it did not otherwise meet the conditions for equity classification. Since equity classification is not available for the conversion feature, we were required to bifurcate the embedded conversion feature and carry it as a derivative liability, at fair value. We also concluded that the Default Put required bifurcation because, while puts on debt instruments are generally considered clearly and closely related to the host, the Default Put is indexed to certain events, noted above, that are not associated with debt instruments. We combined all embedded features that required bifurcation into one compound instrument that is carried as a component of derivative liabilities. We also determined that the warrants did not meet the conditions for equity classification because these instruments did not meet all of the criteria necessary for equity classification. Therefore, the warrants are also required to be carried as a derivative liability, at fair value.

We estimated the fair value of the compound derivative on the inception dates, and subsequently, using the Monte Carlo Valuation technique, because that technique embodies all of the assumptions (including credit risk, interest risk, stock price volatility and conversion estimates) that are necessary to fair value complex derivative instruments. We estimated the fair value of the warrants on the inceptions dates, and subsequently, using the Black-Scholes-Merton Valuation technique, because that technique embodies all of the assumptions (including, volatility, expected terms, and risk free rates) that are necessary to fair value freestanding warrants. As a result of these estimates, our valuation model resulted in a compound derivative balance of $549,808 and $564,735 as of March 31, 2006 and December 31, 2005, respectively. These amounts are included in Derivative Liabilities on our balance sheet.

As of December 31, 2005, all warrants related to the financing had been fully converted.

The following table illustrates fair value adjustments that we have recorded related to the derivative financial instruments associated with the $1,008,000 convertible note financing:

Derivative income (expense)	Three months ended March 31, 2006	Three months ended March 31, 2005
Compound derivative	$14,927	$ 22,179
Warrant derivative	$ --	$190,642

Changes in the fair value of the compound derivative and, therefore, derivative income (expense) related to the compound derivative is significantly affected by changes in our trading stock price and the credit risk associated with our financial instruments. The fair value of the warrant derivative is significantly affected by changes in our trading stock prices. Future changes in these underlying market conditions will have a continuing effect on derivative income (expense) associated with these instruments.

The aforementioned allocations to the compound and warrant derivatives resulted in the discount in the carrying value of the notes. This discount, along with related deferred finance costs and future interest payments, were amortized through periodic charges to interest expense using the effective method.

Interest expense during the three months ended March 31, 2006 and 2005 amounted to approximately $-0- and $192,000, respectively.

(h) $360,000 Convertible Note Financing:

On April 21, 2005, we issued $360,000, six-month-term, 10% convertible notes payable, due October 31, 2005. Net proceeds for this financing transaction amounted to $277,488. The notes were convertible into shares of common stock at a fixed conversion rate of $0.20, with anti-dilution protection for sales of securities below the fixed conversion price. The holder converted the notes on September 30, 2005. We had the option to redeem the notes payable for cash at 120% of the face value. The holder has the option to redeem the convertible notes payable for cash at 130% of the face value in the event of defaults and certain other contingent events, including events related to the common stock into which the instrument is convertible, registration and listing (and maintenance thereof) of our common stock and filing of reports with the Securities and Exchange Commission (the "Default Put").

In our evaluation of this instrument, we concluded that the conversion feature was not afforded the exemption as a conventional convertible instrument due to the anti-dilution protection afforded the holder; and it did not otherwise meet the conditions for equity classification. Therefore, we were required

to bifurcate the embedded conversion feature and carry it as a derivative liability. We also concluded that the Default Put required bifurcation because, while puts on debt instruments are generally considered clearly and closely related to the host, the Default Put is indexed to certain events, noted above, that are not associated with debt instruments. We combined all embedded features that required bifurcation into one compound instrument that was carried as a component of derivative liabilities through the date of conversion.

We allocated the initial proceeds from the financing first to the compound derivative instrument in the amount of $113,925 and the balance to the debt host instrument. We estimated the fair value of the compound derivative on the inception dates, and subsequently, using the Monte Carlo Valuation technique, because that technique embodies all of the assumptions (including credit risk, interest risk, stock price volatility and conversion estimates) that are necessary to fair value complex derivative instruments.

The following table illustrates fair value adjustments that we have recorded related to the compound derivative arising from the $360,000 convertible notes payable.

Derivative income (expense)	Three months ended March 31, 2006	Three months ended March 31, 2005
Compound derivative	$ --	$ --
Warrant derivative	$ --	$ --

Changes in the fair value of the compound derivative and, therefore, derivative income (expense) related to the compound derivative is significantly affected by changes in our trading stock price and the credit risk associated with our financial instruments. Since the instrument was converted on September 30, 2005, there will be no future charges or credits to derivative income (expense) associated with this instrument.

The above allocations resulted in a discount to the carrying value of the notes amounting to approximately $173,925. This discount, along with related deferred finance costs and future interest payments, are being amortized through periodic charges to interest expense using the effective method. Interest expense during the three months ended March 31, 2006 and 2005 amounted to approximately $-0- and -0-, respectively.

Derivative warrant fair values are calculated using the Black-Scholes-Merton Valuation technique. Significant assumptions as of March 31, 2006, corresponding to each of the above financings (by paragraph reference) are as follows:

	5(a)	5(b)	5(c)	5(d)	5(e)
Trading market price	$0.55	$0.55	$0.55	$0.55	$0.55
	$.05--$1.00				
Strike price		$.129	$.10	$.15	$.15
Volatility	148%	133%	136%	136%	136%
Risk-free rate	3.25%	3.71%	3.30%	3.57%	3.30%
Remaining term/life (years)	.67	4.38	3.25	3.75	3.58

Our stock prices have been highly volatile. Future fair value changes are significantly influenced by our trading common stock prices. As previously discussed herein, changes in fair value of derivative financial instruments are reflected in earnings.

Note 6. Preferred Stock

Our articles of incorporation authorize the issuance of 5,000,000 shares of preferred stock. We have designated this authorized preferred stock, as follows:

(a) Series H Preferred Stock:

We have designated 350,000 shares of our preferred stock as Series H Cumulative Convertible Preferred Stock with a stated and liquidation value of $10.00 per share. Series H Preferred Stock has cumulative dividend rights at 7.0% of the stated amount, ranks senior to common stock and is non-voting. It is also convertible into our common stock at a fixed conversion price of $0.40 per common share. The Series H Preferred Stock is mandatorily redeemable for common stock on the fifth anniversary of its issuance. We have the option to redeem the Series H Preferred Stock for cash at 135% of the stated value. The holder has the option to redeem the Series H Preferred Stock for cash at 140% of the stated value in the event of defaults and certain other contingent events, including events related to the common stock into which the instrument is convertible, listing of our common stock and filing of reports with the Securities and

Exchange Commission (the "Default Put").

Based upon our evaluation of the terms and conditions of the Series H Preferred Stock, we concluded that it was more akin to a debt instrument than an equity instrument, which means that our accounting conclusions are based upon those related to a traditional debt security, and that it should be afforded the conventional convertible exemption regarding the embedded conversion feature because the conversion price is fixed. Therefore, we are not required to bifurcate the embedded conversion feature and carry it as a liability. However, we concluded that the Default Put required bifurcation because, while puts on debt-type instruments are generally considered clearly and closely related to the host, the Default Put is indexed to certain events, noted above, that are not associated debt-type instruments. In addition, due to the default and contingent redemption features of the Series H Preferred Stock, we classified this instrument as redeemable preferred stock, outside of stockholders' equity.

Between December 2001 and March 2002, we issued 175,500 shares of Series H Preferred Stock for cash of $1,755,000, plus warrants to purchase an aggregate of 4,387,500 shares of common stock at $0.50 for five years. At March 31, 2006 and December 31, 2005, 64,500 shares of preferred stock remain outstanding; all of the warrants remain outstanding. We allocated $1,596,228 of the proceeds from the Series H Preferred financings to the warrants at their fair values because the warrants did not meet all of the conditions necessary for equity classification and, accordingly, are carried as derivative liabilities, at fair value. We also allocated $134,228 to the Default Puts which, as described above are carried as derivative liabilities, at fair value. We also allocated proceeds of $34,210 to paid-in capital because the aforementioned allocations resulted in an effective beneficial conversion feature, which is recorded in equity. Finally, we recorded derivative expense of $9,666 because one of the financings did not result in sufficient proceeds to record the derivative financial instruments at fair values on the inception date.

We estimated the fair value of the derivative warrants on the inception dates, and subsequently, using the Black-Scholes-Merton valuation technique. As a result of applying this technique, our valuation of the derivative warrants amounted to $936,205 and $1,264,109 as of March 31, 2006 and December 31, 2005,

respectively. We estimated the fair value of the Default Puts on the inception dates, and subsequently, using a cash flow technique that involves probability-weighting multiple outcomes at net present values. Significant assumptions underlying the probability-weighted outcomes included both our history of similar default events, all available information about our business plans that could give rise to or risk defaults, and the imminence of impending or current defaults. As a result of these subjective estimates, our valuation model resulted in Default Put balances associated with the Series H Preferred Stock of $396,362 and $381,377 as of March 31, 2006 and December 31, 2005, respectively. These amounts are included in Derivative Liabilities on our balance sheet. The following table illustrates fair value adjustments that we have recorded related to the Default Puts on the Series H Preferred Stock.

Derivative income (expense)	Three months ended March 31, 2006	Three months ended March 31, 2005
Compound derivative	$(14,985)	$(2,064)

Warrant derivative	$327,903	$66,641

Derivative income (expense) related to the Default Put includes changes to the fair value arising from changes in our estimates about the probability of default events and amortization of the time-value element embedded in our calculations. Higher derivative expense in the three months ended March 31, 2006 when compared to the same period of 2005, reflected the increased probability that the Default Put would become exercisable because we would not timely file certain reports with the Securities and Exchange Commission. In fact, we ultimately did not file our Quarterly Report on Form 10-QSB for the June 2006 reporting period. While the Default Put became exercisable at that time, the holders of the Series H Preferred Stock did not exercise their right prior to curing the event. There can be no assurances that the holders of the Series H Preferred Stock would not exercise their rights should further defaults arise.

The discounts to the Series H Preferred Stock that resulted from the aforementioned allocations are being accreted through periodic charges to retained earnings using the effective method. The following table illustrates the components of preferred stock dividends and accretions:

	Three months ended March 31, 2006	Three months ended March 31, 2005
Preferred stock dividends	$35,100	$35,100
Accretions	$39,174	$89,348

As of March 31, 2006, $351,000 of cumulative dividends are in arrears on Series H Preferred Stock.

(b) Series J Preferred Stock:

We have designated 500,000 shares of our preferred stock as Series J Cumulative Convertible Preferred Stock with a stated and liquidation value of $10.00 per share. Series J Preferred Stock has cumulative dividend rights at 8.0% of the stated amount, ranks senior to common stock and is non-voting. It is also convertible into our common stock at a conversion price of $0.20 per common share. The Series J Preferred Stock is mandatorily redeemable for common stock on the fifth anniversary of its issuance. We have the option to redeem the Series J Preferred Stock for cash at 135% of the stated value. The holder has the option to redeem the Series J Preferred Stock for cash at 140% of the stated value in the event of

defaults and certain other contingent events, including events related to the common stock into which the instrument is convertible, registration and listing (and maintenance thereof) of our common stock and filing of reports with the Securities and Exchange Commission (the "Default Put").

Based upon our evaluation of the terms and conditions of the Series J Preferred Stock, we concluded that its features were more akin to a debt instrument than an equity instrument, which means that our accounting conclusions are generally based upon standards related to a traditional debt security. Our evaluation concluded that the embedded conversion feature was not afforded the exemption as a conventional convertible instrument due to certain variability in the conversion price and it further did not meet the conditions for equity classification. Therefore, we are required to bifurcate the embedded conversion feature and carry it as a liability. We also concluded that the Default Put required bifurcation because, while puts on debt-type instruments are generally considered clearly and closely related to the host, the Default Put is indexed to certain events, noted above, that are not associated debt-type instruments. We combined all embedded features that required bifurcation into one compound instrument that is carried as a component of derivative liabilities. In addition, due to the default and contingent redemption features of the Series J Preferred Stock, we classified this instrument as redeemable preferred stock, outside of stockholders' equity.

In September 2002, February 2003 and May 2003 we issued 100,000 shares, 50,000 shares and 50,000 shares, respectively, of Series J Preferred Stock for cash of $2,000,000. We also issued warrants for an aggregate of 14,000,000 shares of our common stock in connection with the financing arrangement. The warrants have terms of five years and an exercise price of $0.25. We initially allocated proceeds of $658,000 and $1,190,867 from the financing arrangements to the compound derivative discussed above and to the warrants, respectively. Since these instruments did not meet the criteria for classification, they are required to be carried as derivative liabilities, at fair value.

We estimated the fair value of the compound derivative on the inception dates, and subsequently, using the Monte Carlo Valuation technique, because that technique embodies all of the assumptions (including credit risk, interest risk, stock price volatility and conversion estimates) that are necessary to fair value complex derivative instruments. We estimated the fair value of the warrants on the inceptions dates, and subsequently, using the Black-Scholes-Merton Valuation technique, because that technique embodies all of the assumptions (including, volatility, expected terms, and risk free rates) that are necessary to fair value freestanding warrants. As a result of these estimates, our valuation model resulted in a compound derivative balance associated with the Series J Preferred Stock of $4,704,000 and $5,628,000 as of March 31, 2006 and December 31, 2005, respectively. These amounts are included in Derivative Liabilities on our balance sheet.

The following table illustrates fair value adjustments that we have recorded related to the derivative financial instruments associated with the Series J Preferred Stock.

Derivative income (expense)	Three months ended March 31, 2006	Three months ended March 31, 2005
Compound derivative	$924,000	$224,000
Warrant derivative	$ --	$168,000

Changes in the fair value of the compound derivative and, therefore, derivative income (expense) related to the compound derivative is significantly affected by changes in our trading stock price and the credit

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risk associated with our financial instruments. The fair value of the warrant derivative is significantly affected by changes in our trading stock prices. Future changes in these underlying market conditions will have a continuing effect on derivative income (expense) associated with these instruments.

The discounts to the Series J Preferred Stock that resulted from the aforementioned allocations are being accreted through periodic charges to paid-in capital using the effective method. The following table illustrates the components of preferred stock dividends and accretions:

	Three months ended March 31, 2006	Three months ended March 31, 2005
Preferred stock dividends	$ 40,000	$40,000
Accretions	$136,885	$76,348

As of March 31, 2006 $520,000 of cumulative dividends are in arrears on Series J Preferred Stock.

(c) Series K Preferred Stock:

We have designated 500,000 shares of our preferred stock as Series K Cumulative Convertible Preferred Stock with a stated and liquidation value of $10.00 per share. Series K Preferred Stock has cumulative dividend rights at 8.0% of the stated amount, ranks senior to common stock and is non-voting. It is also convertible into our common stock at a fixed conversion price of $0.10 per common share. The Series K Preferred Stock is mandatorily redeemable for common stock on the fifth anniversary of its issuance. We have the option to redeem the Series K Preferred Stock for cash at 120% of the stated value. The holder has the option to redeem the Series K Preferred Stock for cash at 140% of the stated value in the event of defaults and certain other contingent events, including events related to the common stock into which the instrument is convertible, listing of our common stock and filing of reports with the Securities and Exchange Commission (the "Default Put").

Based upon our evaluation of the terms and conditions of the Series K Preferred Stock, we concluded that it was more akin to a debt instrument than an equity instrument, which means that our accounting conclusions are based upon those related to a traditional debt security, and that it should be afforded the conventional convertible exemption regarding the embedded conversion feature because the conversion price is fixed. Therefore, we are not required to bifurcate the embedded conversion feature and carry it as a liability. However, we concluded that the Default Put required bifurcation because, while puts on debt-type instruments are generally considered clearly and closely related to the host, the Default Put is indexed to certain events, noted above, that are not associated debt-type instruments. In addition, due to the default and contingent redemption features of the Series K Preferred Stock, we classified this instrument as redeemable preferred stock, outside of stockholders' equity.

In March 2004, we issued 80,000 shares of Series K Preferred Stock for cash of $800,000. In April 2004, we issued 15,000 shares of Series K Preferred Stock to extinguish debt with a carrying value of $150,000. At the time of these issuances, the trading market price of our common stock exceeded the fixed conversion price and, as a result, we allocated $160,000 and $60,000 from the March and April issuances, respectively, to stockholders' equity which amount represented a beneficial conversion feature. In addition, we recorded a debt extinguishment loss of $60,000 in connection with the April exchange of Series K Preferred Stock for debt because we estimated that it had a fair value that exceeded the carrying value of the extinguished debt by that amount. Finally, we allocated approximately $59,000 and $11,000

to the Default Puts, representing fair values, in connection with the March and April issuances, respectively.

We estimated the fair value of the Default Puts on the inception dates, and subsequently, using a cash flow technique that involves probability-weighting multiple outcomes at net present values. Significant assumptions underlying the probability-weighted outcomes included both our history of similar default events, all available information about our business plans that could give rise to or risk defaults, and the imminence of impending or current defaults. As a result of these subjective estimates, our valuation model resulted in Default Put balances associated with the Series K Preferred Stock of $209,338 and $206,200 as of March 31, 2006 and December 31, 2005, respectively. These amounts are included in Derivative Liabilities on our balance sheet. The following table illustrates fair value adjustments that we have recorded related to the Default Puts on the Series K Preferred Stock.

Derivative income (expense)	Three months ended March 31, 2006	Three months ended March 31, 2005
Compound derivative	$(3,138)	$(1,256)
Warrant derivative	$ --	$ --

Derivative income (expense) related to the Default Put includes changes to the fair value arising from changes in our estimates about the probability of default events and amortization of the time-value element embedded in our calculations. Higher derivative expense in the three months ended March 31, 2006, when compared to the same period of 2005, reflected the increased probability that the Default Put would become exercisable because we would not timely file certain reports with the Securities and Exchange Commission. In fact, we ultimately did not file our Quarterly Report on Form 10-QSB for the June 2006 reporting period. While the Default Put became exercisable at that time, the holders of the Series K Preferred Stock did not exercise their right prior to curing the event. There can be no assurances that the holders of the Series K Preferred Stock would not exercise their rights should further defaults arise.

The discounts to the Series K Preferred Stock that resulted from the aforementioned allocations are being accreted through periodic charges to paid-in capital using the effective method. The following table illustrates the components of preferred stock dividends and accretions:

	Three months ended March 31, 2006	Three months ended March 31, 2005
Preferred stock dividends	$19,000	$19,000

Accretions	$11,015	$10,359

As of March 31, 2006, $152,000 of cumulative dividends are in arrears on Series K Preferred Stock.

(d) Other Preferred Stock Designations and Financings:

Series A Preferred: We have designated 500,000 shares of our preferred stock as Series A Convertible Preferred Stock. There were no Series A Preferred Stock outstanding during the periods presented.