INNOVATIVE FOOD HOLDINGS INC
Form 10QSB
April 18, 2008

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

FORM 10-QSB

x Quarterly report pursuant to Section 13 or 15(d) of the Securities and Exchange Act of 1934.

For the quarterly period ended September 30, 2006

o Transition report pursuant to Section 13 or 15(d) of the Exchange Act for the transition period from _________ to _________.

Commission File Number: 0-9376

INNOVATIVE FOOD HOLDINGS, INC.
(Exact Name of Small Business Issuer as Specified in its Charter)

Florida (State of or Other Jurisdiction of Incorporation or Organization)	20-1167761 (IRS Employer I.D. No.)

1923 Trade Center Way
Naples, Florida 34109
(Address of Principal Executive Offices)

(239) 596-0204
(Issuer's Telephone Number, Including Area Code)

Check whether the issuer: (1) filed all reports required to be filed by Section 13 or 15(d) of the Issuer Exchange Act 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 o

Indicate by check mark whether the issuer is a shell company (as defined in Regulation 12b-2 of the Exchange Act:

YES o NO x

State the number of shares outstanding of each of the issuer's classes of Common equity, as of the latest practicable date:

171,787,638 Common Shares (post-reverse split) as of April 14, 2008

Transitional Small Business Disclosure Format:

YES o NO x

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PART I - FINANCIAL INFORMATION

Innovative Food Holdings, Inc.
Condensed Consolidated Balance Sheet
(unaudited)

	September 30, 2006	September 30, 2005	September 30, 2004
ASSETS			
Current assets			
Cash and cash equivalents	$ 12,695	$ 17,663	$ 24,423
Accounts receivable, net of allowance	249,015	302,476	148,140
Interest receivable	7,147	1,184	-
Loan receivable, net of allowance	285,000	75,000	-
Prepaid expenses	-	45,278	-
Other current assets	31,351	-	-
Total current assets	585,208	441,601	172,563
Property and equipment, net of accumulated depreciation	107,091	71,489	163,510
Total assets	$ 692,299	$ 513,090	$ 336,073
LIABILITIES AND (DEFICIENCY IN) STOCKHOLDERS' EQUITY			
Current liabilities			
Accounts payable and accrued liabilities	$ 708,840	$ 443,222	$ 594,798
Amount due under bank credit line	24,255	15,154	24,400
Accrued interest, net of discount	137,503	15,260	28,195
Accrued interest - related parties, net of discount	94,975	29,352	4,520
Notes payable - current portion	934,443	585,000	-
Notes payable - related parties, current portion	375,000	275,000	-
Warrant liability	1,374,197	10,374,536	-
Conversion option liability	1,461,180	12,453,662	-
Penalty for late registration of shares	583,040	880,000	-
Total current liabilities	5,693,433	25,071,186	651,913
Notes payable	17,763	219,000	365,000
Notes payable - related parties	-	175,000	98,000
Total liabilities	5,711,196	25,465,186	1,114,913
(Deficiency in) stockholder's equity			
Common stock, $0.0001 par value; 500,000,000 shares authorized;			
151,310,796, 103,742,037 and 65,052,037 at September 30, 2006,			

2005, and 2004, respectively		15,130		10,374		6,506
Additional paid-in capital		391,437		-		4,385,318
Accumulated deficit		(5,425,464)		(24,962,470)		(5,170,664)
Total (deficiency in) stockholder's equity		(5,018,897)		(24,952,096)		(778,840)
Total liabilities and (deficiency in) stockholders' equity	$	692,299	$	513,090	$	336,073

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

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Innovative Food Holdings, Inc.
Condensed Consolidated Statements of Operations
(unaudited)

	For the Three Months Ended September 30 2006	For the Three Months Ended September 30 2005	For the Three Months Ended September 30 2004	For the Nine Months Ended September 30 2006	For the Nine Months Ended September 30 2005	For the Nine Months Ended September 30 2004
Revenue	$ 1,564,653	$ 1,303,593	$ 1,171,484	$ 5,044,098	$ 3,799,332	$ 3,237,454
Cost of goods sold	1,167,832	1,002,958	918,392	3,838,060	2,964,413	2,742,653
	396,821	300,635	253,092	1,206,038	834,919	494,801
Selling, general and administrative expenses	484,171	516,051	503,191	1,520,810	1,304,466	4,032,703
Total operating expenses	484,171	516,051	503,191	1,520,810	1,304,466	4,032,703
Operating loss	(87,350)	(215,416)	(250,099)	(314,772)	(469,547)	(3,537,902)
Other (income) expense:						
Interest (income) expense	107,360	253,168	91,113	266,007	694,353	398,375
Cost of penalty for late registration of shares	362,960	1,040,000	-	1,584,912	1,507,200	-
Change in fair value of warrant liability	(5,203,035)	-	-	(4,670,200)	-	-
Change in fair value of conversion option liability	(6,009,676)	-	-	(5,642,095)	-	-
Change in value of penalty for late registration of shares	(1,934,800)	(697,600)	-	(1,928,592)	(627,200)	-
Total other (income) expense	(12,677,191)	595,568	91,113	(10,389,968)	1,574,353	398,375
Income (Loss) before income taxes	12,589,841	(810,984)	(341,212)	10,075,196	(2,043,900)	(3,936,277)
Income tax expense	-	-	-	-	-	-
Net Income (loss)	$ 12,589,841	$ (810,984)	$ (341,212)	$ 10,075,196	$ (2,043,900)	$ (3,936,277)
	$ 0.09	$ (0.01)	$ (0.02)	$ 0.08	$ (0.03)	$ (0.14)

Net income (loss) per share - basic												
Net income (loss) per share - diluted	$	0.05	$	(0.01)	$	(0.00)	$	0.04	$	(0.03)	$	(0.04)
Weighted average shares outstanding - basic		136,912,804		87,659,428		17,994,416		120,338,009		81,506,689		28,825,062
Weighted average shares outstanding - diluted		245,737,804		87,659,428		126,231,711		281,808,565		81,506,689		95,919,044

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

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Innovative Food Holdings, Inc.
Condensed Consolidated Statements of Cash Flows

	For the Nine MonthsEnded September 30, 2006	For the Nine MonthsEnded September 30, 2005	For the Nine Months Ended September 30, 2004
Cash flows from operating activities:			
Net income (loss)	$ 10,075,196	$ (2,043,900)	$ (3,936,277)
Adjustments to reconcile net loss to to net cash used in operating activities:			
Depreciation	39,835	44,372	48,487
Value of warrants issued	10,750	-	-
Vale of options issued to officer	-	-	135,673
Stock issued for services	-	45,400	2,420,000
Stock issued for employee bonus	-	-	-
Stock issued as bonuses to employees and board members	49,901	-	-
Reserve for bad debt	-	75,000	-
Amortization of discount on NP to interest expense	-	595,000	388,000
Amortization of discount on convertible interest	-	-	-
Cost of penalty for late registration	1,584,912	1,507,200	-
Change in fair value of warrant liability	(4,652,805)	-	-
Change in fair value of conversion option liability	(5,642,095)	-	-
(gain) loss from marking to market-penalty	(1,928,592)	(627,200)	-
Changes in assets and liabilities:			
Accounts receivable, net	190,095	23,022	116,876
Interest receivable	-	(1,184)	-
Prepaid expenses	(29,844)	(45,278)	-
Other current liability	-	-	-
Accounts payable and accrued expenses	371,584	(73,374)	158,817
Notes and loans payables	-	-	-
Net cash used in operating activities	68,937	(500,942)	(668,424)
Cash flows from investing activities:			
Loan to Pasta Italiana	(190,000)	(150,000)	-
Acquisition of property and equipment	(26,445)	(12,040)	(134,772)
Net cash used in investing activities	(216,445)	(162,040)	(134,772)
Cash flows from financing activities:			
Proceeds from issuance of long-term-debt	160,000	595,000	463,000
Payments on bank credit line		(9,366)	-
Cash from bank credit line		-	262
Principal payments on notes payable	(10,000)	-	-
Proceeds from sale of common stock	-	67,000	320,225
Net cash provided by financing activities	150,000	652,634	783,487
Increase in cash and cash equivalents	2,492	(10,348)	(19,709)

Cash and cash equivalents at beginning of period		10,203		28,011		44,132
Cash and cash equivalents at end of period	$	12,695	$	17,663	$	24,423
Supplemental disclosure of cash flow information:						
Cash paid during the period for:						
Interest	$	-	$	-	$	-
Taxes	$	-	$	-	$	-

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Innovative Food Holdings, Inc.
Condensed Consolidated Statements of Cash Flows
(continued)

	For the Nine MonthsEnded September 30, 2006	For the Nine MonthsEnded September 30, 2005	For the Nine Months Ended September 30, 2004
Stock issued for services	$ 85,901	$ 45,400	$ 2,420,000
Notes payable issued for acquisition of computer equipment	$ 25,385	$ -	$ -
Common stock issued for conversion of notes payable	$ -	$ 44,000	$ 788,176
Common stock issued for conversion of liability	$ -	$ -	$ 339,750
Value of warrants issued	$ 10,750	$ -	$ -
Common stock issued during recapitalization	$ -	$ -	$ 2,500
Common stock issued as penalty for late registration	$ -	$ 537,600	$ -
Common stock issued in share exchange to acquire subsidiary	$ -	$ -	$ 125,000
Charge to equity for change to liability method for value of beneficial conversion feature of notes payable	$ -	$ 12,453,662	$ -
Charge to equity for change to liability method of warrant valuation	$ -	$ 10,374,536	$ -
Value of warrants and options issued as compensation	$ 10,750	$ -	$ -
Value of shares issued as penalty for late registration	$ 1,584,912	$ -	$ -
Revaluation of conversion option liability	$ (5,642,095)	$ -	$ -
Revaluation of liability for warrants	$ (4,652,805)	$ -	$ -
Revaluation of penalty for late registration of shares	$ (1,928,592)	$ -	$ -

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

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INNOVATIVE FOOD HOLDINGS, INC
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE AND NINE MONTHS ENDED
SEPTEMBER 30, 2006, 2005, AND 2004
(Unaudited)

1. BASIS OF PRESENTATION AND NATURE OF BUSINESS OPERATIONS

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Innovative Food Holdings, Inc. and subsidiary (collectively, the "Company") have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. They do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for a complete financial statement presentation. U.S. accounting principles also contemplate continuation of the Company as a going concern.

Acquisition and Corporate Restructure

We were initially formed in June 1979 as Alpha Solarco Inc., a Colorado corporation. From June 1979 through February 2004, we were either inactive or involved in discontinued business ventures. In February 2003 we changed our name to Fiber Application Systems Technology, Ltd.

On January 26, 2004, through a share exchange, the shareholders of FII converted 10,000 shares (post-reverse split) of FII common stock outstanding into 25,000,000 shares (post-reverse split) of IVFH. On January 29, 2004, in a transaction known as a reverse acquisition, the shareholders of IVFH exchanged 25,000,000 shares (post-reverse split) of IVFH for 25,000,000 shares (post-reverse split) of Fiber Application Systems (formerly known as Alpha Solarco) ("Fiber"), a publicly-traded company. The shareholders of IVFH thus assumed control of Fiber, and Fiber changed its name to Innovative Food Holdings, Inc. The 25,000,000 shares (post-reverse split) of Innovative Food Holdings are shown on the Company's balance sheet at December 31, 2003 as shares outstanding. These shares are shown at their par value of $2,500 as a decrease of additional paid-in capital at the acquisition date of January 29, 2004. There were 157,037 shares (post-reverse split) outstanding in Fiber at the time of the reverse acquisition; the par value of these shares, or $16, was transferred from additional paid-in capital at the time of the reverse acquisition.

2. NATURE OF ACTIVITED AND SIGNIFICANT ACCOUNTING POLICIES

Business Activity

FII is in the business of providing premium white tablecloth restaurants with the freshest origin-specific perishables and specialty products direct from its network of vendors to the end users (restaurants, hotels, country clubs, national chain accounts, casinos, and catering houses) within 24-48 hours, except as stated hereafter, eliminating all wholesalers and distributors. We currently sell the majority of our products through a distributor relationship with Next Day Gourmet, L.P., and a subsidiary of US Foodservice, Inc. ("USF"), a $20 Billion broadline distributor owned by Dutch grocer Royal Ahold.

Interim Financial Information

The accompanying unaudited interim financial statements have been prepared by the Company, in accordance with generally accepted accounting principles pursuant to Regulation S-B of the Securities and Exchange

Commission. Certain information and footnote disclosures normally included in audited financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. Accordingly, these interim financial statements should be read in conjunction with the Company's financial statements and related notes as contained in form 10-KSB for the year ended December 31, 2006. In the opinion of management, the interim financial statements reflect all adjustments, including normal recurring adjustments, necessary for fair presentation of the interim periods presented. The results of the operations for the three and six months ended June 30, 2006 are not necessarily indicative of the results of operations to be expected for the full year.

Reclassification

Certain reclassifications have been made to conform prior periods' data to the current presentation. These reclassifications had no effect on reported income.

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Going Concern

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the Company as a going concern. However, the Company has reported a net income (loss) of $12,589,741, $(810,984) and $(341,212) for the three months ended September 20, 2006, 2005, and 2004, respectively; and $10,075,196, $(2,043,900) and $(3,936,277) for the nine months ended September 30, 2006, 2005 and 2004, respectively; and $(7,417,910) for the year ended December 31, 2005. The Company also had an accumulated deficit of $5,425,464 and a working capital deficiency of $5,108,225 as of September 30, 2006.

The Company cannot be certain that anticipated revenues from operations will be sufficient, to satisfy its ongoing capital requirements. Management's belief is based on the Company's operating plan, which in turn is based on assumptions that may prove to be incorrect. If the Company's financial resources are insufficient the Company may require additional financing in order to execute its operating plan and continue as a going concern. The Company cannot predict whether this additional financing will be in the form of equity or debt, or be in another form. The Company may not be able to obtain the necessary additional capital on a timely basis, on acceptable terms, or at all. In any of these events, the Company may be unable to implement its current plans for growth, repay its debt obligations as they become due or respond to competitive pressures, any of which circumstances would have a material adverse effect on its business, prospects, financial condition and results of operations.

Management plans to take the following steps that it believes will be sufficient to provide the Company with the ability to continue as a going concern. Management intends to raise financing through the sale of its stock or debt instruments in private placements to individual investors. Management may raise funds in the public markets, though there currently are no plans to do so. Management believes that with this financing, the Company will be able to generate additional revenues that will allow the Company to continue as a going concern. This will be accomplished by hiring additional personnel and focusing sales and marketing efforts on the distribution of product through key marketing channels currently being developed by the Company. The Company also intends to pursue the acquisition of certain strategic industry partners where appropriate.

Revenue Recognition

The Company recognizes revenue upon shipment of the product from the vendor. Shipping and handling costs incurred by the Company are included in cost of goods sold.

For revenue from product sales, the Company recognizes revenue in accordance with Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition," which superseded SAB No. 101, "Revenue Recognition in Financial Statements." SAB No. 101 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) are based on management's judgments regarding the fixed nature of the selling prices of the products delivered and the collectibility of those amounts. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the same period the related sales are recorded. The Company defers any revenue for which the product has not been delivered or is subject to refund until such time that the Company and the customer jointly determine that the product has been delivered or no refund will be required. SAB No. 104 incorporates Emerging Issues Task Force ("EITF") No. 00-21, "Multiple-Deliverable Revenue Arrangements." EITF No. 00-21 addresses accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets. The effect of implementing EITF No. 00-21 on the Company's consolidated financial position and results of operations was not significant. This issue addresses determination of whether an arrangement involving more than one deliverable contains more than one unit of accounting and how the arrangement consideration should be measured and allocated to the separate units of accounting. EITF No. 00-21 became effective for revenue arrangements entered into in periods beginning after June 15, 2003. For revenue arrangements occurring on or after August 1, 2003, the Company revised its revenue recognition.

Income Taxes

The Company accounts for income taxes using the liability method. Under the liability method, deferred income taxes are determined based on differences between the financial reporting and tax bases of assets and liabilities. They are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company is required to adjust its deferred tax liabilities in the period when tax rates or the provisions of the income tax laws change. Valuation allowances are established to reduce deferred tax assets to the amounts expected to be realized.

Disclosures about Fair Value of Financial Instruments

The carrying amounts of the Company's financial instruments, which include accounts receivable and accounts payable, approximate fair value at September 30, 2006.

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Inventories

The Company does not currently maintain any material amount of inventory.

Stock-Based Compensation

On January 1, 2006 the company adopted Statement of Financial Accounting Standards No. 123 (revised 2004) "Share-Based Payment" ("SFAS 123 (R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options and employee stock purchases related to a Employee Stock Purchase Plan based on the estimated fair values. SFAS 123 (R) supersedes the company's previous accounting under Accounting Principles Board Opinion No.25, "Accounting for Stock Issued to Employees" for the periods beginning fiscal 2006.

The company adopted SFAS 123(R) using the modified prospective transition method, which required the application of the accounting standard as of January 1, 2006. The company's Consolidated Financial Statements as of and for twelve months Ended June 30, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the company's Consolidated Financial Statements for the prior periods have not been restated to reflect, and do not include the impact of SFAS 123 (R). Stock based compensation expense recognized under SFAS 123(R) for the three months ended September 30, 2006 was $0. Pro forma stock based compensation was $0 for the three months ended September 30, 2006.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period.

A summary of option activity as of September 30, 2006, 2005, and 2004, and changes during the periods then ended are presented below:

	Number of Shares	Weighted Average Exercise Price
Options exercisable at December 31, 2003	-	-
Granted	500,000	$ 0.50
Exercised	-	
Cancelled / Expired	-	-
Options outstanding at 12.31.04	500,000	$ 0.50
Exercisable	-	$ -
Not exercisable	500,000	$ 0.50

Granted	-		-
Exercised	-		-
Cancelled / Expired	-		-
Options outstanding at 03.31.05	500,000	$	0.50
Exercisable	-	$	-
Not exercisable	500,000	$	0.50
Granted	-		-
Exercised	-		-
Cancelled / Expired	-		-

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	Number of Shares		Weighted Average Exercise Price
	-		-
Options outstanding at 06.30.05	500,000	$	0.50
Exercisable	100,000	$	0.50
Not exercisable	400,000	$	0.50
Granted	-		-
Exercised	-		-
Cancelled / Expired	-		-
Options outstanding at 09.30.05	500,000	$	0.50
Exercisable	100,000	$	0.50
Not exercisable	400,000	$	0.50
Granted	-		-
Exercised	-		-
Cancelled / Expired	-		-
Options outstanding at 12.31.05	500,000	$	0.50
Exercisable	100,000	$	0.50
Not exercisable	400,000	$	0.50
Granted	-		0.005
Exercised	-		-
Cancelled / Expired	-		-
Options outstanding at 03.31.06	500,000	$	0.500
Exercisable	100,000	$	0.500
Not exercisable	400,000	$	0.500
Granted	-		-
Exercised	-		-
Cancelled / Expired	-		-
Options outstanding at 06.30.06	500,000	$	0.500
Exercisable	200,000	$	0.500
Not exercisable	300,000	$	0.500
Granted	-		-
Exercised	-		-
Cancelled / Expired	-		-
Options outstanding at 09.30.06	500,000	$	0.500

Exercisable	200,000	$	0.500
Not exercisable	300,000	$	0.500

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Aggregate intrinsic value of options outstanding and options exercisable at September 30, 2006, 2005, and 2004 was $0. Aggregate intrinsic value represents the difference between the company's closing stock price on the last trading day of the fiscal period, which was $0.01, $0.06, and $0.04 (post-reverse split)as of September 30, 2006, 2005, and 2004, respectively, and the exercise price multiplied by the number of options outstanding. As of September 30, 2006, 2005, and 2004, total unrecognized stock-based compensation expense related to non-vested stock options was $0. The total fair value of options vested was $0 for the three-month periods ended September 30, 2006, 2005, and 2004.

Earnings (Loss) per Common Share

The Company computes earnings per share under SFAS 128. Net loss per common share is computed by dividing net loss by the weighted average number of shares of common stock and dilutive common stock equivalents outstanding during the year. Dilutive common stock equivalents consist of shares issuable upon conversion of convertible notes and the exercise of the Company’s stock options and warrants (calculated using the treasury stock method).

Management Estimates

The presentation of financial statements in conformity with generally accepted accounting principles 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. Actual results could differ from those estimates.

Comprehensive Income

The Company has no items of other comprehensive income (loss) for the periods ended September 30, 2006, 2005, and 2004.

3. PER SHARE INFORMATION

The Company computes earnings per share under Financial Accounting Standard No.128, "Earnings Per Share" (SFAS 128). Net loss per common share is computed by dividing net loss by the weighted average number of shares of common stock and dilutive common stock equivalents outstanding during the year. Dilutive common stock equivalents consist of shares issuable upon conversion of convertible notes and the exercise of the Company’s stock options and warrants (calculated using the treasury stock method).

4. ACCOUNTS RECEIVABLE

At September 30, 2006, 2005, and 2004 accounts receivable consists of:

	2006	2005	2004

Accounts receivable from customers	$ 249,015	$ 367,476	$ 148,140
Allowance for doubtful accounts	(0)	(65,000)	(0)
Accounts receivable, net	$ 249,015	$ 302,476	$ 148,140

5. LOAN RECEIVABLE

The balance of loan receivable consisted of a loan to Pasta Italiana, Inc. in the amount of $360,000 and $150,000 as of September 30, 2006 and 2005, respectively. This note bears interest in the amount of 8% per annum. This note matured on August 24, 2006. At September 30, 2006 and 2005, the Company has reserved $75,000 of the loan receivable. The Company stopped accruing interest income on this note at December 31, 2005. At September 30, 2006 and 2005, interest receivable is $7,147 and $1,184, respectively.

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6. PROPERTY AND EQUIPMENT

A summary of property and equipment at September 30, 2006, 2005, and 2004 is as follows:

	2006	2005	2004
Computer equipment	$ 214,507	$ 150,574	$ 197,635
Furniture and fixtures	82,213	63,315	61,275
	296,720	213,889	258,910
Less accumulated depreciation and amortization	(189,629)	(142,400)	(95,400)
Total	$ 107,091	$ 71,489	$ 163,510

Depreciation and amortization expense amounted to $39,835, $44,372, and $48,487 respectively, for the nine months ended September 30, 2006, 2005 and 2004.

7. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities at September 30, 2006, 2005, and 2004 are as follows:

	2006	2005	2004
Accounts payable and accrued expenses	$ 681,838	$ 420,928	$ 440,972
Accrued commissions	3,183	2,907	2,250
Total	$ 685,651	$ 423,835	$ 443,222

8. ACCRUED INTEREST

At September 30, 2006, the Company has the following accrued interest on its balance sheet:

	Gross	Discount	Net
Non-related parties	$ 162,223	$ 24,720	$ 137,503
Related parties	95,928	953	94,975
Total	$ 258,151	$ 25,673	$ 232,478

At September 30, 2005, the Company has the following accrued interest on its balance sheet:

	Gross	Discount	Net
Non-related parties	$ 41,205	$ 25,945	$ 15,260
Related parties	61,792	32,440	29,352
Total	$ 102,997	$ 58,385	$ 44,612

At September 30, 2004, the Company has the following accrued interest on its balance sheet:

	Gross	Discount	Net
Non-related parties	$ 38,812	$ 10,617	$ 28,195
Related parties	7,909	3,389	4,520
Total	$ 46,721	$ 14,006	$ 32,715

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Accrued interest on some of the Company's notes payable is convertible into common stock of the Company at a price of $0.005 per share (post-reverse split) (note 9). There is a beneficial conversion feature embedded in this convertible accrued interest. The Company is amortizing this beneficial conversion feature over the life of the related party notes payable. During the three months ended September 30, 2006, 2005, and 2004, the amounts of $ $227,082, $96,026, and $17,268 were credited to additional paid-in capital as a discount on accrued interest. The Company amortized to interest expense a total of $34,060, $37,642, and $65,398 of these discounts during the three months ended September 30, 2006, 2005, and 2004, respectively.

9. NOTES PAYABLE AND NOTES PAYABLE TO RELATED PARTIES

The Company has a line of credit with Wachovia Bank in the amount of $25,000. The outstanding balance as of September 30, 2006 and 2005 was $24,255 and $15,154, respectively. The Company has a loan payable outstanding for the purchase of a server, at September 30, 2006 the outstanding balance was $24,840.

At September 30, 2006, 2005 and 2004,, the Company has outstanding notes payable in the aggregate amount of $1,327,206 , $1,254,000, and $463,000, respectively. Notes payable and notes payable to related parties at September 30, 2006, 2005, and 2004, consist of the following:

	2006	2005	2004
Convertible note payable in the original amount of $350,000 to Alpha Capital Aktiengesselschaft ("Alpha Capital"), dated February 25, 2005. This note consists of $100,000 outstanding under a previous note payable which was cancelled on February 25, 2005, and $250,000 of new borrowings. We did not meet certain of our obligations under the loan documents relating to this issuance. These lapses include not reserving the requisite number of treasury shares, selling subsequent securities without offering a right of first refusal, not complying with reporting obligations, not having our common shares quoted on the OTC:BB and not timely registering certain securities. This note is entered technical default status on May 16, 2005. The note originally carried interest at the rate of 8% per annum, and is due in full on February 24, 2007. Upon default, the note's interest rate increased to 15% per annum, and the note became immediately due. The note is convertible into common stock of the Company at a conversion price of $0.005 per share (post-reverse split). A beneficial conversion feature in the amount of $250,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2005. Accrued interest is convertible into common stock of the Company at a conversion price of $0.005 per share (post-reverse split). Interest in the amount of $13,233, $13,043 and $0 was accrued on this note during the three months ended September 30, 2006, 2005, and	$ 345,000	$ 350,000	$ 0

2004, respectively.. During the twelve months ended December 31, 2006 the note holder converted $5,000 into shares of common stock. During the twelve months ended December 31, 2006 the holder of the note converted $27,865 of accrued interest into common stock. This note is in default at September 30, 2006 and 2005.						
Convertible note payable in the amount of $160,000 to Michael Ferrone, a board member and related party, dated March 11, 2004. The note bears interest at the rate of 8% per annum, and was originally due in full on March 11, 2006. On February 25, 2005, an amendment to the convertible notes was signed which extended the term, which resulted in a new maturity date of October 12, 2006. The note is convertible by the holder into common stock of the Company at a conversion of $0.005 per share (post-reverse split). A beneficial conversion feature in the amount of $160,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2004. Accrued interest is convertible by the holder into common stock of the Company at maturity of the note at a price of $0.005 per share (post-reverse split) Interest in the amount of $3,226 was accrued on this note during the each of the three months ended September 30, 2006, 2005, and 2004.	$	160,000	$	160,000	$	160,000
Convertible note payable in the original amount of $100,000 to Joel Gold, a board member and related party, dated October 12, 2004. The note bears interest at the rate of 8% per annum, and was due in full on October 12, 2006. The note is convertible by the holder into common stock of the Company at a conversion price of $0.005 per share (post-reverse split). A beneficial conversion feature in the amount of $100,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2004. Accrued interest is convertible by the holder into common stock of the Company at maturity of the note at a price of $0.005 per share (post-reverse split) Interest in the amount of $504, $2,016, and $0 was accrued on this note during the three months ended September 30, 2006, 2005, and 2004, respectively. During the twelve months ended December 31, 2006, $75,000 of the principal amount was converted into common stock.	$	25,000	$	100,000	$	0
Convertible note payable in the amount of $85,000 to Briolette Investments, Ltd, dated March 11, 2004. The note bears interest at the rate of 8% per annum, and is due in Full on March 11, 2006. The note is convertible into common stock of the Company at a conversion of $0.005 per share (post-reverse split). A beneficial conversion feature in the amount of $85,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2004 Accrued interest is convertible by the holder into common stock of the Company at a price of $0.005 per share (post-reverse split) Interest in the amount of $828, $1,310, and $1,715 was accrued on this note during the three months ended September 30, 2006, 2005, and 2004, respectively. During the twelve months ended December 31, 2005, the note holder converted $44,000 of the note payable into common stock. During the twelve months ended December 31, 2006, the Company made a $3,000	$	41,000	$	41,000	$	85,000

cash payment on the principal amount of the note.

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Convertible note payable in the amount of $80,000 to Brown Door, Inc., dated March 11, 2004. The note bears interest at the rate of 8% per annum, and was due in full on March 11, 2006. The note is convertible into common stock of the Company at a conversion of $0.005 per share (post-reverse split). A beneficial conversion feature in the amount of $80,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2004. Accrued interest is convertible by the holder into common stock of the Company at maturity of the note at a price of $0.005 per share (post-reverse split) Interest in the amount of $1,614 was accrued on this note during each of the three months ended September 30, 2006, 2005, and 2004..	$	80,000	$	80,000	$	80,000
Convertible note payable in the amount of $50,000 to Whalehaven Capital Fund, Ltd. ("Whalehaven Capital") dated February 25, 2005. We did not meet certain of our obligations under the loan documents relating to this issuance. These lapses include not reserving the requisites numbers of treasury shares, selling subsequent securities without offering a right of first refusal, not complying with reporting obligations, not having our common shares quoted on the OTC:BB and not timely registering certain securities. This note is in technical default as of May 16, 2005. The note originally carried interest at the rate of 8% per annum, and was due in Full on February 24, 2007. Upon default, the note's interest rate increased to 15% per annum, and the note became due immediately. The note is convertible into common stock of the Company at a conversion of $0.005 per share (post-reverse split). A beneficial conversion feature in the amount of $50,000 was recorded as a discount to the note, and was amortized to interest expense during the three months ended March 31, 2005. Accrued interest is convertible into common stock of the Company at a price of $0.005 per share (post-reverse split). Interest in the amount of $1,596, $1,890, and $0 was accrued on this note during the three months ended September 30, 2006 and 2005, respectively. During the twelve months ended December 31, 2006, $5,000 of principal was converted into common stock. During the twelve months ended December 31, 2006 the holder of the note converted $5,000 of principal and $589 of accrued interest into shares of common stock. This note is in default at September 30, 2006 and 2005.	$	40,000	$	50,000	$	0
Convertible note payable in the amount of $50,000 to Oppenheimer & Co., / Custodian for Joel Gold IRA, a related party, dated March 14, 2004. The	$	50,000	$		$	50,000

note bears interest at the rate of 8% per annum, and was due in full on October 12, 2006. The note is convertible into common stock of the Company at a conversion of $0.005 per share (post-reverse split). A beneficial conversion feature in the amount of $50,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2005. Accrued interest is convertible into common stock of the Company at a price of $0.005 per share (post-reverse split). Interest in the amount of $1,009 was accrued on this note during each of the three months ended December 31, 2006, 2005, and 2004.				50,000		
Convertible note payable in the original amount of $30,000 to Huo Hua dated May 9, 2005. The note bears interest at the rate of 8% per annum, and was due in full on October 12, 2006. The note is convertible into common stock of the Company at a conversion of $0.005 per share (post-reverse split). A beneficial conversion feature in the amount of $30,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2005. Accrued interest is convertible into common stock of the Company at a price of $0.005 per share(post-reverse split) Interest in the amount of $404, $605, and $0 was accrued on this note during the three months ended September 30, 2006, 2005, and 2004, respectively. During the twelve months ended December 31, 2006, the note holder converted $10,000 of principal into common stock.	$	20,000	$	30,000	$	0
Convertible note payable in the original amount of $5,000 to Ke Du dated May 9, 2005. The note bears interest at the rate of 8% per annum, and was due in full on October 12, 2006. The note is convertible into common stock of the Company at a conversion of $0.005 per share (post-reverse split). A beneficial conversion feature in the amount of $5,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2005. This note was converted to common stock during the year ended December 31, 2005. Accrued interest is convertible into common stock of the Company at a price of $0.005 per share(post-reverse split) Interest in the amount of $101 was accrued on this note during the thee months ended September 30, 2005.	$	0	$	5,000	$	0

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Convertible note payable in the amount of $25,000 to Joel Gold a board member and related party, dated January 25, 2005. The note bears interest at the rate of 8% per annum, and is due in full on January 25, 2007. The note is convertible into common stock of the Company at a conversion of $0.025 per share. A beneficial conversion feature in the amount of $25,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2005. Accrued interest is convertible into common stock of the Company at a price of $0.025 per share. Interest in the amount of $504, $504, and $0 was accrued on this note during the three months ended September 30, 2006, 2005, and 2004, respectively.	$	25,000	$	25,000	$	0
Convertible note payable in the amount of $25,000 to The Jay & Kathleen Morren Trust dated January 25, 2005. The note bears interest at the rate of 6% per annum, and is due in full on January 25, 2007. The note is convertible into common stock of the Company at a conversion of $0.005 per share (post-reverse split). A beneficial conversion feature in the amount of $25,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2005. Accrued interest is convertible into common stock of the Company at a price of $0.005 per share (post-reverse split) Interest in the amount of $377, $377, and $0 was accrued on this note during the three months ended September 301, 2006, 2005, and 2004, respectively.	$	25,000	$	25,000	$	0
Convertible note payable in the amount of $10,000 to Lauren M. Ferrone, a relative of a board member and related party, dated October 12, 2004. The note bears interest at the rate of 8% per annum, and was originally due in full on October 12, 2005. On February 25, 2005, an amendment to the convertible notes was signed which extended the term, which resulted in a new maturity date of October 12, 2006. The note is convertible into common stock of the Company at a conversion of $0.01 per share (post-reverse split). A beneficial conversion feature in the amount of $10,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2004. Accrued interest is convertible into common stock of the Company at a price of $0.01 per share (post-reverse split). Interest in the amount of $202, $202, and $0 was accrued on this note during the three months ended September 30, 2006, 2005, and 2004, respectively. This note is in default at September 30, 2006 and 2005.	$	10,000	$	10,000	$	0
	$		$		$	

Convertible note payable in the amount of $10,000 to Richard D. Ferrone, a relative of a board member and related party, dated October 12, 2004. The note bears interest at the rate of 8% per annum, and was originally due in full on October 12, 2005. On February 25, 2005, an amendment to the convertible notes was signed which extended the term, which resulted in a new maturity date of October 12, 2006. The note is convertible into common stock of the Company at a conversion of $0.01 per share (post-reverse split). A beneficial conversion feature in the amount of $10,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2004. Accrued interest is convertible into common stock of the Company at a price of $0.01 per share (post-reverse split) . Interest in the amount of $202, $202, and $0 was accrued on this note during the three months ended September 30, 2006, 2005, and 2004, respectively. This note is in default at September 30, 2006 and 2005	10,000	10,000	0
Convertible note payable in the amount of $10,000 to Christian D. Ferrone, a relative of a board member and related party, dated October 12, 2004. The note bears interest at the rate of 8% per annum, and was originally due in full on October 12, 2005. On February 25, 2005, an amendment to the convertible notes was signed which extended the term, which resulted in a new maturity date of October 12, 2006. The note is convertible into common stock of the Company at a conversion of $0.01 per share (post-reverse split). A beneficial conversion feature in the amount of $10,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2004. Accrued interest is convertible into common stock of the Company at a price of $0.01 per share (post-reverse split). Interest in the amount of $202, $202, and $0 was accrued on this note during the three months ended September 30, 2006, 2005, and 2004, respectively. This note is in default at September 30, 2006 and 2005	$ 10,000	$ 10,000	$ 0

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Convertible note payable in the amount of $10,000 to Andrew I. Ferrone, a relative of a board member and related party, dated October 12, 2004. The note bears interest at the rate of 8% per annum, and was originally due in full on October 12, 2005. On February 25, 2005, an amendment to the convertible notes was signed which extended the term, which resulted in a new maturity date of October 12, 2006. The note is convertible into common stock of the Company at a conversion of $0.01 per share (post-reverse split). A beneficial conversion feature in the amount of $10,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2004. Accrued interest is convertible into common stock of the Company at a price of $0.01 per share (post-reverse split). Interest in the amount of $202, $202, and $0 was accrued on this note during the three months ended September 30, 2006, 2005, and 2004, respectively. This note is in default at September 30, 2006 and 2005	$	10,000	$	10,000	$	0
Convertible note payable in the amount of $8,000 to Adrian Neilan dated March 11, 2004. The note bears interest at the rate of 8% per annum, and is due in full on October 12, 2006. The note is convertible into common stock of the Company at a conversion of $0.005 per share (post-reverse split). A beneficial conversion feature in the amount of $8,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2004.. Accrued interest is convertible into common stock of the Company at a price of $0.005 per share (post-reverse split). Interest in the amount of $161was accrued on this note during the each of the three months ended September 30, 2006, 2005, and 2004, respectively.	$	8,000	$	8,000	$	8,000
Convertible note payable in the amount of $5,000 to Matthias Mueller dated March 11, 2004. The note bears interest at the rate of 8% per annum, and was due in full on October 12, 2006. The note is convertible into common stock of the Company at a conversion of $0.005 per share (post-reverse split). A beneficial conversion feature in the amount of $5,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2005. Accrued interest is convertible into common stock of the Company at a price of $0.005 per share (post-reverse split). Interest in the amount of $101was accrued on this note during the each of the three months ended September 30, 2006, 2005, and 2004, respectively.	$	5,000	$	5,000	$	5,000
	$	120,000	$		$	0

Convertible note payable in the amount of $120,000 to Alpha Capital dated August 25, 2005. We did not meet certain of our obligations under the loan documents relating to this issuance. These lapses include not reserving the requisite number of treasury shares, selling subsequent securities without offering a right of first refusal, not complying with reporting obligations, not having our common shares quoted on the OTC:BB and not timely registering certain securities. This note is in technical default as of November 13, 2005. The note originally carried interest at the rate of 8% per annum, and was due in full on August 25, 2007. Upon default, the note's interest rate increased to 15% per annum and the note became immediately due. The note is convertible into common stock of the Company at a conversion of $0.005 per share (post-reverse split). A beneficial conversion feature in the amount of $120,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2005. Accrued interest is convertible into common stock of the Company at a price of $0.005 per share (post-reverse split). Interest in the amount of $4,537, $947, and $0 was accrued on this note during the three months ended September 30, 2006, 2005, and 2004, respectively. This note is in default at September 30, 2006 and 2005.		120,000	
Convertible note payable in the amount of $30,000 to Whalehaven Capital dated August 25, 2005. We did not meet certain of our obligations under the loan documents relating to this issuance. These lapses include not reserving the requisite number of treasury shares, selling subsequent securities without offering a right of first refusal, not complying with reporting obligations, not having our common shares quoted on the OTC:BB and not timely registering certain securities. This note was in technical default as of November 13, 2006. The note originally carried interest at the rate of 8% per annum, and was due in full on August 25, 2007. Upon default, the note's interest rate increased to 15% per annum and the note became immediately due. The note is convertible into common stock of the Company at a conversion of $0.005 per share (post-reverse split). A beneficial conversion feature in the amount of $30,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2005. Accrued interest is convertible into common stock of the Company at a price of $0.005 per share (post-reverse split). Interest in the amount of $1,134 and $236 was accrued on this note during the three months ended September 30, 2006 and 2005, respectively. This note is in default at September 30, 2006 and 2005.	$ 30,000	$ 30,000	$ 0

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Convertible note payable in the original amount of $25,000 to Asher Brand, dated August 25, 2005. We did not meet certain of our obligations under the loan documents relating to this issuance. These lapses include not reserving the requisite number of treasury shares, selling subsequent securities without offering a right of first refusal, not complying with reporting obligations, not having our common shares quoted on the OTC:BB and not timely registering certain securities. This note was in technical default as of November 13, 2006. The note originally carried interest at the rate of 8% per annum, and was due in full on August 25, 2007. Upon default, the note's interest rate increased to 15% per annum and the note became immediately due The note is convertible into common stock of the Company at a conversion of $0.005 per share (post-reverse split). A beneficial conversion feature in the amount of $25,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2005. Accrued interest is convertible into common stock of the Company at a price of $0.005 per share (post-reverse split) Interest in the amount of $938 and $197 was accrued on this note during the three months ended September 30, 2006 and 2005, respectively. During the three months ended September 30, 2006, the holder of the note converted $2,000 of principal and $3,667 of accrued interest into common stock. This note is in default at September 30, 2006 and 2005.	$	23,000	$	25,000	$	0
Convertible note payable in the original amount of $25,000 to Momona Capital, dated August 25, 2005. We did not meet certain of our obligations under the loan documents relating to this issuance. These lapses include not reserving the requisite number of treasury shares, selling subsequent securities without offering a right of first refusal, not complying with reporting obligations, not having our common shares quoted on the OTC:BB and not timely registering certain securities. This note was in technical default at November 13, 2005. The note originally carried interest at the rate of 8% per annum, and was due in full on August 25, 2007. Upon default, the note's interest rate increased to 15% per annum and the note became immediately due The note is convertible into common stock of the Company at a conversion of $0.005 per share (post-reverse split). A beneficial conversion feature in the amount of $25,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2005. Accrued interest is convertible into common stock of the Company at a price of $0.005 per share (post-reverse split. Interest in the amount of $938 and $197 was accrued on this note during the three months ended September 30, 2006	$	23,000	$	25,000	$	0

and 2005, respectively. During the twelve months ended December 31, 2006, the holder of the note converted $2,000 of principal and $3,667 of accrued interest into common stock. This note is in default at September 30, 2006 and 2005.			
Convertible note payable in the amount of $10,000 to Lane Ventures dated August 25, 2005. We did not meet certain of our obligations under the loan documents relating to this issuance. These lapses include not reserving the requisite number of treasury shares, selling subsequent securities without offering a right of first refusal, not complying with reporting obligations, not having our common shares quoted on the OTC:BB and not timely registering certain securities. This note was in technical default at November 13, 2005. The note originally carried interest at the rate of 8% per annum, and was due in full on August 25, 2007. Upon default, the note's interest rate increased to 15% per annum and the note became immediately due. The note is convertible into common stock of the Company at a conversion of $0.005 per share (post-reverse split). A beneficial conversion feature in the amount of $10,000 was recorded as a discount to the note, and was amortized to interest expense during the twelve months ended December 31, 2005. Accrued interest is convertible into common stock of the Company at a price of $0.005 per share (post-reverse split). Interest in the amount of $364 and $79 was accrued on this note during the three months ended September 30, 2006 and 2005, respectively. During the twelve months ended December 31, 2006, the holder of the note converted $4,000 of principal and $1,467 of accrued interest into common stock. This note is in default at September 30, 2006 and 2005.	$ 6,000	$ 10,000	$ 0
Note payable in the amount of $120,000 to Alpha Capital, dated February 7, 2006. The originally carried interest at the rate of 15% per annum, and was originally due in full on February 7, 2007. The Company is not in compliance with various terms of this note, including making timely payments of interest, and this note was in technical default at May 8, 2006. At this time, the interest rate increased to 20% and the note became immediately due and payable. Interest in the amount of $6,049 was accrued on this note during the three months ended September 30, 2006. This note is in default at September 30, 2006.	$ 120,000	$ 0	$ 0

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Note payable in the amount of $30,000 to Whalehaven Capital dated February 7, 2006. The note originally carried interest at the rate of 15% per annum, and was due in full on February 7, 2007. The Company is not in compliance with various terms of this note, including making timely payments of interest, and this note was in technical default at May 8, 2006. At this time, the interest rate increased to 20% and the note became immediately due and payable. Interest in the amount of $1,512 was accrued on this note during the three months ended September 30, 2006. This note is in default at September 30, 2006.	$ 30,000	$ 0	$ 0
Note payable in the amount of $75,000 to Michael Ferrone, dated August 2, 2004. The note bears interest at the rate of 8% per annum, and was due in full on February 2, 2005. Interest in the amount of $1,512, $1,512, and $970 was accrued on this note during the twelve months ended December 31, 2006, 2005, and 2004, respectively. This note is in default at September 30, 2006, 2005, and 2004.	$ 75,000	$ 75,000	$ 75,000
Note payable in the amount of $10,000 to Alpha Capital, dated May 19, 2006. The note bears interest at the rate of 15% per annum, and was due in full on November 19, 2006. Interest in the amount of $461 was accrued on this note during the three months ended September 30, 2006.	$ 10,000	$ 0	$ 0
Note payable in the original amount of $25,787 to Microsoft Corporation dated May 3, 2006. The note bears interest at the rate of 9.7% per annum, and is payable in 60 monthly payments of $557 beginning October 1, 2006. Negative interest in the amount of $419 was capitalized to this note during the three months ended September 30, 2006.	$ 26,206	$ -	$ -
Total	$ 1,327,206	$ 1,254,000	$ 463,000
Less: Current maturities	(1,309,443)	(860,000)	(75,000)
Long-term portion	$ 17,763	$ 394,000	$ 388,000
Total Non-related parties	$ 952,206	$ 804,000	$ 178,000
Total related parties	375,000	450,000	285,000
Total	$ 1,327,206	$ 1,254,000	$ 463,000

Accounting for Conversion Options Embedded in Convertible Notes and Convertible Interest

The Company has certain convertible notes payable which contain embedded beneficial conversion features. Through August 2005, the beneficial conversion features of these convertible notes were accounted for by the equity method, whereby the intrinsic value of the beneficial conversion features were considered discounts to the notes. These discounts were immediately amortized to interest expense. During September 2005, the number of shares of the Company's common stock issued and issuable exceeded the number of shares of common stock the Company had authorized, and this triggered a change in the manner in which the Company accounts for these beneficial conversion features. In accordance with Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities, as amended ("SFAS 133"), the debt features provision contained in the terms governing the Notes are not clearly and closely related to the characteristics of the Notes. Accordingly, the features qualified as embedded derivative instruments at September 30, 2005 and because they do not qualify for any scope exception within SFAS 133, they were required by SFAS 133 to be accounting for separately from the debt instrument and recorded as derivative financial instruments. In September 2005, the Company valued the beneficial conversion features of its notes payable using the Black-Scholes valuation method, and arrived at an aggregate value of $12,528,662. Pursuant to Emerging Issues Task Force Issue 00-19 "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" ("EITF 00-19") "If a contract is reclassified from permanent or temporary equity to an asset or a liability, the change in fair value of the contract during the period the contract was classified as equity should be accounted for as an adjustment to stockholders' equity." Accordingly, during the year ended December 31, 2005, the Company charged the amount of $12,445,576 to stockholders' equity. $5,665,290 of this amount was charged to additional paid-in capital, which brought the balance of additional paid-in capital to $0. The remainder, or $6,780,286, was charged to accumulated deficit. During subsequent periods, the conversion option liability will be revalued, and any change in value charged to operations. At September 30, 2006, the conversion option liability was valued at $1,461,180. The revaluation resulted in a gain during the three months ended September 30, 2006 of $6,009,676.

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The Company valued these embedded conversion options using the Black-Scholes option pricing model with the following assumptions:

	Risk Free Interest Rate	Expected Dividend Yield	Expected Option Life	Volatility
September 30, 2006	4.75%	0	5	141.4%

10. RELATED PARTY TRANSACTIONS

The Company engaged in the following transactions with related parties:

Three months ended September 30, 2006:

None.

Three months ended September 30, 2005:

None.

Three months ended September 30, 2004:

The Company issued 230,000 shares of common stock to a director for services rendered.

11. EQUITY

On March 27, 2003 a one for 1-for-1,000 reverse stock split of the Company's common stock was effected. On March 8, 2004, a 1-for 200 reverse stock split of the Company's common stock was effected.

Common Stock

The Company had the following common stock transactions during the three months ended September 30, 2006:

The Company issued 1,117,778 shares (post reverse-split) of common stock for conversion of notes payable and accrued interest in the amount of $5,589.

The Company issued 8,933,358 shares (post reverse-split) of common stock for conversion of notes payable and accrued interest in the amount of $44,666;

The Company issued 5,573,158 shares of common stock for conversion of notes payable. The par value of $557 was charged to additional paid-in capital.

The Company had the following common stock transactions during the three months ended September 30, 2005:

The Company sold 13,400,000 shares (post-reverse split)of common stock for cash of $67,000. These shares were issued during the three months ended September 30, 2005, and the amount of $67,000 is shown as common stock subscribed on the Company's balance sheet at June 30, 2005.

The Company issued 8,800,000 shares (post-reverse split)of common stock pursuant to the partial conversion of a note payable. The Company charged the fair value of these shares of $44,000.

The Company had the following common stock transactions during the three months ended September 30, 2004:

The Company sold 15,000,000 shares of common stock (post reverse-split) for cash proceeds of $320,225.

The Company issued 7,925,000 shares of common stock (post reverse-split) with a fair value of $204,500 to employees and board members for services performed.

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INNOVATIVE FOOD HOLDINGS, INC
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE AND NINE MONTHS ENDED
SEPTEMBER 30, 2006, 2005, AND 2004
(Unaudited)

Warrants

During the three months ended March 31, 2005, the Company issued five year warrants to purchase 80,000,000 shares (post reverse-split) of common stock at an exercise price equal to 115% of the closing stock price on the date of exercise to investors in conjunction with convertible note agreements (see note 9). During the three months ended June 30, 2005, these warrants were re-priced to an exercise price of $0.005 per share (post reverse-split). The Company also issued five year warrants to purchase 20,000,000 (post reverse-split) shares of common stock at a price equal to 110% of the closing stock price on the date of exercise to investors in conjunction with convertible note agreements (see note 9). During the three months ended June 30, 2005, these warrants were re-price to an exercise price of $0.005 per share (post reverse-split). The Company also issued five year warrants to purchase 32,000,000 shares (post reverse-split) of common stock at a price of $0.005 per share (post reverse-split) to investors in conjunction with convertible note payable agreements (see note 9).

During the three months ended September 30, 2005, the Company issued five year warrants to purchase 56,700,000 shares (post reverse-split) of common stock at prices ranging from $0.005 to $0.115 per share (post reverse-split) to investors in conjunction with convertible note payable agreements (see note 9).

During the three months ended June 30, 2006, the Company issued five year warrants to purchase 300,000 shares (post reverse-split) of common stock at $0.005 per share (post reverse-split) to investors in conjunction with convertible note payable agreements (see note 9).

There were no warrants outstanding at September 30, 2004.

The following table summarizes the warrants outstanding at September 30, 2005 (post reverse-split):

Range of exercise prices	Number of shares outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price of outstanding warrants	Number of shares exercisable	Weighted average exercise price of exercisable options
$ 0.0050	136,200,000	4.42	$ 0.0050	136,200,000	$ 0.0050
$ 0.1100	10,500,000	4.89	$ 0.1100	10,500,000	$ 0.1100
$ 0.1150					