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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

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 (I.R.S. Employer
incorporation or organization) 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 No Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

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

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BRAVO! FOODS INTERNATIONAL CORP. AND SUBSIDIARY

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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

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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.

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CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

| | Three Months Ended March 31, | |
|--|------------------------------|---------------------------|
| | 2006 | 2005 |
| | (Unaudited) (Restated) | (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

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| | 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.

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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.

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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

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

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

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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.

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

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 |
|----------------|-------------------|
|----------------|-------------------|

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| | | |
|-------------------------------|--------------|--------------|
| 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 |

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

| | |
|-------------------|-------------|
| 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

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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 | |

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

| | | | | | |
|----------------------------|-------|-----------|-----------|-----------|--|
| \$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 | |

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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 |
| | <u>\$4,949,188</u> | <u>\$1,471,743</u> |

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 |

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| | | | | |
|--|-------|-----------|-----------|-------|
| \$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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| | | | | |
|--|-------|------------|------------|------------|
| 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

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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

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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 |
|-------|-------|
| ----- | ----- |

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| | | |
|---|-------------|-------------|
| 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

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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

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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

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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 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 \$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.

| | Three months ended March 31, 2006 | Three months ended March 31, 2005 |
|-----------------------------|---|---|
| Derivative income (expense) | | |
| 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

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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.

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(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

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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

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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 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

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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 associated with this financing arrangement of \$286,200 and \$153,700 as of March 31,

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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:

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

Changes in the fair value of the compound derivative and, therefore, derivative

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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

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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,

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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

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common stock into which the instrument is convertible, registration and listing

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(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:

| | Three months ended March 31, 2006 | Three months ended March 31, 2005 |
|-----------------------------|---|---|
| Derivative income (expense) | | |
| 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.

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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 insignificantly 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

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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.

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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 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:

| | Three months ended March 31, 2006 | Three months ended March 31, 2005 |
|-----------------------------|---|---|
| Derivative income (expense) | ----- | ----- |
| 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.

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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

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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.

| | Three months ended March 31, 2006 | Three months ended March 31, 2005 |
|-----------------------------|---|---|
| Derivative income (expense) | ----- | ----- |
| 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

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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 |

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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

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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,

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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.

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

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| | | |
|--------------------|-----------|----------|
| 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

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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

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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 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 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.

| | Three months ended March 31, 2006 | Three months ended March 31, 2005 |
|-----------------------------|---|---|
| Derivative income (expense) | | |
| 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

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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

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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.

| | Three months ended March 31, 2006 | Three months ended March 31, 2005 |
|-----------------------------|---|---|
| Derivative income (expense) | ----- | ----- |
| 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 |
| | ===== | ===== |

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| | | |
|------------|----------|----------|
| 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.

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Series B Preferred: We have designated 1,260,000 shares of our preferred stock as Series B Convertible Preferred Stock with a stated and liquidation value of \$1.00 per share. Series B Preferred has cumulative dividend rights of 9.0%, ranks senior to common stock and has voting rights equal to the number of common shares into which it may be converted. Series B Preferred is convertible into common on a share for share basis. Based upon our evaluation of the terms and conditions of the Series B Preferred Stock, we have concluded that it meets all of the requirements for equity classification. We had 107,440 shares of Series B Preferred outstanding as of March 31, 2006 and December 31, 2005, respectively.

Series D Preferred: We have designated 165,000 shares of our preferred stock as Series D Cumulative Convertible Preferred Stock with a stated and liquidation value of \$10 per share. Series D Preferred has cumulative dividend rights of 6.0%, ranks senior to common stock and is non-voting. There are no shares of Series D Preferred Stock outstanding during any of the periods reported in this quarterly report. However, we continue to have 611,250 warrants outstanding that were issued in connection with the original Series D Preferred Stock Financing arrangement.

Series F Preferred: We have designated 200,000 shares of our preferred stock as Series F Convertible Preferred Stock with a stated and liquidation value of \$10 per share. There were 5,248 shares of Series F Preferred Stock outstanding at March 31, 2006 and December 31, 2005. Series F Preferred is non-voting and convertible into common stock at a variable conversion price equal to the lower of \$0.60 or 75% of the trading prices near the conversion date. In addition, the holder has the option to redeem the convertible notes payable for cash at 125% 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"). We concluded that the conversion feature was not afforded the exemption as a conventional convertible instrument due to 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-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 with debt-type instruments. These two derivative features were combined into one compound derivative instrument. In addition, due to the default and contingent redemption features of the Series F Preferred Stock, we classified this instrument as redeemable preferred stock, outside of stockholders' equity.

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Series I Preferred: We have designated 200,000 shares of our preferred stock as Series I Convertible Preferred Stock with a stated and liquidation value of \$10.00 per share. Series I Preferred has cumulative dividend rights at 8.0% of the stated value, ranks senior to common stock and is non-voting. Series I Preferred is convertible into a variable number of common shares at the lower conversion price of \$0.40 or 75% of the average trading market price. There were no Series I Preferred Stock outstanding as of March 31, 2006 or December 31, 2005. We accounted for Series I Preferred Stock, while it was outstanding as an instrument that was more akin to a debt instrument. We also bifurcated the embedded conversion feature and freestanding warrants issued with the financing and carried these amounts as derivative liabilities, at fair value. The table below reflects derivative income and (expense) associated with changes in the fair value of this derivative financial instrument.

The following table summarizes derivative income (expense) related to compound derivatives and freestanding warrant derivatives that arose in connection with the preferred stock transactions discussed above.

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| | Three months ended March 31, 2006 | Three months ended March 31, 2005 |
|-----------------------------|---|---|
| Derivative income (expense) | | |
| Compound derivative | \$ 5,303 | \$161,082 |
| Warrant derivative | \$91,932 | \$200,348 |

The following table summarizes preferred stock dividends related to the convertible preferred stock discussed above:

| | Three months ended March 31, 2006 | Three months ended March 31, 2005 |
|---------------------------|---|---|
| Preferred stock dividends | \$ -- | \$7,800 |
| Accretions | \$ -- | \$ -- |

Note 7. - Stock Based Compensation Plans

On April 6, 2005, our Board of Directors adopted an incentive share-based plan (the "2005 Stock Incentive Plan") that provides for the grant of options for up to 10,397,745 shares of our common stock to our directors, officers, key employees and consultants. On May 10, 2006, our Board of Directors adopted the recommendation of our Compensation Committee to grant options for 8,872,745 shares to our directors, officers and key employees. As of March 31, 2006, there were 1,475,000 shares of common stock reserved for future grants under our 2005 Stock Incentive Plan. Options granted under 2005 Stock Incentive Plan vest over two years in equal annual installments with the first third exercisable on grant date, provided that the individual is continuously employed by us.

Prior to May 2005, we granted options for 650,000 shares to now former employees; 220,000 shares to now former directors and 360,714 shares to

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consultants, all which are fully vested and exercisable, under individual plans. Currently, there are no shares reserved for future issuances under these individual plans.

On January 1, 2006, we adopted Financial Accounting Standard 123 (revised 2004), Share-Based Payments ("FAS 123R") which is a revision of FAS No. 123, using the modified prospective method. Under this method, compensation cost recognized for the three months ended March 31, 2006 includes compensation cost for all share-based payments modified or granted prior to but not yet vested as of, January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of FAS No. 123. Compensation cost is being recognized on a straight-line basis over the requisite service period for the entire award in accordance with the provisions of FAS 123R.

As we had previously adopted the fair-value provisions of FAS 123, effective January 1, 2005, the adoption of FAS 123R had a negligible impact on our earnings before income taxes and net earnings for the first quarter of 2006. Accordingly, there was no impact on basic or diluted loss applicable to common shareholders per share for the first quarter of 2006. We recorded compensation costs of \$111,592 and \$0 for the first quarter of 2006 and 2005, respectively. We recognized no tax benefit for share-based compensation arrangements due to the fact that we are in a cumulative loss position and recognize no tax benefits in our Consolidated Statement of Operations.

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As required by FAS 123R, we estimate forfeitures of employee stock options and recognize compensation costs only for those awards expected to vest. Forfeiture rates are determined for two groups of employees - directors / officers and key employees based on historical experience. We adjust estimated forfeitures to actual forfeiture experience as needed. The cumulative effect of adopting FAS 123R of \$17,000, which represents estimated forfeitures for options outstanding at the date of adoption, was not material and therefore has been recorded as a reduction of our stock-based compensation costs in General and Administrative expense rather than displayed separately as a cumulative change in accounting principle in the Consolidated Statement of Operations. The adoption of SFAS No. 123R had no effect on cash flow from operating activities or cash flow from financing activities for the three months ended March 31, 2006.

We estimate the fair value of each stock option on the date of grant using a Black-Scholes-Merton option-pricing formula, applying the following assumptions and amortize that value to expense over the option's vesting period using the straight-line attribution approach.

Assumptions

Expected Term: The expected term represents the period over which the share-based awards are expected to be outstanding. It has been determined as the midpoint between the vesting date and the end of the contractual term.

Risk-Free Interest Rate: We based the risk-free interest rate used in our assumptions on the implied yield currently available on U.S. Treasury zero-coupon issues with a remaining term equivalent to the stock option award's expected term.

Expected Volatility: The volatility factor used in our assumptions is based on the historical price of our stock over the most recent period commensurate with

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the expected term of the stock option award.

Expected Dividend Yield: We do not intend to pay dividends on our common stock for the foreseeable future. Accordingly, we use a dividend yield of zero in our assumptions.

A summary of option activity under the stock incentive plans for the three months ended March 31, 2006 is presented below:

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| Options | Shares | Weighted- Average Exercise Price | Remaining Contractual Term (in years) |
|---|--------------------|---|--|
| Outstanding at December 31, 2005 | 9,600,422 | \$0.30 | |
| Granted | - | - | |
| Exercised | - | - | |
| Forfeited | (33,333) | \$0.30 | |
| Expired | (155,000) | \$0.27 | |
| Outstanding at March 31, 2006 | 9,412,088 ===== | \$0.30 ===== | 8.75 ===== |
| Vested or expected to vest at March 31 2006 | 8,861,971 ===== | \$0.30 ===== | 8.73 ===== |
| Exercisable at March 31 , 2006 | 3,810,913 ===== | \$0.33 ===== | 8.23 ===== |

No options were granted during the three months ended March 31, 2006 or 2005, and there were no exercises of options during those the three month periods.

At March 31, 2006, the Company had \$534,191 of total unrecognized compensation expense related to non-vested stock options, which is expected to be recognized over a weighted-average period of one year.

Note 8. - Other Stockholders' Equity

(a) Issuances of Common Stock

On March 31, 2005, we received notices of exercise for and issued 1,000,000 shares of common stock as provided in our June 2004 A Warrant and 500,000 shares of our October 2004 C Warrant. The shares of common stock underlying these Warrants were registered pursuant to a registration statement declared effective April 18, 2005.

(b) Outstanding Warrants

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As of March 31, 2006, we had the following outstanding warrants:

| Warrants | Grant date | Expiration date | Warrants/ Options Granted | Exe P |
|------------------------------------|------------|-----------------|---------------------------------|----------|
| Series D Preferred Stock Financing | 3/9/1999 | 11/17/2008 | 17,500 | 0 |
| Series D Preferred Stock Financing | 4/23/1999 | 11/17/2008 | 8,750 | 0 |
| Series D Preferred Stock Financing | 2/1/2000 | 11/17/2008 | 130,000 | 0 |
| Series D Preferred Stock Financing | 2/1/2000 | 11/17/2008 | 455,000 | 0 |
| Series F Preferred Stock Financing | 10/13/2000 | 11/17/2008 | 1,038,259 | 0 |
| Series H Preferred Stock Financing | 12/5/2001 | 12/4/2006 | 2,637,500 | 0 |
| Series H Preferred Stock Financing | 1/30/2002 | 1/30/2007 | 375,000 | 0 |
| Series H Preferred Stock Financing | 2/15/2002 | 2/14/2007 | 125,000 | 0 |

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| | | | | |
|--|------------|------------|------------|---|
| Series H Preferred Stock Financing | 3/18/2002 | 3/17/2007 | 1,250,000 | 0 |
| January 2005 Convertible Debt Financing | 11/20/2003 | 11/20/2008 | 2,000,000 | 0 |
| Warrant to Licensor (c) | 6/20/2005 | 6/19/2007 | 1,000,000 | 0 |
| Warrant to Consultant | 4/8/2005 | 4/7/2007 | 1,000,000 | 0 |
| Warrant to Distributor | 8/30/2005 | 8/29/2008 | 30,000,000 | 0 |
| April 2004 Financing | 4/20/2004 | 4/19/09 | 1,500,000 | 0 |
| November 2005 Common Stock Financing (d) | 11/28/2005 | 11/27/2010 | 15,667,188 | 0 |
| November 2005 Common Stock Financing (d) | 11/28/2005 | 11/27/2010 | 1,012,500 | 0 |
| January 2005 Financing | 1/31/05 | 1/30/2010 | 2,000,000 | 0 |
| Other Financings | 12/27/2001 | 2/28/2007 | 25,000 | 0 |
| | | | ----- | |
| Total Warrants | | | 60,241,697 | |
| | | | ===== | |

Certain conversion features in our debt and preferred stock are indexed to a variable number of common shares based upon our trading stock price. Accordingly, in the event of stock price declines, we may have insufficient shares to share-settle all of our contracts that are convertible into or exercisable for common stock. As a result, current accounting standards require us to assume that we would not have sufficient authorized shares to settle these other warrants and, therefore, reclassify other warrants and contracts that were otherwise carried in stockholders' equity to derivative liabilities. Such warrants and contracts that required reclassification were indexed to 48,679,688 and 47,679,688 shares of our common stock as of March 31, 2006 and December 31, 2005, respectively. We are not required to reclassify certain exempt contracts and employee stock options, so those items are not included in this caption. Derivative income (expense) associated with these other warrants are summarized in the following table.

| | Three months ended March 31, 2006 | Three months ended March 31, 2005 |
|-----------------------------|--------------------------------------|--------------------------------------|
| Derivative income (expense) | ----- | ----- |

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| | | |
|--------------------|-------------|----------|
| Warrant derivative | \$3,669,077 | \$72,317 |
|--------------------|-------------|----------|

Note 9- Commitments and Contingencies

Lease of Office

We lease office space, used for our corporate offices in Florida, under an operating lease that expires October 31, 2015. Future non-cancelable minimum rental payments required under the operating lease as of March 31, 2006 are as follows:

| | Amount |
|--------------------------------------|----------|
| Nine months ending December 31, 2006 | \$69,651 |
| Years ending December 31, | |
| 2007 | \$92,868 |
| 2008 | \$92,868 |
| 2009 | \$92,868 |
| 2010 | \$92,868 |
| 2011 | \$92,868 |

Rent expense for the three months ended March 31, 2006 amounted to \$23,217; and, rent expense for the three months ended March 31, 2005 amounted to \$22,404.

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Royalties:

We license trademarks and trade dress from certain Licensors for use on our products. Royalty advances are payable against earned royalties on a negotiated basis for these licensed intellectual property rights. The table below identifies each Licensor to which our licenses require advance payments and, in addition, reflects the term of the respective licenses as well as the advance royalties remaining to be paid on such negotiated advance royalty payments, as of March 31, 2006. We currently are in default of our guaranteed royalty payments to Marvel Enterprises on our license for the United Kingdom by the aggregate advance remaining listed below for Marvel (UK)

| Licensor: | Term | Aggregate Advance Remaining |
|-----------------------------|-----------|-----------------------------|
| Marvel (UK) | Two years | \$ 120,960 |
| Masterfoods | Six years | 2,430,000 |
| Diabetes Research Institute | One year | 2,500 |

Employment Contacts

Our Chief Executive Officer, Mr. Warren, has a two-year employment contract, expiring October 2007, that provides a base salary of \$300,000, plus a bonus of one quarter percent (0.25%) of net revenue and normal corporate benefits. This contract has a minimum two-year term plus a severance package upon change of control based on base salary.

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Officers Toulan, Patipa, Edwards and Kee have employment contracts with base salaries aggregating \$710,000 annually, plus discretionary bonuses and normal corporate benefits. These contracts have minimum two-year terms plus severance packages upon change of control based on base salary.

Our Chief Financial Officer, Mr. Kaplan, has an employment contract, expiring November 2008, that provides a base salary of \$180,000 for year one, \$200,000 for year two and \$220,000 for year three, plus discretionary bonuses and normal corporate benefits. This contract has a minimum three-year term plus a severance package upon change of control based on base salary

Marketing Commitments

Coca-Cola Enterprises ("CCE"). In August 2005, we executed a Master Distribution Agreement with CCE. Pursuant to this agreement, we are contractually obligated to spend an aggregate of \$5,000,000 on marketing activities in 2005 and 2006 for our products that are distributed by CCE. Beginning in 2007, we are further obligated to spend an amount annually in each country within a defined territory equal or greater than 3% of our total CCE revenues in such territory (on a country by country basis). Such national and local advertising for our products includes actively marketing the Slammers mark, based on a plan to be mutually agreed each year. We are required to maintain our intellectual property rights necessary for the production, marketing and distribution of our products by CCE.

During the period commencing at the inception of the CCE agreement through the period ended March 31, 2006, we have spent \$1.6 million on marketing activities pursuant to our agreement with CCE.

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

Note 10. Restatement of Prior Financial Statements

Our statements of operations for the three months ended March 31, 2006 and March 31, 2005, and our balance sheet as of December 31, 2005 have been restated as illustrated in the following tables:

| | Three months ended March 31, 2006 | Three months ended March 31, 2005 |
|--|--------------------------------------|--------------------------------------|
| Net income (loss), as reported | \$(3,885,572) | \$(1,237,248) |
| Share-based payments | (39,356) | -- |
| Deferred development costs | -- | (12,586) |
| Derivative income (expense) | 4,949,188 | 1,471,743 |
| Amortization of debt discounts and other charges | (265,725) | (772,181) |
| Investor relations charges | (347,566) | (30,000) |

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| | | |
|--------------------------------|--------------|--------------|
| Liquidated damages expense | (685,887) | -- |
| Other | (1,749) | (72,798) |
| Net income (loss), as restated | \$ (276,667) | \$ (653,070) |

Share-based payments: We improperly measured and deferred share-based payment expense related to employee stock options that were issued commencing in the second quarter of the year ended December 31, 2005. These adjustments, which are reflected in operating expenses, reflect the effects of re-measurement of the stock options and the elimination of previously deferred compensation amounts.

Deferred development costs: We improperly capitalized development costs on our balance sheet. These adjustments reflect our revised policy that requires development costs to be expensed as they are incurred. We record development costs as a component of operating expenses.

Derivative income (expense): Derivative income (expense) arises from adjustments to our derivative liabilities to carry these instruments at fair value at the end of each reporting period. Our derivative financial instruments consist of compound and freestanding instruments. These derivative financial instruments arose from (i) our notes payable, convertible notes payable and preferred stock financing transactions and (ii) the reclassification of non-exempt warrants from stockholders' equity to derivative liabilities because share settlement is presumed not to be within our control. We previously did not properly allocate proceeds from our financing transactions to derivative liabilities where applicable; nor did we reclassify our other warrants to derivative liabilities when we presumably lost our ability to share settle such instruments.

Amortization of debt discounts and other charges: We have adjusted our notes payable and convertible notes payable to reflect the allocation of proceeds to derivative liabilities. These allocations have resulted in discounts to the face value of the debt, and we are required to amortize these discounts through periodic charges to interest expense using the effective method. The adjustments reflect the difference between our previous method of recognizing interest expense based upon the stated interest rate and amounts derived from the application of the effective interest method. Other charges include gains and losses on extinguishments of our debt instruments that have arisen when modifications to such instruments were considered to be significant.

Investor relations charges: We entered into a contract with an investor relations firm during 2005 that required payment in our equity securities. We incorrectly did not recognize the value of these services until the securities were issued. This adjustment reflects the proper recognition of the consulting cost in general and administrative expenses and a reciprocal amount in accrued liabilities.

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Liquidated damages: We have restated our consolidated financial statements to record estimated liquidated damages that arose in connection with a registration rights agreement, pursuant to financial accounting standard No. 5, Accounting for Contingencies. In our previous filing, we recorded these amounts as incurred.

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| | Three months ended March 31, 2006 | Three months ended March 31, 2005 |
|---|--------------------------------------|--------------------------------------|
| Loss applicable to common shareholders, as reported | \$ (3,957,281) | \$ (1,332,308) |
| Cumulative adjustments to net income (loss), above | 3,608,905 | 584,178 |
| Preferred stock accretions | (187,074) | (176,055) |
| Loss applicable to common shareholders, as restated | \$ (535,450) | \$ (924,185) |

Preferred stock accretions: We did not allocate proceeds from certain of our preferred stock financings to derivative financial instruments (warrants and compound derivatives) and stockholders' equity (beneficial conversion features). These adjustments reflect the accretion of discounts to the preferred stock carrying values, which are reductions to net income (loss) to arrive at income (loss) applicable to common shareholders. We have accreted these discounts in our restated financial statements through periodic charges to retained earnings using the effective method.

| | Three months ended March 31, 2006 | Three months ended March 31, 2005 |
|---|--------------------------------------|--------------------------------------|
| Income (loss) per common share, basic and diluted as reported | \$ (0.02) | \$ (0.02) |
| Share-based payments | (0.00) | -- |
| Deferred development costs | -- | (0.00) |
| Derivative income (expense) | 0.03 | 0.02 |
| Amortization of debt discounts and other charges | (0.00) | (0.02) |
| Investors relations charges | (0.00) | -- |
| Liquidated damages expense | (0.01) | -- |
| Preferred stock accretions | (0.00) | (0.00) |
| Preferred stock accretions | (0.00) | (0.00) |
| Income (loss) per common share, as restated | \$ (0.00) | \$ (0.02) |

See descriptions that we have provided under the tables for net income (loss) and income (loss) applicable to common stockholders. Our restated income (loss) per common share reflects the application of the treasury stock method and the if-converted methods where those methods are appropriate.

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| | Three months ended March 31, 2006 | Three months ended March 31, 2005 |
|--|--------------------------------------|--------------------------------------|
| Comprehensive income (loss), as reported | \$ (3,886,262) | \$ (1,245,464) |
| Comprehensive income (loss), as restated (a) | \$ (277,357) | \$ (661,093) |

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(a) Our restated comprehensive income (loss) reflects the adjustments attributable to net income (loss), above.

Note 11. - Subsequent Events

On April 13, 2006, we issued 457,125 shares of common stock pursuant to a notice of conversion of interest and premium associated with our June 2004 convertible note. The common stock underlying this note was registered pursuant to a registration statement declared effective on April 18, 2005.

On April 17, 2006 we issued 807,692 shares of common stock underlying our Series F Warrant for 1,000,000 shares to an accredited investor. The shares of common stock underlying the Warrant were issued pursuant Regulation D.

On April 21, 2006, we issued 437,500 shares of common stock to an accredited investor pursuant to notices of conversion of our April, June and October 2004 convertible notes. The common stock underlying these notes was registered pursuant to a registration statement declared effective on August 3, 2004 and April 18, 2005, respectively.

On April 28, 2006 we issued 1,500,000 shares of common stock underlying our April 2004 Warrant. The shares of common stock underlying the Warrant were registered pursuant to a registration statement declared effective on August 3, 2004.

On April 28, 2006, we issued 196,078 shares of our common stock in a private placement, pursuant to Section 4(2) of the Securities Act of 1933, to an accredited investor.

On May 12, 2006, we issued \$2,500,000, six-month-term, 10% notes payable plus detachable warrants to purchase 1,500,000 shares of our common stock with a strike price of \$0.80 for a period of five-years. Net proceeds from this financing transaction amounted to \$2,235,000. The holder has the option to redeem the notes for cash 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"). We evaluated the terms and conditions of the notes and warrants and determined that (i) the Default Put required bifurcation because it did not meet the "clearly and closely related" criteria of FAS 133 and (ii) the warrants did not meet all of the requisite conditions for equity classification under FAS 133. As a result, the net proceeds from the arrangement were first allocated to

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the Default Put (\$87,146) and the warrants (\$901,665) based upon their fair values, because these instruments are required to be initially and

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subsequently carried at fair values. These instruments will be carried in our balance sheet following the financing under the classification, Derivative Liabilities and adjusted to fair value. The warrants and shares of common stock underlying the warrants and notes were issued to two accredited investors in a private placement exempt from registration under the Securities Act of 1933 pursuant Regulation D.

On May 16, 2006, we issued 2,000,000 shares of common stock pursuant to an exercise of a warrant associated with our November 2003 convertible note financing. The common stock underlying these notes was registered pursuant to a registration statement declared effective by the Securities and Exchange Commission in 2004.

On June 7, 2006, we issued 101,100 shares of common stock pursuant to a conversion of our May 2005 convertible note. The shares of common stock underlying the preferred were issued pursuant to a registration statement declared effective by the Securities and Exchange Commission in 2004.

On July, 6, 2006, we issued 83,121 shares of our common stock in a private placement, pursuant to Section 4(2) of the Securities Act of 1933, to an accredited investor.

On July, 14, 2006, we issued 436,388 shares of common stock upon the cashless exercise of a warrant associated with our Series D convertible preferred stock. These shares were issued to an accredited investor pursuant to Regulation D and Section 4(2) of the Securities Act of 1933.

On July 14, August 14 and August 31, 2006, we issued, in the aggregate, 250,000 shares of common stock pursuant to a conversion of our Series H preferred stock. The shares of common stock underlying the preferred were issued pursuant to Regulation D.

On July, 19, 2006, we issued 1,008,065 shares of common stock upon the cashless exercise of a warrant associated with our Series H convertible preferred stock. These shares were issued to an accredited investor pursuant to Regulation D and Section 4(2) of the Securities Act of 1933.

On July 27, 2006, we entered into definitive agreements to sell \$30 million senior convertible notes that are due in 2010 to several institutional and accredited investors in a private placement exempt from registration under the Securities Act of 1933. The notes initially carry a 9% coupon, payable quarterly and are convertible into shares of common stock at \$0.70 per share. In 2007, the coupon may decline to LIBOR upon the Company achieving certain financial milestones. The notes will begin to amortize in equal, bi-monthly payments beginning in mid-2007. We concurrently issued warrants to purchase 12,857,143 shares of common stock at \$0.73 per share that expire in July 2011 to the investors in the private placement. Under the terms of the financing, we will sell \$30 million notes, of which \$15.0 million of the notes will be held in escrow. The release of the escrowed funds will be subject to stockholder approval. We intend to file a proxy statement seeking such shareholder approval as soon as practical. As a result of our failure to file our March 31, 2006 Form 10QSB timely, an event of default has occurred under the terms of the Notes, and

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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. We have 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.

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

On August 24, 2006, we issued 168,937 shares of common stock pursuant to a conversion of our May 2005 convertible note. The shares of common stock underlying the preferred were issued pursuant to a registration statement declared effective by the Securities and Exchange Commission in 2004.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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 the 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 are profitable.

OVERVIEW

Our business model includes the development and marketing of our Company owned Slammers(R) and Bravo!(TM) trademarked brands, the obtaining of license rights from third party holders of intellectual property rights to other trademarked brands, logos and characters and the production of our branded flavored milk drinks through third party processors. In the United States and the United Kingdom, we generate revenue from the unit sales of finished branded flavored milk drinks to retail consumer outlets. We generate revenue in our Middle East business through the sale of "kits" to these dairies. The price of the "kits" consists of an invoiced price for a fixed amount of flavor ingredients per kit used to produce the flavored milk and a fee charged to the dairy processors for the production, promotion and sales rights for the branded flavored milk.

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Our business in the United Kingdom started at the end of the second quarter of 2005. Our UK business has not been profitable owing to the difficulties encountered in initial market penetration with new products introduced in the last half of 2005 through the first quarter of 2006. In the current period we had a negative gross margin for our UK operations. We are examining other distribution alternatives in the UK and, while we are making this determination, we have curtailed our production of inventory necessary to maintain a normal supply pipeline.

RESTATEMENT DISCLOSURE - NON-RELIANCE ON OUR PRIOR FINANCIAL STATEMENTS

On December 1, 2005, the Securities and Exchange Commission ("SEC") issued a comment letter concerning accounting issues associated with our Form 10-KSB for the year ended December 31, 2004 (the "Initial Comment Letter"). In an effort to satisfy our registration requirements, on December 21, 2005, in accordance with a Registration Rights Agreement associated with our November 2005 financing, we filed a registration statement registering the Shares and the shares of common stock underlying the Warrants issued in connection with the financing with the SEC, as well as a response letter addressing the seven comments discussed by the SEC in the Initial Comment Letter.

In its letter of December 1, 2005, the SEC's Division of Corporation Finance issued questions on the application of EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, ("EITF 00-19") and Statement of Financial Accounting Standard No. 133, Accounting for Derivative Instruments and Hedging Activities ("FAS 133"), to financial instruments containing an embedded conversion feature, such as convertible preferred stock,

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

convertible notes and associated warrants. In general, EITF 00-19 requires that certain types of convertible equity instruments be reclassified as liabilities in cases where the issuer's ability to settle the instrument in equity is not entirely within the issuer's control. The standard also requires, if liability classification is determined to be appropriate, that the instrument be valued at fair value with future changes in the value reflected in income. As we have financed our operations with various convertible instruments over the last several years, we were required to reevaluate each of our financings in order to ensure the proper treatment under EITF 00-19.

As a result of the SEC's December 1, 2005 comment letter, we immediately began to examine the classification of and our accounting methodology for our convertible preferred and convertible debt financing. Based upon comments from the SEC Staff and the completion of our internal examination, we have changed the classification of certain convertible preferred stock and convertible notes from equity to liabilities. We have examined the accounting methodology utilized to report the value of embedded derivatives associated with our financing instruments, including the balance sheet reclassification and valuation of warrants associated with such financing instruments. We have made changes in the accounting treatment of these derivatives in that they will have been valued separately, and fluctuations of value will be reflected on our past consolidated statements of operations and balance sheets. We also reviewed our accounting for the amortization of discounts, the impact of certain modifications to warrants and the beneficial conversion features associated with our various financing instruments.

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Additionally, we reviewed our accounting for employee stock options, including the fair value calculations made, the method of recognizing compensation expense and the impact of modifications made to certain options, and our treatment of deferred development costs. Lastly, the Staff of the SEC has requested that we restate our historical financial statements to reclassify shipping and handling costs from selling expenses to cost of product sales.

As a result of the items described above, we have restated our annual report on Form 10-KSB for the year ended December 31, 2005 and our quarterly report on Form 10-QSB for the quarterly period ended March 31, 2006. We have also restated the quarterly and year-to-date results for March 31, 2005.

Notwithstanding these restatements, the SEC may have further comments on our financial information based on the restated financial results that will be filed as soon as practicable. The possibility exists that we may be required to adjust and further modify our proposed restated financial results for the periods in question. Such adjustments and modifications, if any, may have a material effect on the financial results set forth in those reports.

CORPORATE GOVERNANCE

The Board of Directors

Our board has positions for seven directors that are elected as Class A or Class B directors at alternate annual meetings of our shareholders. Six of the seven current directors of our board are independent. Our chairman and chief executive officer are separate. The board meets regularly either in person or by telephonic conference at least four times a year, and all directors have access to the information necessary to enable them to discharge their duties. The board, as a whole, and the audit committee in particular, review our financial condition and performance on an estimated vs. actual basis and financial projections as a regular agenda item at scheduled periodic board meetings, based upon separate reports submitted by our Chief Executive Officer and Chief Accounting Officer. Our shareholders elect directors after nomination by the board, or the board appoints directors when a vacancy arises prior to an election. This year we have adopted a nomination procedure based upon a rotating nomination committee made up of those members of the director Class not up for election. The board

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presently is examining whether this procedure, as well as the make up of the audit and compensation committees, should be the subject of an amendment to the by-laws.

Audit Committee

Our audit committee is composed of three independent directors and functions to assist the board in overseeing our accounting and reporting practices. Our financial information is recorded in house by our Chief Accounting Officer's office, from which we prepare financial reports. Lazar Levine & Felix LLP, independent registered public accountants and auditors, audit or review these financial reports. Our Chief Accounting Officer reviews the preliminary financial and non-financial information prepared in house with our securities counsel and the reports of the auditors. The committee reviews the preparation of our audited and unaudited periodic financial reporting and internal control reports prepared by our Chief Accounting Officer. The committee reviews significant changes in accounting policies and addresses issues and recommendations presented by our internal accountants as well as our auditors.

Compensation Committee

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Our compensation committee is composed of three independent directors and reviews the compensation structure and policies concerning executive compensation. The committee develops proposals and recommendations for executive compensation and presents those recommendations to the full board for consideration. The committee periodically reviews the performance of our other members of management and the recommendations of the chief executive officer with respect to the compensation of those individuals. Given the size of our company, the board periodically reviews all such employment contracts. The board must approve all compensation packages that involve the issuance of our stock or stock options. Currently, there is one vacancy on the compensation committee.

Nominating Committee

The nominating committee was established in the second quarter 2002 and consists of those members of the director Class not up for election. The committee is charged with determining those individuals who will be presented to the shareholders for election at the next scheduled annual meeting. The full board fills any mid term vacancies by appointment.

CRITICAL ACCOUNTING POLICIES

Estimates

This discussion and analysis of our consolidated financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles for interim reports that are generally accepted in the United States of America. 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.

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

Revenue Recognition and Accounts Receivable

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. Geographically, our revenues are 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

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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 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.

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% of our accounts receivable balances at March 31, 2006. Approximately, 6% of our accounts receivable at March 31, 2006 are due from international customers.

Inventories

Our inventories, which consists primarily of finished goods, are stated at the lower of cost on the first in, first-out method or market. 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.

Impairment of Long-Lived Assets

Our long-lived assets consist of furniture and equipment and intangible 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

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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

We generally do not use derivative financial instruments to hedge exposures to cash-flow, market or foreign-currency risks. However, we frequently enter into certain other financial instruments and contracts, such as debt

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financing 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.

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 techniques, 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 freestanding warrants, we generally use the Black-Scholes 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.

RESULTS OF OPERATIONS

Three Months Ended March 31, 2006 Compared to the Three Months

Ended March 31, 2005

Consolidated Revenues

The Company had revenues for the three months ended March 31, 2006 of \$3,561,215, with product costs of \$2,946,460 and shipping costs of \$393,452, resulting in a gross margin of \$221,303, or 6.2 % of sales. Our revenues for the three months ended March 31, 2006 increased by \$2,663,445, a 297% increase compared to revenues of \$897,770 for the three months ended March 31, 2005. The increase in revenue is the result of the increased distribution of our product through Coca-Cola Enterprises.

Consolidated Product Costs

The Company incurred product costs of \$2,946,460 and shipping costs of \$393,452 for the three months ended March 31, 2006. Product costs for this period increased by \$2,268,797, a 335% increase compared to \$677,663 for the three months ended March 31, 2005. The increase in product costs and

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shipping costs in the United States for the three months ended March 31, 2006 is the result of increased revenues.

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Consolidated Operating Expenses

The Company incurred selling expenses for the three months ended March 31, 2006 of \$2,843,098. Selling expenses increased for the three months ended March 31, 2006 by \$2,358,067, a 486% increase compared to the selling expenses of \$485,031 for the three months ended March 31, 2005. The increase in selling expenses is the result of increased sales.

The Company incurred general and administrative expenses for the three months ended March 31, 2006 of \$1,768,203. General and administrative expenses for the three months ended March 31, 2006 increased by \$1,009,949, a 133% increase compared to \$758,254 for the same period in 2005. The increase in general and administrative expenses for the current period is the result of the hire of additional staff and other costs associated with the management and implementation of our relationship with Coca-Cola Enterprises under the Master Distribution Agreement.

As a percentage of total revenue, our general and administrative expenses decreased from 84% in the period ended March 31, 2005, to 50% for the current period in 2006. We anticipate a continued effort to reduce these expenses as a percentage of sales through revenue growth, cost cutting efforts and the refinement of business operations.

Consolidated Derivative Income (Expense)

Derivative income (expense) arises from changes in the fair value of our derivative financial instruments and, in rare instances, day-one losses when the fair value of embedded and freestanding derivative financial instruments issued or included in financing transactions exceed the proceeds or other basis. Derivative financial instruments include freestanding warrants, and compound embedded derivative features that have been bifurcated from debt and preferred stock financings. In addition, our derivative financial instruments arise from the reclassification of other non-financing derivative and other contracts from stockholders' equity because share settlement is not within our control while certain variable share price indexed financing instruments are outstanding.

Our derivative income amounted to \$4,949,188 for the three months ended March 31, 2006, compared to \$1,471,743 for the corresponding period of the prior year.

Changes in the fair value of compound derivatives indexed to our common stock are significantly affected by changes in our trading stock price and the credit risk associated with our financial instruments. The fair value of warrant derivatives is significantly affected by changes in our trading stock prices. The fair value of derivative financial instruments that are settled solely with cash fluctuate with changes in management's weighted probability estimates following the financing inception and are generally attributable to the increasing probability of default events on debt and preferred stock financings. The fair value of the warrants fluctuate principally due to the fluctuation in our common stock trading price. Since these instruments are measured at fair value, future changes in assumptions, arising from both internal factors and general market conditions, may cause further variation in the fair value of these instruments. Future changes in these underlying internal and external market conditions will have a continuing effect on derivative expense associated with our derivative financial instruments.

In addition, we entered into a \$30 million debt and warrant financing in July 2006 that will require the bifurcation of derivative financial instruments. We have not calculated the amounts of these

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derivatives, but their effects on our earnings, arising from fair value changes, will be consistent with the derivatives that we carry as of March 31, 2006.

Consolidated Interest Expense

We incurred interest expense for the period ended March 31, 2006 of \$34,007. Our interest expense decreased by \$860,154 compared to \$894,161 for the same period in 2005. The decrease was due to conversions of several of our debt instruments to equity, and to our payment of debt instruments incurred in 2005 to finance our operations.

Consolidated Liquidating Damages Expense

During the three months ended March 31, 2006, we recorded liquidated damages expense of \$685,887 (none in the comparable period of 2005). However, we recorded \$303,750 in liquidated damages during the fourth fiscal quarter of our year ended December 31, 2005. We have entered into registration rights agreements with certain investors that require us to file a registration statement covering underlying indexed shares, 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 cash penalties to the investors in the event we do not achieve the requirements. We record estimated liquidated damages penalties as liabilities and charges to our income when the cash penalties are probable and estimable. We will evaluate our estimate of liquidated damages in future periods and adjust our estimates for changes, if any, in the facts and circumstances underlying their calculation.

Consolidated Net Loss

We have net loss for the three months ended March 31, 2006 of \$276,667, compared with a net loss of \$653,070 for the same period in 2005. Net income for the quarter of March 2006 is largely the result of our recording changes in the fair value in our derivatives.

Consolidated Loss Applicable to Common Shareholders

Loss applicable to common shareholders represents net income less preferred stock dividends and accretion of our redeemable preferred stock to redemption value using the effective method. Diluted income per common share reflects the assumed conversion of all dilutive securities, such as convertible preferred stock, convertible debt, warrants, and employee stock options.

Consolidated Loss per Common Share

The Company's basic loss per common share for the three months ended March 31, 2006 was \$0.00 compared with a basic per common share for the same period in 2005 of \$(0.02).

The weighted average common shares outstanding increased from 59,618,018 for the three months ended March 31, 2005 to 184,253,753 for the same period in 2006. The increase is attributed primarily to conversions of our convertible debt and preferred instruments into common shares. Potential common stock conversions excluded from the computation of diluted loss applicable to common shareholders per share because they would be antidilutive amounted to 81,913,744 and 129,857,869 for the three months ended March 31, 2006 and 2005, respectively.

Comprehensive Loss

Comprehensive loss differs from net income (loss) for the three months ended

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March 31, 2006 and 2005 by \$(690) and (\$8,023), respectively, which represents the effects of foreign currency translation on the financial statements of our subsidiaries denominated in foreign currencies. Our foreign operations are currently not significant. Increases in our foreign operations will likely increase the effects of foreign currency translation adjustments on our financial statements.

LIQUIDITY AND CAPITAL RESOURCES

Management's Plans:

As reflected in the accompanying consolidated financial statements, we have incurred operating losses and negative cash flow from operations and have negative working capital of \$37,818,789 as of

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March 31, 2006. This negative figure is largely the effect of our recording for derivative liabilities. 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 currently are being corrected. Our inability to make these filings is resulting in our recognition of penalties payable to the investors. 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 third party financings as we execute on our business model and plans. While 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 held in escrow, and we are in default on this instrument due to the delay in filing our quarterly financial report for the quarterly period ended June 30, 2006. We have 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.

We plan to increase our revenues, improve our gross 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.

Information about our cash flows

We reported that net cash used in operating activities was \$4,210,671, net cash provided by financing activities was \$286,606 and net cash used in investing activities was \$413,446 during the three months ended March 31, 2006. We had a negative working capital of \$37,818,789 as of March 31, 2006. This negative figure is largely the effect of our recording for derivative liabilities at their fair value.

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Compared to \$728,304 of net cash used in operating activities in the three months ended March 31, 2005, our current period net cash used in operating activities increased by \$3,482,367 to \$4,210,671. This increase was primarily the result of our inventory build up.

Changes in accounts receivable in this current period in 2006 resulted in a cash increase of \$1,596,042, compared to a cash increase in receivables of \$16,844 for the same period in 2005, having a net result of an increase of \$1,579,198. Cash used for inventory in the current period was \$2,652,769, compared to cash generated of \$6,982 for the same period in 2005. This increase was the result of our building inventory in connection with the continued implementation of our Master Distribution Agreement with Coca-Cola Enterprises. The changes in accounts payable and accrued liabilities in the current period ending March 31, 2006 contributed to a cash increase of \$1,668,557, whereas the changes in accounts payable and accrued liabilities for the three months ended March 31, 2005 contributed to such an increase of \$397,710. Cash flow generated through our operating activities were inadequate to cover all of our operating cash needs in the period ended March 31, 2006, and we had to rely on prior equity and debt financing to cover those expenses.

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Cash used in the period ended March 31, 2006 by our investing activities was \$413,446 compared to \$383,274 for the same period in 2005. During 2006, we incurred \$163,536 for license, trademark and finance costs and \$249,910 in the purchase of new equipment, which included eight vans that are being used for sales and promotional purposes.

Net cash provided by our financing activities for the three months ended March 31, 2006 was \$286,606. Net cash provided by financing activities for the same period in 2005 was \$1,123,272.

Going forward, our primary requirements for cash consist of the following:

- o the continued development of our business model in the United States and on an international basis;
- o promotional and logistic production support for the capacity demands presented by our Master Distribution Agreement with Coca-Cola Enterprises;
- o general overhead expenses for personnel to support the new business activities;
- o development, launch and marketing costs for our line of new branded flavored milk products; and
- o the payment of guaranteed license royalties.

We estimate that our need for financing to meet cash requirements for operations will continue through the fourth quarter of 2006, when we expect that cash supplied by operating activities will approach the anticipated cash requirements for operating expenses. We anticipated the need for additional financing during the remainder of 2006 to reduce our liabilities, assist in marketing and to improve stockholders' equity status, and we secured \$30 million in senior convertible note financing in July 2006. We have received half of the proceeds from this financing in the third quarter, with the balance being held in escrow pending a shareholder vote to increase our authorized shares to cover the escrowed balance. No assurances can be given that we will be able to obtain the approval of our shareholders to increase our authorized shares, or that operating cash flows will be sufficient to fund our operations.

We currently have monthly working capital needs of approximately \$550,000. We will continue to incur significant selling and other expenses in 2006 in order to derive more revenue in retail markets, through the introduction and

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ongoing support of our new products and the implementation of the Master Distribution Agreement with Coca-Cola Enterprises. We expect that certain of these expenses, such as slotting fees and freight charges, will be reduced as a function of unit sales costs as we expand our sales markets and increase our revenues within established markets. Freight charges will be reduced as we are able to ship more full truckloads of product given the reduced per unit cost associated with full truckloads versus less than full truckloads. Similarly, slotting fees, which are paid to warehouses or chain stores as initial set up or shelf space fees, are essentially one-time charges per new customer. We believe that along with the increase in our unit sales volume, the average unit selling expenses and associated costs will decrease, resulting in gross margins sufficient to satisfy our cash needs. In addition, we are actively seeking additional financing to support our operating needs and to develop an expanded promotional program for our products.

External Sources of Liquidity

On May 12, 2006, we obtained financing in the amount \$2,500,000 and issued promissory notes in that aggregate principal amount to two accredited investors. One of these investors has exercised rights of participation and has reinvested \$1,000,000 of this note in the July 27, 2006 financing described below. The remaining \$1,500,000 principal of the notes has been paid in full with the part of the July 27, 2006 financing proceeds.

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On July 27, 2006, we entered into definitive agreements to sell \$30 million senior convertible notes (the "Notes") that are due in 2010 to several institutional and accredited investors in a private placement exempt from registration under the Securities Act of 1933. The notes initially carry a 9% coupon, payable quarterly, and are convertible into shares of common stock at \$0.70 per share. In 2007, the coupon may decline to LIBOR upon the Company achieving certain financial milestones. The Notes will begin to amortize in equal, bi-monthly payments beginning in mid-2007. We issued warrants to purchase 12,857,143 shares of common stock at \$0.73 per share that expire in July 2011 to the investors in the private placement. Under the terms of the financing, we sold \$30 million notes, of which \$15.0 million of the proceeds are being held in escrow. The release of these funds will be subject to stockholder approval of the increase of our authorized shares from 300,000,000 to 500,000,000 and the effectiveness of a registration statement converting the common stock underlying the Notes, Additional Notes and associated warrants. We will utilize this financing for, among other things, our working capital needs. We have filed a proxy statement seeking such shareholder approval at a Special Meeting of Shareholders..

As a result of our failure to timely file our Form 10QSB for the six months ended June 30, 2006, 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. We have 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 the above mentioned Form 10-QSB. See Item 3 of Part II of this report, entitled "Default on Senior Securities", for a description of the terms of the Amendment Agreement.

EFFECTS OF INFLATION

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We believe that inflation has not had any material effect on our net sales and results of operations.

ITEM 3. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We maintain "disclosure controls and procedures," as such term is defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act") designed to ensure information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief accounting officer, as appropriate, to allow timely decisions regarding required disclosure.

We have carried out an evaluation, under the supervision and with the participation of our audit committee and management, including our chief executive officer and chief accounting officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rules 13a-15(b) and 15d-15(b). During this evaluation, management considered the impact any material weaknesses and other deficiencies in our internal control over financial reporting might have on our disclosure controls and procedures.

Based upon this evaluation, we determined that the following material weakness existed:

Inadequate controls over the process for the identification and implementation of the proper accounting for complex and non-routine transactions, particularly as they relate to accounting for

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derivatives, which has caused the Company to restate its consolidated financial statements for each of the two years ended December 31, 2004 and 2005, and for the quarterly periods contained within those years (collectively, the "financial statements") in order to properly present those financial statements;

Because the material weakness identified in connection with the assessment of our internal control over financial reporting as of March 31, 2006 has not been fully remedied, our Chief Executive Officer and our Chief Accounting Officer concluded our disclosure controls and procedures were not effective as of March 31, 2006. To address these control weaknesses, the Company engaged advisory accountants, who performed additional analysis and performed other procedures in order to prepare the unaudited quarterly condensed consolidated financial statements appearing in this Form 10-QSB in accordance with generally accepted accounting principles in the United States of America.

In addition, we have added or are initiating the following additional controls to the Company's internal control over financial reporting which will improve such internal control subsequent to the date of the evaluation. These changes are:

- o We have restructured certain departmental responsibilities as they relate to the financial reporting function.
- o We have added one more experienced full-time accountant to our accounting staff, whose responsibilities will include the

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identification and implementation of proper accounting procedures relating to current and new guidance on financial reporting issues which apply to the Company.

- o We have commenced a search for a consultant to perform a review for the purpose of evaluating the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

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

See Note 8 of Notes to Consolidated Financial Statements.

Item 3. Default on Senior Securities

On July 27, 2006, we entered into definitive agreements to sell \$30 million senior convertible notes (the "Notes") that are due in 2010 to several institutional and accredited investors in a private placement exempt from registration under the Securities Act of 1933. Under the terms of the financing, we sold \$30 million notes, of which \$15.0 million were issued upon closing (the "Notes") with the balance of the notes (the "Additional Notes") held in escrow until our satisfaction of certain conditions.. As a result of the Company's non-timely filing of its Form 10-QSB for the six months ended June 30, 2006, an event of default occurred under the terms of the \$30 million Senior Convertible Notes issued on July 27, 2006 and the annual interest rate on the Notes and Additional Notes was increased from 9% to 14%. In the event, however, that such event of default is subsequently cured, interest on the Notes shall revert to the rate of 9% per annum. In addition, upon the occurrence of an event of default, holders of the Notes and Additional Notes may, upon written notice to the Company, require the Company to redeem all or any portion of their Notes.

On August 31, 2006, the Company entered into Amendment Agreements with the holders of the Notes and Additional Notes, pursuant to the which holders each agreed to release the Company from the events of default that occurred under the terms of the Notes as a result the Company's non-filing of its Form 10-QSB for the six months ended June 30, 2006. The Company agreed, in consideration for such releases, to

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exchange the \$15 million Additional Notes for amended and restated notes (the Amended and Restated Notes). The Amendment Agreement provides for termination by the non-breaching party if closing of the transactions contemplated by the Amendment Agreement does not occur by September 1, 2006 due to one party's failure to satisfy its conditions to closing. The Amendment Agreement also provides for the extension of certain time limits with regard to dates set forth in the financing documentation in connection with the Securities Purchase Agreement, dated as of July 26, 2006.

The Amended and Restated Notes will be issued upon closing of the transactions contemplated by the Amendment Agreement. The terms of the Amended and Restated Notes differ from the terms of the Additional Notes in certain regards. The conversion price applicable to the conversion of any portion of the principal of the Amended and Restated Notes is \$0.51, which price is reduced from \$0.70 for the Additional Notes. The Amended and Restated Notes also provide that, from and after the earlier of (i) October 10, 2006 and (ii) the date the Stockholder Approval is obtained, the holder may require the Company to redeem at such holder's option any portion of the holder's Amended and Restated Note in cash at a price equal to 125% of the amount redeemed. Notwithstanding the foregoing, between November 15, 2006 and December 15, 2006, provided the Company meets

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certain conditions, the Company may request the holder to require that the Company redeem any portion of such holder's notes. In the event that such holder does not so request, the holder's right to any such optional redemptions shall terminate; provided, however, that once a holder delivers such a request, its right to deliver a subsequent request shall terminate. The holders, pursuant to the Amended and Restated Notes, each will also agree, upon such holder's delivery of an optional redemption request, to waive certain debt and equity restrictions applicable to the Company pursuant to the financing documentation in connection with the Securities Purchase Agreement, dated as of July 26, 2006.

Subsequent Events

See Note 11 of Notes to Consolidated Financial Statements.

Item 6. Exhibits

Exhibits - Required by Item 601 of Regulation S-B:

- No. 20.1: Form 8-K filed August 2, 2006 Item 8.01 Transaction Documents for \$30 million financing (incorporated by reference)
- No. 20.2: Form 8-K Filed August 14, 2006 Item 7.01 Triggering Events of Default (incorporated by reference)
- No. 20.3: Form 8-K Filed August 22, 2006 Item 4.02 Non-Reliance on Previously Issued Financial Statements (incorporated by reference)
- No. 20.4: Form 8-K Filed September 5, 2006 Item 1.01 Amendment Agreement -Release of Default (incorporated by reference)
- No. 31: Rule 13a-14(a) / 15d-14(a) Certifications
- No. 32: Section 1350 Certifications

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SIGNATURES

In accordance with the requirements of the Exchange Act of 1934, the registrant caused this report to be signed on its behalf of the undersigned, duly authorized.

BRAVO! FOODS INTERNATIONAL CORP.
(Registrant)

Date: October 2, 2006

/s/Roy G. Warren
Roy G. Warren, Chief Executive Officer

In accordance with the Securities Exchange Act of 1934, Bravo! Foods International Corp. has caused this report to be signed on its behalf by the undersigned in the capacities and on the dates stated.

| Signature | Title | Date |
|----------------------------|--|--------------------------|
| ----- /S/ Roy G. Warren | ----- Chief Executive Officer and Director | ----- October 2, 2006 |
| /S/ Tommy E. Kee | Chief Accounting Officer | October 2, 2006 |

