APPLIED SIGNAL TECHNOLOGY INC
Form 10-K
January 17, 2006

United States
Securities and Exchange Commission
Washington, D.C. 20549

Form 10-K

(Mark One)

[X] Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Fiscal Year Ended October 31, 2005

or

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Transition Period from ____________________ to ____________________.

Commission file number 0-21236

Applied Signal Technology, Inc.
(Exact name of registrant as specified in its charter)

California	**77-0015491**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

400 West California Avenue, Sunnyvale, CA 94086
(Address of principal executive offices)

(408) 749-1888
(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: Not Applicable.

Securities registered pursuant to Section 12(g) of the Act: Common Stock, without par value.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

	ü
Yes	No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

	ü
Yes	No

Indicate by checkmark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

ü	
Yes	No

Indicate by checkmark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant’s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

Indicate by a check whether the registrant is an accelerated filer (as defined by Rule 12b-2 of the Act).

ü	
Yes	No

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

	ü
Yes	No

Aggregate market value of the voting common stock held by non-affiliates of the registrant:
Common Stock, without par value – $212,869,708 as of April 30, 2005, based on the closing price on such date for the registrant's common stock reported by the NASDAQ National Market System. For purposes of this disclosure, shares of common stock held by persons who held more than 5% of the outstanding shares of common stock and shares held by officers and directors of the registrant have been excluded in that such persons may be deemed to be affiliates. The determination of affiliate status is not necessarily a conclusive determination for other purposes.

Number of shares of registrant's common stock outstanding:
Common Stock, without par value – 11,528,318 shares as of October 31, 2005.

Documents Incorporated by Reference

The registrant has incorporated by reference into Part II, item 5 and Part III of this Form 10-K portions of its proxy statement for the registrant's Annual Meeting of Shareholders to be held on March 15, 2006.

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Part I

Item 1: Business

This Annual Report on Form 10-K contains forward-looking statements made pursuant to the provisions of Section 21E of the Securities Exchange Act of 1934. These forward-looking statements are based on management's current expectations and beliefs, including estimates and projections about our industry. Forward-looking statements may be identified by the use of terms such as "anticipates," "expects," "intends," "plans," "seeks," "estimates," "believes," and similar expressions, although some forward-looking statements are expressed differently. Statements concerning financial position, business strategy, and plans or objectives for future operations are forward-looking statements. These statements are not guarantees of future performance and are subject to certain risks, uncertainties, and assumptions that are difficult to predict and may cause actual results to differ materially from management's current expectations. Such risks and uncertainties include those set forth below under "Item 1A: Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations." The forward-looking statements in this report speak only as of the time they are made and do not necessarily reflect management's outlook at any other point in time. We undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events, or for any other reason. However, readers should carefully review the risk factors set forth in other reports or documents we file from time to time with the Securities and Exchange Commission (SEC) after the date of the Annual Report. These SEC filings, as well as our latest annual report, can be obtained through our website at www.appsig.com. In addition, hard copies can be obtained free of charge through our investor relations department.

Description of the Business

Applied Signal Technology, Inc., (AST) provides advanced digital signal processing products, systems, and services in support of intelligence, surveillance, and reconnaissance (ISR) for global security. We provide processing of both man-made and non-man-made signals. The man-made signal processing is for both communications intelligence (COMINT) and electronic intelligence (ELINT). The non-man-made signal processing is applied to phenomenological sensors. Our primary customer is the United States Government. We develop and manufacture equipment for both the collection and processing of signals.

COMINT derives intelligence from telecommunications signals. Our COMINT signal collection equipment consists of sophisticated receivers that scan through potentially thousands of cellular telephone, microwave, ship-to-shore, and military transmissions in the radio frequency (RF) spectrum with the goal of collecting certain specific signals. Our COMINT signal processing equipment uses advanced software and hardware to evaluate characteristics of the collected signals and selects those most likely to contain relevant information. At inception, our efforts were primarily focused on COMINT processing equipment. Over time, we have broadened our scope to add specialized collection equipment and complete signal processing systems and related services.

ELINT derives intelligence from signals associated with weapon systems. Our investment in ELINT is directed toward the development of equipment for the collection and processing of weapons systems signals. This equipment will be able to scan the radar bands associated with weapons systems and determine the type of system and its precise location for battlefield characterization and force protection. The equipment will also analyze the command and control signals associated with these weapons systems to provide information about battlefield readiness.

In order to diversify into phenomenological sensor signal processing, AST acquired Dynamics Technology, Inc. (DTI) on July 1, 2005. DTI was a privately held California corporation headquartered in Torrance, California with offices in Anaheim, California and Arlington, Virginia. DTI was a provider of advanced sensor signal processing solutions for advanced space-based, airborne, terrestrial, and undersea sensor technologies.

We are incorporated in California. Our principal executive offices are located at 400 West California Ave., Sunnyvale, CA, 94086, and our telephone number is (408) 749-1888. Our web site address is www.appsig.com. The information posted on our web site is not incorporated into this Annual Report. However, investors can obtain a copy of this Annual Report on Form 10-K, our quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to such reports filed or furnished with the SEC on our web site free of charge.

Communications Intelligence (COMINT)

Accurate and comprehensive information regarding foreign affairs and developments has become increasingly important to the United States Government. The political instability in certain regions such as the Middle East, Eastern Europe, Africa, and Central and South America and the ongoing counterterrorism campaign have heightened the United States Government’s need to be able to monitor activities in foreign countries. In order to obtain information about activities within foreign countries, the United States Government gathers and analyzes telecommunications signals emanating from those countries.

The ever-increasing commercial development of telecommunications equipment has led to a significant increase in the overall quantity of information communicated and an increase in the density of signals transmitted throughout the RF spectrum. This increase can be seen in the proliferation of facsimile, cellular, and digital signal telecommunications equipment and in the global information network (such as the Internet) in recent years, resulting in a significant increase in the amount of information being communicated. Consequently, the requirement to develop COMINT equipment capable of collecting and processing an increased quantity of signals, as well as new types of signals, has increased significantly.

We devote significant resources toward understanding the United States Government’s COMINT goals, capabilities, and perceived future needs. We obtain information about these signal reconnaissance needs through frequent marketing contact between our employees and technical and contracting officials of the United States Government. In addition, we invest in research and development (R&D) activities that we anticipate will enable us to develop signal reconnaissance equipment that meets the future needs of the United States Government.

Our COMINT products can be used, with or without further modification, to satisfy requirements of a variety of customers. Our products can be deployed readily in a wide variety of circumstances to meet current United States Government signal reconnaissance requirements.

The United States Government is continuing to increase funding for counterterrorism. Counterterrorism is focused on individuals and groups of individuals, and relies heavily on intelligence gathering. A key source for intelligence is COMINT. We are a resource to the United States Government, providing COMINT products, systems, and services.

Electronic Intelligence (ELINT)

The same countries that have political instability and terrorist activities are modifying older Soviet-developed weapon systems as well as developing new weapon systems. Accordingly, the United States Government must invest in new ELINT technologies to gather intelligence about these weapon systems. There is also a need to advance ELINT technology to provide battlefield mapping and force protection against these new weapon systems.

We are investing to develop a state-of-the-art ELINT processor that will provide characterization and location of these new weapon systems. We expect that this investment will result in a product that will also be applicable to unmanned aerial vehicles, which we believe will be the platform of choice for future ELINT missions.

Sensor Processing

In the current counterterrorism campaign, the United States Government has determined that phenomenological information is very important in aiding the detection and location of terrorist activities. We believe that sensor detection of chemicals that might be used for explosives or ferrous materials that might indicate installations of improvised explosive devices is a high-priority information source to the United States Government.

As a result, the United States Government is investing to add phenomenological sensor data to other forms of intelligence (for example, COMINT) in order to obtain a more complete information set regarding possible terrorist activities. With the acquisition of DTI on July 1, 2005, AST now has a phenomenological sensor processing capability and we are currently investing to transition some of the acquired technological sensor processing solutions into fieldable solutions.

Homeland security requires a robust system that quickly conducts covert or overt inspection of containers, vehicles, packages and facilities anywhere in the world, on land or sea, using tools that reach beyond the fixed site border security systems. In particular, U.S. security forces need to have a portable capability to “see” through walls and other barriers to non-intrusively identify dangerous materials on the other side.

To address this need, Applied Signal Technology, united with industry and government partners, is developing neu-VISION™ — a portable neutron imaging and material identification system designed to provide through-barrier detection and classification of explosives, chemical agents, radiological or nuclear materials, and other hazardous materials in a variety of operational settings. The innovative neutron imaging technology serves an important role in the nation’s integrated security capability with its unique combination of barrier penetration, 3-dimensional representation, material identification, and operational flexibility. We have obtained a license to operate neutron-imaging equipment at our non-intrusive inspection test facility in Torrance, California.

Segments

We have reviewed our business operations and determined that we operate in a single homogeneous business segment. We sell similar products and services with similar economic characteristics to similar classes of customers, primarily to the U.S. Government, its agencies, or prime contractors for the United States Government. Our technologies and the operations of our groups and divisions are highly integrated. Revenues and costs are reviewed monthly by management on an individual contract basis as a single business segment.

Strategy

Our objective is to anticipate the needs of the global security marketplace and to invest in research and development so we can provide solutions before our competitors. In some cases, our solution is to develop equipment or services that address new telecommunications technologies or detection of new phenomena of importance. In other cases, our solution is to develop equipment that offers smaller size, lower power consumption, and lower cost than potentially competitive products. Our strategy to accomplish these objectives focuses on the following elements:

Anticipate marketplace needs. We devote significant resources in order to anticipate future global security needs. We monitor technological and commercial advances in telecommunications as well as trends in terrorist activities to identify what we believe are new opportunities for the development of our products. We obtain information about marketplace needs through frequent contact with technical and contracting officials of pertinent government agencies within the intelligence community.

Many times, the United States Government grants sole-source contracts when a single contractor is deemed to have expertise or technology that is superior to that of competing contractors. Since our inception, a significant portion of our revenues has been from sole-source contracts.

Invest in research and development. We invest in research and development that we believe will enable us to develop equipment and services that will satisfy the future global security needs of our customers. This, in turn, often enables us to introduce products that meet marketplace demands before our competitors. An important aspect of our R&D efforts is the understanding of information sources that could enhance global security in order to anticipate the future signal processing needs of our customers. Not only does this allow us to direct R&D engineering efforts to produce solutions promptly once a customer expresses a requirement, but it often allows us to educate the customer about potential requirements and simultaneously present a conceptual solution to those requirements.

Develop flexible products. We develop products that can be used as originally designed, or with further customization, to satisfy the needs of a variety of customers. We use prior product development efforts to offer customers cost-effective solutions and to offer these solutions promptly.

Develop highly integrated products. We design our products to use advanced circuitry and highly integrated components. This enables us to offer products that are smaller, consume less power, and cost customers less when multiple units are built than equipment of similar functionality that uses fewer advanced designs and materials. The lower cost of many of our products appeals to customers with budget constraints, and the small size and low power consumption of many of our products appeals to customers with physical installation constraints.

Focus on signal processing. Since inception, we have focused our attention on developing signal processing equipment and services. We believe that there have been and will continue to be opportunities to develop specialized signal processing equipment and services to satisfy emerging technological requirements.

Increase business with existing customers and broaden customer base. We believe that our current customers offer opportunities for sales growth through sales of additional units of developed products and through contracts to develop new products. Accordingly, we direct much of our marketing efforts toward these customers in order to increase our penetration of these markets. Additionally, we continue to try to broaden our customer base by increasing marketing efforts toward military signal reconnaissance.

Products

Communications Intelligence (COMINT) Products

Our COMINT products consist of signal collection and processing equipment that use software and hardware that we developed over many years. This software and hardware enables our processing equipment to evaluate large numbers of radio frequency signals and to select the relatively small portion that contains information likely to be useful to the United States Government. We offer a variety of COMINT products that can be categorized as follows.

Voice grade channel processors. These processors are designed to process voice grade channels (VGCs), which carry audio and other signals. The standard telecommunication systems used throughout the world put a large number of VGCs on a single carrier channel to increase the number of signals that can be transmitted at a particular frequency. Our VGC processors can scan thousands of signals in less than one second, evaluate their characteristics, and use sophisticated processing technology to detect and record relevant data that is then analyzed by United States Government personnel. Our VGC processors currently range in price from approximately $40,000 to approximately $200,000.

Wideband processors. These processors “clean” telecommunication signals for further processing by VGC processors by adjusting for signal distortions that commonly occur during transmission. The two primary types of distortions that these processors correct are multipath interference (caused by the reception of a signal and its reflections) and co-channel interference (caused by the reception of multiple interfering signals). Commercial telecommunication companies overcome these distortions with careful alignment and tuning that requires interruption of the telecommunication signals. Our wideband processors perform this alignment independently and automatically by using proprietary adaptive algorithms that let the processors “learn” how to adjust their parameters to process the incoming signals. One of our wideband products processes signals that carry thousands of VGCs in a globally used digital format that is particularly susceptible to distortions. Our wideband processors currently range in price from approximately $40,000 to approximately $60,000.

Collection products. We offer a limited number of signal collection products designed to complement some of our processing products. Our collection products include a low-cost, small receiver that collects very complex signaling formats, and a receiver that optimizes multiple antenna inputs to overcome co-channel interference and certain forms of multi-path interference. Our collection products currently range in price from approximately $20,000 to approximately $60,000.

Software products. Software products are based upon the use of commercial off-the-shelf hardware processors. With current state-of-the-art computer and component technologies (for example, field-programmable gate arrays, Pentium processors, G4 processors), global security requirements can often be met by utilizing off-the-shelf “compute engines.” We develop our software products so the signal processing can be performed in these engines when applicable. Our software products, utilizing our proprietary licenses, range in price from approximately $5,000 to approximately $100,000.

***Sensor products*.** Our sensor products are comprised of two categories: active sensing and passive sensing.

Active sensing products analyze the phenomena that result from a stimulus such as sonar, radar, or neutron bombardment. These products include synthetic aperture sonar for undersea imaging, associated particle imaging for cargo inspection, and synthetic aperture radar processing for global change detection.

The passive products include magnetic, acoustic, and electromagnetic processors for land mine detection, underground facility detection, and anti-submarine warfare.

The sensor products range in price from approximately $200,000 to approximately $1,000,000.

Systems

Systems development. We also develop and deliver entire systems in situations where the capabilities of our products formulate the majority of the system capability. These systems include our custom developed system software, and the integration of the appropriate compilation of our products as well as, at times, the integration of other vendors’ products.Pricing for processing systems can vary widely depending on systems requirements and may range from one to tens of millions of dollars.

Systems integration. In recent years, we have applied our expertise to integrate signal processing systems comprised mainly of other vendors’ products. These system integration efforts are usually performed at a customer’s facility or site (many times in foreign countries). These contracts may include the development of system software, the physical integration of other vendors’ products, and the final system testing to verify performance. These contracts may require us to perform on-going maintenance and mission management efforts. These contracts can range from approximately $500,000 to millions of dollars.

ELINT systems. We are currently investing to develop an airborne ELINT processing system capable of being installed in either manned or unmanned aerial vehicles. This system will be capable of identifying modern weapon systems of foreign countries and precisely geo-locating

their position in the battlefield.

Services

We perform engineering services for current operational systems. Examples of these services are: 1) evaluation of current performance; 2) engineering improvements for performance enhancement; 3) evaluation of signals being processed to develop system operation techniques that can improve the intelligence gathering; 4) on-going mission management of a system; and 5) customer training in the usage of our standard products. Contracts for these services range in price from approximately $50,000 to several hundred thousand dollars.

Customers, Contracts, and Marketing

Customers

Since our inception, purchases by the United States Government have accounted for almost all of our revenues. These purchases occur in two ways: contracts directly with the government, and subcontracts to prime contractors. Direct contracts with the United States Government accounted for approximately 67%, 63%, and 59% of revenues in fiscal years 2005, 2004, and 2003, respectively. The subcontracts under which we supply products or services to prime contractors that have contracts with the United States Government accounted for approximately 28%, 34%, and 39% of revenues in fiscal years 2005, 2004, and 2003, respectively.

Our United States Government customers consist of military and intelligence agencies that have signal reconnaissance needs. Within our primary customer agencies, we have contracts with approximately 40 different offices, each with separate budgets and contracting authority.

The following table identifies the source of our revenues for fiscal years 2005, 2004, and 2003 by customer type:

	FY05	FY04	FY03
Intelligence Agencies	72%	80%	84%
Military	23%	17%	14%
Law Enforcement	—	—	1%
Foreign	2%	2%	1%
Commercial	3%	1%	—
	100%	100%	100%

Contracts with all offices of two intelligence agencies accounted for approximately 28% and 44% of revenues in fiscal year 2005; approximately 26% and 54% of revenues in fiscal year 2004; and approximately 30% and 54% of revenues in fiscal year 2003, respectively.

Contracts

Most of our business is conducted under contracts that include United States Government security requirements. Our contracts with United States Government agencies are of two types.

Sole-source contracts are awarded by the United States Government when a single contractor is deemed to have an expertise or technology that is superior to that of competing contractors. Potential suppliers compete informally for sole-source contracts through R&D investment and marketing efforts. This competition requires a contractor to identify the United States Government's requirements early and invest in developing potential solutions so that the contractor can demonstrate a distinguishing expertise or technology promptly after the United States Government has identified a requirement. Sole-source contracts are awarded without a formal competition.

Competitive-bid contracts are awarded based on formal proposal evaluation criteria established by the procuring agency. Interested contractors prepare a bid and proposal in response to the agency's request. A bid and proposal is usually prepared in a short time period (for example, 45 days) in response to a deadline, and requires the extensive involvement of numerous technical and administrative personnel. Competitive-bid contracts are awarded after a formal bid and proposal competition among suppliers.

The following table identifies the allocation of revenues we generated for fiscal years 2005, 2004, and 2003 between contracts awarded on a sole-source basis and contracts awarded on a competitive-bid basis.

	FY05	FY04	FY03
Sole-Source Contracts	82%	96%	81%
Competitive-Bid Contracts	18%	4%	19%
	-----------	-----------	-----------
	100%	100%	100%
	======	======	======

Sole-source or competitive-bid contracts can be either fixed-price contracts, where we agree to deliver equipment for a fixed price and we assume the risk of cost overruns, or they can be cost-reimbursement contracts, where we are reimbursed for our direct and indirect costs and paid a negotiated profit. Historically, we have achieved greater profit margins from our fixed-price contracts than from our cost-reimbursement contracts.

Four contracts represented an aggregate of 29.4% of revenues for fiscal year 2005, and three contracts represented an aggregate of 28.4%, and 19.7% of revenues for fiscal years 2004, and 2003, respectively. These contracts are all cost-reimbursement contracts. The following table represents our revenue concentration during the respective periods by contract type:

	FY05	FY04	FY03
Cost-reimbursement contracts	79%	74%	73%
Fixed-price contracts	21%	26%	27%
	-----------	-----------	-----------
	100%	100%	100%
	======	======	======

We believe that our mix of contract types in fiscal year 2006 will be similar to our mix of contract types in fiscal year 2005.

Most of our fixed-price contracts are for the manufacture of multiple units of our established products, rather than the development of new products. We believe that the risk of cost overruns is much less in the case of fixed-price manufacturing contracts, where the product has already been developed and at least a prototype made, than in the case of fixed-price development contracts.

We are subject to price redetermination on certain fixed-price United States Government contracts if it is determined that we did not price our products and services consistent with the requirements of the Federal Acquisition Regulations. During fiscal years 2005, 2004, and 2003, we did not have claims against us for noncompliance with these regulations, although, during fiscal year 2005 we did settle one dispute with the U.S. Government relating to earlier contracts.

Almost all of our contracts contain termination clauses that permit contract termination upon our default or for the convenience of the other contracting party. In either case, terminations could adversely affect our operating results. Under contracts terminable at the convenience of the United States Government, a contractor is generally entitled to receive payments for its allowable costs and, in general, the proportionate share of fees or earnings for the work done. Contracts that are terminable for default generally provide that the United States Government only pays for the work it has accepted and may require the contractor to pay for the incremental cost of reprocurement and may hold the contractor liable for damages.

Marketing

Our primary marketing efforts consist of personal contact between our technical personnel and technical representatives of existing and potential customers. We involve all technically qualified staff members in our marketing program. We believe that it is extremely important to have technically knowledgeable staff make marketing contacts since an initial system concept is often developed during the first marketing contact.

In addition to our primary technical marketing, we also conduct marketing activities designed to increase our visibility with existing and potential customers. Each year we conduct equipment shows in the Washington, D.C. area, demonstrating the operation of many of our products. Additionally, we use direct mail and magazine advertising from time to time to inform potential customers of available products. We also produce a product summary catalog.

Backlog

Our backlog, which consists of anticipated revenues from the uncompleted portions of existing contracts, was $140,193,000, $143,369,000, and $87,074,000, at October 31, 2005, 2004, and 2003, respectively. Anticipated revenues included in backlog may be realized over a multi-year

period and include contracts that are fully funded as well as contracts that are only partially funded. We include a contract in backlog when the contract is signed by us and by our customer. We believe the backlog figures are firm, subject only to the cancellation and modification provisions contained in our contracts. (See Item 7: "Management's Discussion and Analysis of Financial Condition and Results of Operations—Backlog.") Because of possible future changes in delivery schedules and cancellations of orders, backlog at any particular date is not necessarily representative of actual sales to be expected for any succeeding period, and actual sales for the year may not meet or exceed the backlog represented. We may experience significant contract cancellations that were previously booked and included in backlog.

Research and Development

We conduct R&D pursuant to United States Government R&D contracts and as part of our own R&D investment. We believe that our investment in R&D provides us with a significant competitive advantage. Research and development expenses incurred by us were approximately $16,125,000, $14,160,000, and $7,526,000 in fiscal years 2005, 2004, and 2003, respectively. As a percent of revenue, R&D equated to 10.3%, 9.9%, and 7.9% in fiscal years 2005, 2004, and 2003 respectively.

In fiscal years 2005, 2004 and 2003, our R&D program was funded entirely by the billing rates charged to our customers.

We seek to develop technology capable of addressing new global security signal processing requirements before our competitors. In addition, we focus R&D on developing products and services that can be used, with or without further modification, to satisfy various needs of a variety of customers, thereby permitting us to offer a prompt solution.

Company Technical Operations

The technical operations of AST consists of a Communications Systems Group, a Sensor Signal Processing Group, an Electronic Systems Division, and an Operations Division. All of these organizations report to our Chief Operating Officer. Because of the integral technologies and operations of our groups and divisions to date, we have determined that AST has only one corporate-wide reporting entity.

The Communications Systems Group provides our COMINT products and services, and research and development for COMINT collection and processing solutions. Within the Communications Systems Group are two engineering divisions, the Wireless Communications Systems Division and the Multichannel Systems Division.

The Sensor Signal Processing Group provides advanced sensor signal processing solutions for advanced space-based, airborne, terrestrial, and undersea sensor technologies. Within the Sensor Signal Processing Group are two engineering divisions, the Ocean Systems Division and the National Security Systems Division.

The Electronic Systems Division, an engineering division, provides research and development for solutions to ELINT requirements.

The Operations Division is primarily responsible for manufacturing multiple units of products for our divisions and groups.

The engineering and operations organizations work together to ensure that production-related issues, such as reliability, maintenance, and the ability to manufacture, are addressed from initial product definition through the final product shipment.

As of December 16, 2005, there were 454 employees in the engineering organizations and 71 employees in the Operations Division. (See "Employees" on page 13.)

Engineering

The engineering organizations are responsible for all of our R&D activities. Our R&D activities include both United States Government development contracts and our own R&D projects. The R&D activities of the engineering organizations are directed toward developing products that will ultimately be produced by the Operations Division, and solutions that will be sold as software licenses or open architecture equipment. The engineering organizations work in conjunction with the Operations Division to assure that the product development efforts will culminate in a product that can be manufactured efficiently in quantity.

Operations

The Operations Division is responsible for manufacturing multiple units of products. By combining engineering and production expertise within the Operations Division, we are able to maximize manufacturing efficiency and, therefore, reduce overall production costs. The Operations Division uses batch production methods to manufacture products. The division's extensive cross-training of personnel enables workers to participate in the manufacturing of all products, which helps to achieve labor efficiency. The division is also responsible for managing purchases of goods and services, including third-party manufacturing and assembly services.

Competition

The global security market is highly competitive and we expect that competition will continue to increase in the future. Some of our current and potential competitors have significantly greater technical, manufacturing, financial, and marketing resources than we do. Our current competitors include L-3 Communications, BAE Systems, Boeing, Raytheon Corporation, General Dynamics, Harris Corporation, Lockheed Martin, Northrop Grumman, Argon ST, Digital Receiver Technology, EDO Corporation, QinetiQ, and Sierra Nevada Corporation. Substantial competition could impose pricing pressure on sales of our products, develop and introduce new products meeting market demand more quickly than we can, and result in lower revenue and decreased sales, which would have a materially adverse effect on our financial condition and operating results.

The competition for competitive-bid contracts differs from the competition for sole-source contracts. Companies competing for competitive-bid contracts prepare bids and proposals in response to either commercial or government requests and typically compete on price. Potential suppliers compete informally for sole-source contracts through R&D investment and marketing efforts. Companies competing for sole-source contracts attempt to identify the customer’s requirements early and invest in solutions so that they can demonstrate a distinguishing expertise or technology promptly after the customer has identified a signal processing requirement. The principal factors of competition for sole-source contracts include investments in R&D; the ability to respond promptly to government needs; and product price relative to performance, quality, and customer support. We believe that we compete favorably on each of these factors.

Proprietary Rights

The United States Government has rights to most of the technology that we have developed under government contracts, including rights to permit other companies, including our competitors, to use this technology to develop products for the United States Government. To our knowledge, the United States Government has not exercised these rights related to our products.

As of October 31, 2005, we had four issued patents. We believe that, given the rapidly changing nature of signal collection and processing technology, our future success will depend primarily upon the technical competence and creative skills of our personnel, rather than the legal protection afforded by patents. We attempt to protect our trade secrets and other proprietary information through agreements with customers, employees, and consultants, and through other security measures. To the extent we wish to assert our patent rights, we cannot be sure that any claims of our patents will be sufficiently broad to protect our technology. In addition, there can be no assurance that any patents issued to us will not be challenged, invalidated, or circumvented; that any rights granted under these patents will provide us adequate protection; or that there will be sufficient resources to protect and enforce our rights. In addition, the laws of some foreign countries may not protect our proprietary rights to the same extent as do the laws of the United States. Although we do not believe that we are infringing upon the intellectual property rights of others, it is possible that such a claim will be asserted against us in the future. In the event any third party makes a claim against us for infringement of patents or other intellectual property rights of a third party, such claims, with or without merit, could be time-consuming and result in costly litigation. In addition, we could experience loss or cancellation of customer orders, product shipment delays, or could subject us to significant liabilities to third parties. If our products were found to infringe on a third party’s proprietary rights, we could be required to enter into royalty or licensing agreements to continue selling our products. Royalty or licensing agreements, if required, may not be available under acceptable terms or at all, which could seriously harm our business. Our involvement in any patent dispute or other intellectual property dispute or action to protect trade secrets and expertise could have a materially adverse effect on our business.

Government Regulations

Many of our operations are subject to compliance with regulatory requirements of federal, state, and municipal authorities, including regulations concerning employment obligations and affirmative action, workplace safety, and protection of the environment. Most importantly, we must comply with detailed government procurement and contracting regulations and with United States Government security regulations, certain of which carry substantial penalties for noncompliance or misrepresentation in the course of negotiations. Failure to comply with our government procurement or contracting obligations or security obligations could result in penalties imposed against us or suspension from government contracting, which would prevent us from selling our products to the United States Government, severely limiting our ability to operate our business and generate revenue, resulting in a materially adverse effect on our financial condition and operating results. (See Item 1: “Business—Customers, Contracts, and Marketing” on page 6 .)

While compliance with applicable regulations has not adversely affected our operations in the past, we cannot be sure that we will continue to be in compliance in the future or that these regulations will not change, resulting in increased operational costs.

Employees

As of December 16, 2005**,** we had 677 employees. Our business requires that a large number of our technical employees obtain security clearances from the United States Government, which limits the available pool of eligible candidates for such positions to those who can satisfy the prerequisites to obtaining these clearances. In particular, the personnel involved in marketing require the appropriate clearances to meet with government technical representatives and discuss the government’s needs. We have a United States Government-sanctioned security program

that allows staff members to obtain appropriate clearances. Approximately 70% of our staff has security clearances. Our success is dependent on attracting, retaining, and motivating qualified key management and technical personnel, the loss of whom could adversely affect our business materially. We believe we maintain a good relationship with our employees.

Item 1A: Risk Factors

Our future performance is subject to a variety of risks. If any of the following risks actually occurs, our business could be harmed and the trading price of our common stock could decline. In addition to the following disclosures, please refer to the other information contained in this report, including consolidated financial statements and the related notes.

We are subject to a number of special risks as a result of our acquisition of Dynamics Technology, Inc. On July 1, 2005, we acquired DTI for approximately $30.1 million, plus estimated transaction costs. Our future results of operations will be substantially influenced by the operations of the new business unit, and as a result of the acquisition, we will be subject to a number of risks and uncertainties, including the following:

- We continue to integrate the technologies and operations of DTI, and if we do not complete this integration in a timely and efficient manner, management resources could be diverted and our business and operating results could suffer. We are a larger, more geographically dispersed and complex organization, and if our management is unable to effectively manage the combined company, our operating results will suffer.
- As a result of the acquisition, we are entering markets in which AST has no or limited prior experience. We may not be successful in these markets, and we may be unable to retain all existing, or enter into new, contracts for DTI's business lines. In addition, we may not achieve the strategic objectives and other anticipated potential benefits of the acquisition. Our failure to achieve these strategic objectives could have a material, adverse effect on our revenues, expenses, and operating results.
- Transaction costs associated with the acquisition have been included as part of the total purchase cost for accounting purposes. In addition, we may incur charges to operations in amounts that are not currently estimable, in the quarters following the acquisition, to reflect costs associated with integrating the two companies, and we will continue to record additional operating expenses associated with the amortization of other intangible assets acquired in the acquisition. These costs could adversely affect our future liquidity and operating results.
- Both companies had as their largest customer the U.S. Government. The contracts entered into by both companies with the U.S. Government are terminable by the U.S. Government. It is still too early to determine whether the U.S. Government will maintain existing, or enter into new contracts with the combined company. It is possible that, as a result of the acquisition, our customers may delay or defer contracting decisions, which could have a material, adverse effect on our business.
- As a result of the acquisition, we incurred debt in the amount of $10 million, and our failure to repay this debt when due would materially, adversely affect our financial condition and results of operations.
- The acquisition will increase the cost and complexity of complying with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 with regard to the evaluation and attestation of our internal control systems.
- We may also be assuming unknown liabilities; risk the incurrence of expenses related to the future impairment of goodwill; or the incurrence of other large write-offs immediately or in the future.

We may not achieve the anticipated benefits of our investments in new business opportunities and any such investments could have a negative, material impact on our operating results and financial condition. We have formed the Electronic Systems Division in order to expand our historical COMINT business into ELINT. This diversification requires us to invest additional capital, open new facilities, and incur additional R&D expenditures. In addition, diversification results in diversion of management's attention from our core business. Although we believe that entering into these new business areas will be important to remaining competitive in the defense electronics marketplace, there can be no assurance that we will derive benefits from this diversification and we could incur significant unanticipated costs, which could have a material impact on our results of operations.

Any decrease in expected product sales during a period could adversely impact our revenues, results of operations, and financial condition. From time to time, we have derived a significant portion of our revenue from product sales. In recent periods, however, we have been focusing on sales of systems and software, and targeting larger programs. In addition, we have experienced some seasonality in product sales to the U.S. Government, with more product sales occurring in the second half of the fiscal year than the first. The amount and timing of Government purchases of products is unpredictable, and fluctuates significantly from period to period, making it difficult for us to predict the amount of revenue we will generate from product sales in any particular period, and causing our revenues to fluctuate from period to period. If we are not able to generate revenues from product sales as expected in a particular period, we may fail to meet our revenue expectations and the expectations of industry analysts and investors, which could cause our stock price to decline.

If we are unable to recruit, train, and retain key personnel with required security clearances, our ability to develop, introduce, and sell our products may be adversely impacted. Our ability to execute our business plan is contingent upon successfully attracting and retaining qualified employees who obtain, or are able to obtain, necessary government security clearances. If we fail to attract and retain qualified employees who can obtain the necessary security clearances, our business could be significantly harmed. The loss of the services of any of our qualified employees, the inability to attract or retain qualified personnel in the future, or delays in hiring required personnel could negatively impact our

ability to develop, introduce, and sell our products. In addition, employees may leave us and subsequently compete against us.

Many of the personnel we hire will need U.S. Government security clearances in order to perform tasks required on our government contracts. We have found that there is a shortage of qualified personnel possessing the necessary clearances, and new security clearances are taking longer to be granted. If we are not able to obtain security clearances for our personnel where required, they will be unable to perform tasks requiring clearances, and we may be unable to satisfy the terms of our contracts, resulting in customer dissatisfaction and possible loss of current or future contracts.

Stop-work orders could negatively impact our operating results and financial condition. Almost all of our contracts contain stop-work clauses that permit the other contracting party, at any time, by written order, to stop work on all or any part of the work called for by the contract for a period of ninety days. Within the ninety-day period, the other contracting party may cancel the stop-work order and resume work or terminate all or part of the work covered by the stop-work order.

For example, during June 2004, we received a stop-work order instructing us to stop work on a portion of our largest single contract. In accordance with the instructions received from the other contracting party, we prepared a proposal that detailed the tasks that were stopped and estimated the reduction in contract costs. Final negotiations were completed during the fourth quarter of 2005. New orders and backlog were reduced by approximately $12 million. As a result of the stop-work order, we estimate that our opportunity to generate revenues from this contract was reduced by approximately $3 to $4 million in fiscal year 2004, by approximately $6 to $7 million in fiscal year 2005, and the balance in fiscal year 2006. There can be no assurance that stop-work orders will not be received in future periods.

Any reduction in government spending on global security could materially adversely impact our revenues, results of operations, and financial condition. Historically, defense and intelligence agencies of the United States Government have accounted for almost all of our revenues. There are risks associated with programs that are subject to appropriation by Congress, which could be potential targets for reductions in funding to pay for other programs. Future reductions in United States Government spending on global security or future changes in the kind of products or services required by the United States Government agencies could limit demand for our products and services, which would have a materially adverse effect on our operating results and financial condition.

In the event there are shifts in responsibilities and functions within the defense and intelligence communities, it could result in a reduction of orders for global security by the defense and intelligence agencies that have historically been our major customers. Our relationships with other Government agencies to whom responsibilities and functions for our contracts have been shifted may not be as strong as our relationships with current customer agencies. Accordingly, a reduction in contracts from our customer agencies may not be offset by contracts from other United States Government agencies. Even if other agencies increase spending for global security, we may not secure the same amount of work from these agencies. As a result, demand for our products and services could decline, resulting in a decrease in revenues, and could adversely affect our operating results and financial condition materially.

If we are unable to comply with complex government regulations governing security and contracting practices, we could be disqualified as a supplier to the United States Government. As a supplier to United States Government defense and intelligence agencies, we must comply with numerous regulations, including those governing security and contracting practices. Failure to comply with these procurement regulations and practices could result in fines being imposed against us or our suspension for a period of time from eligibility for bidding on, or for award of, new government contracts. If we are disqualified as a supplier to government agencies, we will lose most, if not all, of our customers, revenues from sales of our products would decline significantly, and our ability to continue operations would be seriously jeopardized. Among the causes for disqualification are violations of various statutes, including those related to procurement integrity, export control, U.S. Government security regulations, employment practices, protection of the environment, accuracy of records in the recording of costs, and foreign corruption. The government may investigate and make inquiries of our business practices and conduct audits of contract performance and cost accounting. Depending on the results of these audits and investigations, the government may make claims against us, and if it prevails, certain incurred costs would not be recoverable.

We depend on revenues from a few significant contracts, and any loss, cancellation, reduction, or delay in these contracts could harm our business. From time to time, including recent periods, we have derived a material portion of our revenue from one or more individual contracts that could be terminated by the customer at the customer's discretion. We expect that in future periods we may again enter into individual contracts with significant revenue concentrations. If such contracts were terminated or substantially reduced, revenues and net income could significantly decline, and we have in the past experienced a significant reduction on one of our contracts.

U.S. Government contracts are generally not fully funded at inception and funding may be terminated or reduced at any time. We act as a prime contractor or subcontractor for many different U.S. Government programs. Department of Defense and intelligence contracts typically involve long lead times for design and development and are subject to significant changes in contract scheduling. Congress generally appropriates funds on a fiscal year basis even though a program may continue for several years. Consequently, programs are often only partially funded initially, and additional funds are committed only as Congress makes further appropriations. The termination or reduction of funding for a government program would result in a loss of anticipated future revenues attributable to that program.

Many of our government contracts span one or more base years with multiple option terms. Government agencies generally have the right not to exercise these option terms. If an option term on a contract is not exercised, we will not be able to recognize the full value of the contract awarded. Our backlog as of October 31, 2005 was approximately $140.2 million. We exclude from backlog unexercised options on contracts. Our backlog includes orders under awards that in some cases extend several years. The actual receipt of revenues on awards included in backlog may never occur or may change because a program schedule could change or the program could be canceled, or a contract could be reduced, modified, or terminated early.

Our business depends upon our relationships with, and the performance of, our prime contractors. We expect to continue to depend on relationships with other contractors for a substantial portion of our revenues in the foreseeable future. Our business, prospects, financial condition, or operating results could be adversely affected if other contractors eliminate or reduce their subcontracts or relationships with us, either because they choose to establish relationships with our competitors or because they choose to directly offer services that compete with our business, or if the Government terminates or reduces these other contractors' programs or does not award them new contracts.

In addition, on those contracts for which we are not the prime contractor, the U.S. Government could terminate a prime contract under which we are subcontractor, irrespective of the quality of our performance as a subcontractor. A prime contractor's performance deficiencies could adversely affect our status as a subcontractor on the program, jeopardize our ability to collect award or incentive fees, cause customers to delay payments, and result in contract terminations.

We depend on revenues from a few significant customers, the loss of any significant customer could have an adverse effect on our business. Our success will depend on our continued ability to develop and manage relationships with significant customers. The markets in which we sell our products are dominated by a relatively small number of governmental agencies and allies of the United States Government, thereby limiting the number of potential customers. Our dependence on large orders from a relatively small number of customers makes our relationship with each customer critical to our business. We cannot be sure that we will be able to retain our largest customers, that we will be able to attract additional customers, or that our customers will continue to buy our products and services in the same amounts as in prior years. The loss of one or more of our largest customers, any reduction or delay in sales to these customers, our inability to successfully develop relationships with additional customers, or future price concessions that we may have to make could significantly harm our business.

Continued competition in global security may lead to a reduction in our revenues and market share. The global security market is highly competitive and we expect that competition will continue to increase in the future. Our current competitors have significantly greater technical, manufacturing, financial, and marketing resources than we do. We expect that more companies will enter the market for global security, possibly resulting in pricing pressures on our products and services. We may not be able to compete successfully against either current or future competitors. Increased competition could result in reduced revenue, lower margins, or loss of market share, any of which could significantly harm our business. Our competitors may introduce improved products with lower prices, and we will have to do the same to remain competitive.

Unexpected increases in the cost to develop or manufacture our products under fixed-price contracts may cause us to experience unreimbursed cost overruns. A significant portion of our revenue is derived from fixed-price contracts. Under fixed-price contracts, unexpected increases in the cost to develop or manufacture a product, whether due to inaccurate estimates in the bidding process, unanticipated increases in materials costs, inefficiencies, or other factors, are borne by us. We have experienced cost overruns in the past that have resulted in losses on certain contracts, and may experience additional cost overruns in the future. Such cost overruns would increase our operating expenses, reduce our net income and earnings per share, and could have a material adverse effect on our future results of operations and financial condition.

Unexpected contract terminations could negatively impact our operating results and financial condition. Almost all of our contracts contain termination clauses that permit contract termination upon our default or for the convenience of the other contracting party. In either case, termination could adversely affect our operating results and financial condition. There were no such notifications in fiscal years 2005 or 2004.

Our future revenues are inherently unpredictable, our operating results are likely to fluctuate from period to period, and if we fail to meet the expectations of securities analysts or investors, our stock price could decline significantly. Our quarterly and annual operating results have fluctuated in the past and are likely to fluctuate significantly in the future due to a variety of factors, some of which are outside our control. Accordingly, we believe that period-to-period comparisons of our results of operations are not meaningful and should not be relied upon as indications of future performance. Some of the factors that could cause our quarterly or annual operating results to fluctuate include conditions inherent in government contracting and our business such as the timing of cost and expense recognition for contracts, the United States Government contracting and budget cycles, and contract closeouts. Because we base our operating expenses on anticipated revenue trends and a high percentage of our expenses are fixed in the short term, any delay in generating or recognizing forecasted revenues could significantly harm our business. Fluctuations in quarterly results, competition, or announcements of extraordinary events such as acquisitions or litigation may cause earnings to fall below the expectations of securities analysts and investors. In this event, the trading price of our common stock could significantly decline. In addition, there can be no assurance that an active trading market will be sustained for our common stock. The stock market in recent years has experienced extreme price and volume fluctuations that have particularly affected the market prices of many technology companies. These fluctuations, as well as general economic and market conditions, may adversely affect the future market price of our common stock.

Our market is subject to rapid technological change, and to compete effectively, we must continually introduce new signal processing solutions and create contractual obligations that achieve market acceptance. The market for our products is characterized by rapidly changing technology, frequent new product introductions, changes in customer requirements, and evolving industry standards. We believe that we have been successful to date in identifying certain global security needs early, investing in research and development to meet these needs, and delivering products before our competitors. We believe that our future success will depend upon continued development and timely introduction of products capable of satisfying emerging global security needs. However, we expect that new requirements will continue to emerge. Our future performance will depend on the successful development, introduction, and market acceptance of new and enhanced products that address these new requirements. The introduction of new and enhanced products may cause our customers to defer or cancel orders for existing products. There can be no assurance that we will be able to develop and market new products successfully in the future or respond effectively to new requirements, or that new products introduced by others will not render our products or technologies noncompetitive or obsolete.

We also may not be able to develop the underlying core technologies necessary to create new products and enhancements or to license these technologies from third parties. Product development delays may result from numerous factors, including:

- Changing product specifications and customer requirements
- Difficulties in hiring and retaining necessary technical personnel
- Difficulties in reallocating engineering resources and overcoming resource limitations
- Difficulties with contract manufacturers
- Changing market or competitive product requirements
- Unanticipated engineering complexities

The development of new, technologically advanced products is a complex and uncertain process requiring high levels of innovation and highly skilled engineering and development personnel, as well as the accurate anticipation of technological and market trends. We cannot ensure that we will be able to identify, develop, manufacture, market, or support new or enhanced products successfully, or on a timely basis, if at all. Further, we cannot ensure that our new products will gain market acceptance or that we will be able to respond effectively to product announcements by competitors, technological changes, or emerging industry standards. Any failure to respond to technological change would significantly harm our business.

Our results of operations could be negatively impacted if we are required to write off inventory deemed not saleable or usable. Some of our products or raw materials may become obsolete or unusable while in inventory. This could be due to changing customer specifications, decreases in demand for existing products, or changes in government spending on signal intelligence. Work in process deemed not saleable is written off to contract costs in our Statement of Operations, while unusable raw materials are written off to general and administrative expenses.

We may lose sales if our suppliers fail to meet our needs. Although we procure most of our parts and components from multiple sources or believe that these components are readily available from numerous sources, certain components are available only from sole sources or from a limited number of sources. While we believe that substitute components or assemblies could be obtained, use of substitutes would require development of new suppliers or would require us to re-engineer our products, or both, which could delay shipment of our products and could have a materially adverse effect on our operating results and financial condition.

Our headquarters and most of our operations are located in California where natural disasters may occur, resulting in disruption to our business. Our corporate headquarters, including most of our research and development operations and production facilities, are located in the Silicon Valley area of Northern California, a region known for being vulnerable to natural disasters and other risks, such as earthquakes, fires, and floods, which at times have disrupted the local economy and posed physical risks to our property. A significant earthquake could materially affect operating results. We are not insured for most losses and business interruptions of this kind, and do not presently have redundant, multiple site capacity in the event of a natural disaster. In the event of such disaster, our business would suffer.

Delays in the receipt of contracts could negatively impact our business. During our history, the receipt of certain final contracts has periodically been delayed to periods later than originally expected. While we work closely with our customers to try to capture what we believe to be sole-source orders, delays in the receipt of such orders could result in revenues falling short of estimates. On some of these contracts, we will make expenditures in advance of receipt of the final contract in anticipation of meeting the expected timetables, and will from time to time hire personnel in anticipation of receipt of the contract. If the contract is delayed, these costs are not covered. In addition, gross margins and net income will decrease if we elect to hold our cost structure in place while awaiting the award of delayed contracts.

Our failure to protect our intellectual property may significantly harm our business. Our success and ability to compete is dependent in part on our proprietary technology. We rely on a combination of patent, copyright, trademark, and trade secret laws, as well as confidentiality agreements to establish and protect our proprietary rights. We license certain of our proprietary technology to customers, and we rely largely on provisions of our licensing agreements to protect our intellectual property rights in this technology. To date, we have relied primarily on proprietary processes and know-how to protect our intellectual property. Although we have filed applications for several patents, four of which we currently hold, we cannot ensure that any patents will be issued as a result of pending patent applications or that our issued patents will be upheld. Any infringement of our proprietary rights could result in significant litigation costs, and any failure to adequately protect our

proprietary rights could result in our competitors offering similar products, potentially resulting in loss of a competitive advantage and decreased revenues. Despite our efforts to protect our proprietary rights, existing patent, copyright, trademark, and trade secret laws afford only limited protection. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as do the laws of the United States. Attempts may be made to copy or reverse engineer aspects of our products or to obtain and use information that we regard as proprietary. Accordingly, we may not be able to prevent misappropriation of our technology or deter others from developing similar technology. Furthermore, policing the unauthorized use of our products is difficult. Litigation may be necessary in the future to enforce our intellectual property rights or to determine the validity and scope of the proprietary rights of others. This litigation could result in substantial costs and diversion of resources, and could significantly harm our business.

Claims that we infringe third-party intellectual property rights could result in significant expenses or restrictions on our ability to sell our products. It is possible that from time to time, other parties may assert patent, copyright, trademark, and other intellectual property rights to technologies and in various jurisdictions that are important to our business. Any claims asserting that our products infringe or may infringe proprietary rights of third parties, if determined adverse to us, could significantly harm our business. Any claims, with or without merit, could result in costly litigation, divert the efforts of our technical and management personnel, cause product shipment delays, or require us to enter into royalty or licensing agreements, any of which could significantly harm our business. Royalty or licensing agreements, if required, may not be available on terms acceptable to us, if at all. In addition, our agreements with our customers typically require us to indemnify our customers from any expense or liability resulting from claimed infringement of third-party intellectual property rights. In the event a claim against us was successful and we could not obtain a license to the relevant technology on acceptable terms, license a substitute technology, or redesign our products to avoid infringement, our business would be significantly harmed.

Continued compliance with new regulatory and accounting requirements will be challenging and is likely to cause our general and administrative expenses to increase and impact our future financial position and results of operations. As a result of compliance with the Sarbanes-Oxley Act of 2002, as well as changes to listing standards adopted by the Nasdaq Stock Market, and the attestation and accounting changes required by the Securities and Exchange Commission, we are required to implement additional internal controls, to improve our existing internal controls, and to comprehensively document and test our internal controls. As a result, we are required to hire additional personnel and to obtain additional outside legal, accounting and advisory services, all of which will cause our general and administrative costs to increase. Changes in the accounting rules, including legislative and other requirements to account for employee stock options as a compensation expense among others, are expected to materially increase the expenses that we report under generally accepted accounting principles, which may adversely affect our operating results.

Changes in stock option accounting rules are expected to adversely impact our operating results prepared in accordance with generally accepted accounting principles. We have historically used broad-based employee stock option programs to hire, incentivize and retain our workforce in a competitive marketplace. Statement of Financial Accounting Standards No. 123, “Accounting for Stock-Based Compensation” (“SFAS 123”), allows companies the choice of either using a fair value method of accounting for options, which would result in expense recognition for all options, or using an intrinsic value method, as prescribed by Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees” (“APB 25”), with a pro forma disclosure of the impact on net income (loss) of using the fair value option expense recognition method. Historically, we elected to apply APB 25 and the disclosure provisions of SFAS 123 and accordingly we did not recognize any expense with respect to employee stock options for periods up to and including October 31, 2005 as long as such options were granted at exercise prices equal to the fair value of our common stock on the date of grant.

In December 2004, the Financial Accounting Standards Board issued Statement 123(R), “Share-Based Payment,” which requires all companies to measure compensation cost for all share-based payments, including employee stock options, at fair value. The SEC has issued rules which allow companies to implement Statement 123(R) at the beginning of the annual reporting period that begins after June 15, 2005. Consistent with the new rule, we will be required to adopt Statement 123(R) in the first quarter of our 2006 fiscal year, and will implement the new standard on a prospective basis. We are continuing to evaluate the effect that the adoption of Statement 123(R) will have on our financial position and results of operations, we expect that our adoption of this standard will adversely affect our operating results in future periods. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Recent Accounting Pronouncements” below.

Item 1B: Unresolved Staff Comments

None.

Item 2: Properties

Our corporate offices, located in Sunnyvale, California, also serve as our primary research and development, engineering, production, marketing, and administrative center. As of October 31, 2005, we leased five buildings totaling approximately 266,077 square feet under a lease that expires in March 2012.

In addition, we maintain eight offices within the United States. We lease the following properties: 29,121 square feet in Annapolis Junction, Maryland (lease expires May 2009); 15,250 square feet in Herndon, Virginia (lease expires March 2011); 10,962 square feet in Hillsboro, Oregon (lease expires October 2009); 27,345 square feet in Salt Lake City, Utah (lease expires October 2009); 32,000 square feet in Allen, Texas (lease expires February 2011); 19,383 square feet in Torrance, California (lease expires February 2008); 2,008 square feet in Torrance, California (lease expires October 2007); 4,328 square feet in Anaheim, California (lease expires April 2009); and 14,090 square feet in Arlington, Virginia (lease expires June 2013).

Our business requires that we maintain a facility clearance, sponsored and approved by the United States Government, at most of our offices. This approval could be suspended or revoked if we are found not to have complied with security regulations applicable to such facilities. Any revocation or suspension of such approval that materially delayed delivery of our products to customers would have a material adverse impact on our ability to manufacture and sell our products and operate our business. Although we have adopted policies directed at assuring our compliance with relevant regulations, there can be no assurance that the approved status of our facilities will continue without interruption.

Item 3: Legal Proceedings

We are subject to litigation, from time to time, in the ordinary course of business including, but not limited to, allegations of wrongful termination or discrimination or governmental agency investigations. As a government contractor, we may also be subject to investigations by the United States Government for alleged violations of procurement or other federal laws. Under present government procurement regulations, if judged in violation of procurement or other federal civil laws, we could be suspended or barred from eligibility for awards of new government contracts.

On March 11 and July 19, 2005, purported securities class action complaints were filed in the United States District Court, Northern District of California. The cases have been consolidated as *In regards to Applied Signal Technology, Inc. Securities Litigation*, Master File No. 4:05-cv-1027 (SBA) (N.D. Cal.). The consolidated complaint is brought on behalf of a putative class of persons who purchased our securities during a class period of August 24, 2004 through February 22, 2005. The complaint names us, our Chief Executive Officer, and our Chief Financial Officer as defendants, and alleges that false and misleading statements regarding us were issued during the class period. We believe that there are meritorious defenses against this litigation and intend to vigorously defend it. However, due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the litigation. Any unfavorable outcome of the litigation could have an adverse impact on our business, financial condition, and results of operations.

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

There were no matters submitted to a vote of security holders during the fourth quarter of the fiscal year.

Part II

Item 5: Market for Registrant's Common Equity, Related Shareholder Matters, and Issuer Purchases of Equity Securities

Selected Common Stock Data

Our common stock trades on the NASDAQ National Market under the symbol "APSG." As of October 31, 2005**,** the closing price of our common stock, as reported on NASDAQ, was $17.87, and we had approximately 307 registered shareholders of record with our transfer agent. The following table sets forth the high and low closing prices for our common stock over the eight quarters ending October 31, 2005.

Closing Prices, as reported on NASDAQ	High	Low
Fiscal Year ended October 31, 2004		
First quarter	$28.39	$20.07
Second quarter	$29.28	$25.00
Third quarter	$35.73	$24.30
Fourth quarter	$37.64	$28.40

Fiscal Year ended October 31, 2005		
First quarter	$38.89	$27.42
Second quarter	$30.35	$19.51
Third quarter	$21.75	$16.50
Fourth quarter	$21.25	$17.16

In November 2004, the Board of Directors approved the continuation of the dividend at the rate of $0.50 per share per annum, payable quarterly. Dividends were paid on February 11, 2005, May 13, 2005, August 12, 2005, and November 11, 2005 to shareholders of record at January 28, 2005, April 29, 2005, July 29, 2005, and October 31, 2005.

In November 2005, the Board of Directors approved the continuation of the dividend at the rate of $0.50 per share per annum, payable quarterly. Dividends are expected to be paid on February 10, 2006, May 12, 2006, August 11, 2006, and November 10, 2006 to shareholders of record at January 27, 2006, April 28, 2006, July 28, 2006, and October 31, 2006.

The continued payment of dividends and the amount thereof in the future will depend on a number of factors, including our financial condition, capital requirements, results of operations, future business prospects, and other factors that our Board of Directors may deem relevant.

We did not repurchase any of our equity securities during the fourth quarter of fiscal year 2005 nor issue any securities that were not registered under the Securities Act of 1933.

Equity Compensation Plan Information

The equity compensation plan information required to be provided in this Annual Report on Form 10-K is incorporated by reference to our proxy statement for the 2005 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year ended October 31, 2005.

Item 6: Selected Financial Data

(In thousands, except per share data)

Summary of Operations:	**Year Ended October 31, 2005**				
	2005	**2004**	**2003**	**2002**	**2001**
Revenues from contracts	$156,061	$142,836	$95,384	$76,184	$73,489
Operating expenses:					
Contract costs	102,938	94,705	63,335	49,067	52,199
Research and development	16,125	14,160	7,526	8,798	17,122
General and administrative	22,167	16,601	15,337	15,160	20,451
Restructuring costs	—	—	—	—	2,689
Total operating expenses	141,230	125,466	86,198	73,025	92,461
Operating income (loss)	14,831	17,370	9,186	3,159	(18,972)

Interest income (expense), net	648 ------------	576 ------------	510 ------------	34 ------------	435 ------------	
Income (loss) before provision for income taxes	15,479	17,946	9,696	3,193	(18,537)	
Provision (benefit) for income taxes	6,235 ------------	2,408,957				1,781,809

Total operating expenses		1,208,343		1,122,172		2,408,957		1
Operating income		279,510		70,085		651,923		8
Other expense:								
Interest expense		371,992		52,682		714,557		9
Cost of warrant extension		-		842,100		-		8
Loss from change in fair value of warrant liability		-		75,356		-		2
Loss from change in fair value of conversion option liability		-		89,569		-		4
Total other expense		371,992		1,059,707		714,557		1
Loss before income taxes		(92,482)		(989,622)		(62,634)		(
Income tax expense		-		-		-		-
Net loss	$	(92,482)	$	(989,622)	$	(62,634)	$	(

Net loss per share - basic	$	(0.015	)	$	(0.100	)	$	(0.010	)	$	(
Net loss per share - diluted	$	(0.015	)	$	(0.100	)	$	(0.010	)	$	(
Weighted average shares outstanding - basic		6,342,288			5,873,801			6,284,658			5
Weighted average shares outstanding - diluted		6,342,288			5,873,801			6,284,658			5

See notes to these unaudited condensed consolidated financial statements.

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Innovative Food Holdings, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(UNAUDITED)

	For the Six Months Ended June 30, 2013	For the Six Months Ended June 30, 2012
Cash flows from operating activities:		
Net loss	$ (62,634)	$ (1,594,259)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Increase in allowance for doubtful accounts	125,951	-
Depreciation and amortization	127,686	14,584
Non-cash compensation	35,662	-
Amortization of discount on notes payable	637,665	1,308
Amortization of discount on accrued interest	-	43,863
Value of shares issued in settlement	-	7,302
Value of options issued to officer and directors	-	186,299
Value of extension of term of warrants	-	842,100
Change in fair value of warrant liability	-	269,177
Change in fair value of option liability	-	71,351
Change in fair value of conversion option liability	-	468,004
Changes in assets and liabilities:		
Accounts receivable, net	(239,611)	(103,078)
Inventory and other current assets, net	(175,804)	(76,070)
Accounts payable and accrued expenses - related party	(263,215)	(76,594)
Accounts payable and accrued expenses	(15,976)	(81,190)
Net cash provided by (used in) operating activities	169,724	(27,203)
Cash flows from investing activities:		
Payment to acquire Artisan Specialty Foods, net	-	(1,176,605)
Acquisition of property and equipment	(309,676)	(29,717)
Net cash used in investing activities	(309,676)	(1,206,322)
Cash flows from financing activities:		
Proceeds from issuance of notes payable	-	1,080,000
Principal payments on debt	(230,998)	(20,284)
Principal payments on notes payable - related parties	(5,640)	-
Net cash provided by financing activities	(236,638)	1,059,716
(Decrease) in cash and cash equivalents	(376,590)	(173,809)
Cash and cash equivalents at beginning of period	1,347,029	862,464
Cash and cash equivalents at end of period	$ 970,439	$ 688,655
Supplemental disclosure of cash flow information:		

Cash paid during the period for:				
Interest	$	27,941	$	33,118
Taxes	$	-	$	-
Non-cash transactions:				
Issuance of 279,310 shares of common stock previously subscribed	$	75,638	$	-
Issuance of 341,794 shares of common stock for conversion of notes payable and accrued interest	$	85,448	$	-
Mortgage and purchase of land and building	$	546,000	$	-

See notes to these unaudited condensed consolidated financial statements.

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INNOVATIVE FOOD HOLDINGS, INC.
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2013(Unaudited)

1. BASIS OF PRESENTATION

Basis of Presentation

The accompanying unaudited interim condensed consolidated financial statements of Innovative Food Holdings, Inc., and its wholly owned subsidiaries, Artisan Specialty Foods, Inc. ("Artisan"), Food Innovations, Inc. ("FII"), Food New Media Group, Inc. ("FNM"), Gourmet Foodservice Group, Inc. ("GFG"), and 4 The Gourmet, Inc (d/b/a For The Gourmet, Inc.) ("Gourmet" (collectively, the "Company, or "IVFH"), have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. FNM currently holds the Company's intellectual property rights related to its private label brand. All material intercompany transactions have been eliminated upon consolidation of these entities.

The accompanying unaudited interim condensed consolidated financial statements have been prepared by the Company, in accordance with generally accepted accounting principles pursuant to Regulation S-X of the Securities and Exchange Commission and with the instructions to Form 10-Q. Certain information and footnote disclosures normally included in audited consolidated financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. Accordingly, these interim financial statements should be read in conjunction with the Company's financial statements and related notes as contained in Form 10-K for the year ended December 31, 2012. In the opinion of management, the interim unaudited condensed consolidated financial statements reflect all adjustments, including normal recurring adjustments, necessary for fair presentation of the interim periods presented. The results of the operations for the three and six months ended June 30, 2013 are not necessarily indicative of the results of operations to be expected for the full year.

2. NATURE OF ACTIVITIES AND SIGNIFICANT ACCOUNTING POLICIES

Business Activity

FII is in the business of providing premium foodservice establishments, including white tablecloth restaurants with the freshest origin-specific perishables and specialty food products direct from its network of vendors to the end users (restaurants, hotels, country clubs, national chain accounts, casinos, and catering houses) within 24 - 72 hours. For The Gourmet Inc., through its website www.forthegourmet.com, and through additional sales channels, provides the highest quality gourmet food products to the retail consumer market under the For The Gourmet line.

We currently sell the majority of our products through a distributor relationship between FII and Next Day Gourmet, L.P., a subsidiary of U.S. Foods ("USF"), a $20 Billion broad line distributor. On May 18, 2012, the Company executed a Stock Purchase Agreement to acquire all of the issued and outstanding shares of Artisan Specialty Foods, Inc., an Illinois corporation ("Artisan"). Artisan was previously a supplier to the Company. Artisan is a supplier of over 1,500 niche gourmet products to over 500 customers in the Greater Chicago area.

Use of Estimates

The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. These estimates include certain assumptions related to doubtful accounts receivable, stock-based services, valuation of financial instruments, and income taxes. On an on-going basis, we evaluate these estimates, including those related to

revenue recognition and concentration of credit risk. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. We believe our estimates have not been materially inaccurate in past years, and our assumptions are not likely to change in the foreseeable future.

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On August 25, 2005, we entered into contracts which obligated the company under certain circumstances to issue shares of common stock in excess of the number of shares of common stock authorized. Under accounting guidance provided by FASB ASC 815-40-05, from August 25, 2005 through December 27, 2012, we accounted for all derivative financial instruments, including warrants, conversion features embedded in notes payable, and stock options, via the liability method of accounting. Accordingly, all these instruments were valued at issuance utilizing the Black-Scholes valuation method, and were re-valued at each period ending date, also using the Black-Scholes valuation method. Any gain or loss from revaluation was charged to operations during the period. On December 27, 2012, we entered into agreements (the "2012 Notes Payable Extension Agreement") with certain holders of our convertible notes which, among other things, created a minimum conversion price for the principal amount of the notes of $0.05. Under accounting guidance provided by FASB ASC 815-40-05, this resulted in a change in accounting method for our derivative financial instruments to the equity method of accounting.

Significant Recent Accounting Pronouncements

Management does not believe that any recently issued, but not yet effective, accounting standards if currently adopted would have a material effect on the accompanying unaudited condensed consolidated financial statements.

3. ACQUISITIONS

Artisan Specialty Foods, Inc.

On May 18, 2012, the Company executed a Stock Purchase Agreement to acquire all of the issued and outstanding shares of Artisan Specialty Foods, Inc., an Illinois corporation ("Artisan"), from its owner, Mr. David Vohaska. The purchase price was $1.2 million, with up to another $300,000 (with a fair value of $131,000) payable in the event certain financial milestones are met by April 30, 2014. During the three and six months ended June 30, 2013, the Company made a payment in the amount of $0 and $37,500 to Mr. Vohaska for the attainment of certain of these financial milestones. As of June 30, 2013, the Company accrued the payment of $37,500, which is shown on the balance sheet as Contingent purchase price liabilities.

The purchase price was primarily financed via a loan from Alpha Capital Aktiengesselschaft (see note 10) in the principal amount of $1,200,000. Prior to the acquisition, Artisan was a supplier and had sold products to the Company.

The total purchase price was allocated to Artisan's net tangible assets, with the residual allocated to intangible assets:

Closing cash payment	$ 1,200,000
Contingent purchase price	131,000
Total purchase price	$ 1,331,000
Tangible assets acquired	$ 918,515
Liabilities assumed	614,515(*)
Net tangible assets	304,000
Trade name	217,000
Non-compete agreement	244,000
Customer relationships	415,000

Goodwill	151,000
Total purchase price	$ 1,331,000

(*) excluding the Line of Credit paid off with closing cash payment

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INNOVATIVE FOOD HOLDINGS, INC.
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Pro forma results

The following tables set forth the unaudited pro forma results of the Company as if the acquisition of Artisan had taken place on the first day of the periods presented. These combined results are not necessarily indicative of the results that may have been achieved had the companies always been combined.

	For the Three Months Ended June 30,	
	2013	2012
Total revenues	$ 5,518,949	$ 4,981,147
Net loss	(92,482)	(1,073,088)
Basic net loss per common share	$ (0.015)	$ (0.183)
Diluted net loss per common share	$ (0.015)	$ (0.183)
Weighted average shares – basic	6,342,288	5,873,801
Weighted average shares – diluted	6,342,288	5,873,801

	For the Six Months Ended June 30,	
	2013	2012
Total revenues	$ 11,126,270	$ 9,340,340
Net loss	(62,634)	(1,400,695)
Basic net loss per common share	$ (0.010)	$ (0.238)
Diluted net loss per common share	$ (0.010)	$ (0.238)
Weighted average shares – basic	6,284,658	5,873,801
Weighted average shares – diluted	6,284,658	5,873,801

The Haley Group

The Haley Group, LLC is a food manufacture representative that manages the vendor relationships at a food distributor's corporate level. The Haley Group also provides their suppliers with guidance and assistance as needed at the distributor's regional and divisional level. The Haley Group provides these services in exchange for a combination of monthly retainers and percentages of future sales of client products. On November 2, 2012, the Company entered into an asset purchase agreement (the "Haley Acquisition Agreement") with Haley Group, LLC whereby the Company acquired all existing contracts between Haley Group and its customers for the following consideration: 300,000 shares of the Company's common stock; 150,000 shares of which vest immediately and 150,000 shares of which vest in one year under certain conditions; options to purchase 100,000 shares of the Company's common stock at a price of $0.44 per share; and $20,000 cash contingent upon the attainment of future revenue milestones. The Haley Acquisition was valued at a total cost of $119,645. This intangible fair value of the purchase amount was allocated to Haley Group's customer relationships and capitalized accordingly on the Company's balance sheet at June 30, 2013 and is being amortized over 3 years. During the three and six months ended June 30, 2013, the Company charged the amount of $9,970 and $19,941 to operations, respectively, related to the amortization of these intangible assets.

4. ACCOUNTS RECEIVABLE

At June 30, 2013 and December 31, 2012, accounts receivable consists of:

	June 30, 2013	December 31, 2012
Accounts receivable from customers	$ 1,204,963	$ 965,352
Allowance for doubtful accounts	(131,498)	(5,547)
Accounts receivable, net	$ 1,073,465	$ 959,805

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INNOVATIVE FOOD HOLDINGS, INC.
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5. INVENTORY

Inventory consists of specialty products which are warehoused in Naples, Florida and Lyons, Illinois, and other products held by Company's vendors. At June 30, 2013 and December 31, 2012, finished goods inventory is as follows:

	June 30, 2013	December 31, 2012
Finished goods inventory	$ 692,605	$ 517,631

6. PROPERTY AND EQUIPMENT

Acquisition of Building

During the six months ended June 30, 2013, the Company purchased a building and property located at 28411 Race Track Road, Bonita Springs, Florida 34135 and with respect thereto entered into each of a Loan Agreement, Mortgage, Security Agreement and Note with Fifth Third Bank, each with an effective date of February 26, 2013. The property consists of approximately 1.1 acres of land and close to 10,000 square feet of combined office and warehouse space and was purchased as part of a bank short sale. The Company moved its operations to these premises on July 15, 2013. The purchase price of the property was $792,758 and was financed in part by a five year note in the amount of $546,000 carrying an annual interest rate of 3% above LIBOR Rate, as such term is defined in the Note.

A summary of property and equipment at June 30, 2013 and December 31, 2012, is as follows:

	June 30, 2013	December 31, 2012
Land	$ 177,383	$ -
Building	619,955	-
Computer Equipment	448,420	382,300
Warehouse Equipment	7,733	7,733
Furniture and Fixtures	144,453	152,236
Vehicles	33,238	33,239
Total before accumulated depreciation	1,431,182	575,508
Less: accumulated depreciation	(465,620)	(429,876)
Total	$ 965,562	$ 145,632

Depreciation and amortization expense for property and equipment amounted to $17,727 and $11,707 for the three months ended June 30, 2013 and, 2012, respectively. Depreciation and amortization expense for property and equipment amounted to $35,745 and $14,584 for the six months ended June 30, 2013 and, 2012, respectively.

7. INTANGIBLE ASSETS

The Company acquired certain intangible assets pursuant to the acquisition of Artisan Specialty Foods and the acquisition of certain assets of The Haley Group (see note 2). The following is the net book value of these assets:

	June 30, 2013		
	Gross	Accumulated Amortization	Net
Trade Name	$ 217,000	$ -	$ 217,000
Non-Compete Agreement	244,000	(61,000)	183,000
Customer Relationships	534,645	(106,263)	428,382
Goodwill	151,000	-	151,000
	$ 1,146,645	$ (167,264)	$ 979,382

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	December 31, 2012		
	Gross	Accumulated Amortization	Net
Trade Name	$ 217,000	$ -	$ 217,000
Non-Compete Agreement	244,000	(30,500)	213,500
Customer Relationships	534,645	(44,823)	489,822
Goodwill	151,000	-	151,000
	$ 1,146,645	$ (75,323)	$ 1,071,322

Total amortization expense charged to operations for the three months ended June 30, 2013 and 2012 was $45,970 and $0, respectively. Total amortization expense charged to operations for the six months ended June 30, 2013 and 2012 was $91,940 and $0, respectively.

The trade name is not considered a finite-lived asset, and is not being amortized. The non-compete agreement is being amortized over a period of 48 months. The customer relationships acquired in the Artisan and Haley transactions are being amortized over a period of 60 and 36 months.

As detailed in ASC 350, the Company tests for goodwill impairment in the fourth quarter of each year and whenever events or changes in circumstances indicate that the carrying amount of the asset exceeds its fair value and may not be recoverable. As detailed in ASC 350-20-35-3A, in performing its testing for goodwill impairment, management has completed a qualitative analysis to determine whether it was more likely than not that the fair value of a reporting unit is less than its carrying amount, including goodwill. To complete this review, management followed the steps in ASC 350-20-35-3C to evaluate the fair values of goodwill and considered all known events and circumstances that might trigger an impairment of goodwill. The analysis completed in 2012, determined that there was no impairment to goodwill assets.

8. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities at June 30, 2013 and December 31, 2012 are as follows:

	June 30, 2013	December 31, 2012
Trade payables	$ 1,277,732	$ 1,325,490
Accrued payroll and commissions	42,802	51,282
Total accounts payable and accrued liabilities - non-related parties	$ 1,320,534	$ 1,376,772

At June 30, 2013 and December 31, 2012, accrued liabilities to related parties consisted of accrued payroll and payroll related benefits.

9. ACCRUED INTEREST

Accrued interest on the Company’s convertible notes payable is convertible at the option of the note holders into the Company’s common stock at prices of $0.25 to $1.00 per share. There is a beneficial conversion feature embedded in the convertible accrued interest, which can be exercised at any time by the note holders. Through December 27, 2012,

the Company had immediately charged the value of this beneficial conversion feature of convertible accrued interest to operations. At December 27, 2012, the Company entered into the 2012 Note Extension Agreements, the terms of which brought about a change in the Company's accounting for its convertible equity instruments from the liability method to the equity method.

During the three months ended June 30, 2013 and 2012, the amounts of $0 and $30,226, respectively, were credited to additional paid-in capital as a discount on convertible interest. The aggregate amount of discounts on convertible interest charged to operations during the three months ended June 30, 2013 and 2012 was $0 and $21,998, respectively.

During the six months ended June 30, 2013 and 2012, the amounts of $0 and $50,272, respectively, were credited to additional paid-in capital as a discount on convertible interest. The aggregate amount of discounts on convertible interest charged to operations during the six months ended June 30, 2013 and 2012 was $0 and $43,863, respectively.

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At June 30, 2013, convertible accrued interest was $771,494 (including $44,251 to a related party), which is convertible into 3,085,976 shares of common stock; at December 31, 2012, convertible accrued interest was $759,053 (including $39,866 to a related party) which was convertible into 2,916,614 shares of common stock.

10. NOTES PAYABLE AND NOTES PAYABLE TO RELATED PARTIES

	June 30, 2013	December 31, 2012
Secured Convertible note payable to Alpha Capital Anstalt (f/k/a/ Alpha Capital Aktiengesselschaft) ("Alpha Capital"), originally dated February 25, 2005 and due February 1, 2014. The note contains a cross default provision, and is secured by a majority of the Company's assets. This note bears interest at the rate of 8% per annum. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	$ 213,500	$ 263,500
Convertible note payable to Alpha Capital due February 1, 2014. This note bears interest at the rate of 8% per annum. This note is unsecured. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	21,478	21,478
Convertible note payable to Osher Capital Partners LLC due February 1, 2014. This note bears interest at the rate of 8% per annum. This note is unsecured. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	9,638	9,638
Convertible note payable to Assameka Capital Inc. due February 1, 2014. This note bears interest at the rate of 8% per annum. This note is unsecured. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	6,884	6,884
Convertible note payable to Alpha Capital due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	22,609	22,609
Convertible note payable to Osher Capital Partners LLC due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable	10,145	10,145

Extension Agreement.		
Convertible note payable to Assameka Capital Inc. due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	7,246	7,246
Convertible note payable to Huo Hua due February 1, 2014. This note bears interest at the rate of 8% per annum. This note is unsecured. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share.	20,000	20,000
Convertible secured note payable to Alpha Capital due February 1, 2014. This note bears interest at the rate of 8% per annum, This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	100,000	100,000

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Convertible secured note payable to Alpha Capital due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	15,287	15,287
Convertible secured note payable to Osher Capital Partners LLC due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	6,860	6,860
Convertible secured note payable to Assameka Capital, Inc. due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	4,900	4,900
Convertible secured note payable to Asher Brand due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	5,000	5,000
Convertible secured note payable to Lane Ventures due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	6,000	6,000
Convertible secured note payable Alpha Capital due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	120,000	120,000
	16,957	16,957

Convertible secured note payable Alpha Capital due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.		
Convertible secured note payable to Osher Capital Partners LLC due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	7,609	7,609
Convertible secured note payable to Assameka Capital, Inc. due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	5,435	5,435
Twenty-nine convertible notes payable in the amount of $4,500 each to Sam Klepfish, the Company's CEO and a related party, dated the first of the month beginning on November 1, 2006, issued pursuant to the Company's then employment agreement with Mr. Klepfish, which provided that the amount of $4,500 in salary is accrued each month to a note payable. These notes are unsecured. These notes bear interest at the rate of 8% per annum and have no due date. These notes and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share.	110,500	110,500

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Convertible secured note payable to Alpha Capital due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	10,000	10,000
Convertible secured note payable to Alpha Capital due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	230,000	230,000
Convertible secured note payable to Whalehaven Capital Fund Limited, due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	21,478	21,478
Convertible secured note payable to Osher Capital Partners LLC due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	9,638	9,638
Convertible secured note payable to Assameka Capital, Inc. due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company's assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	6,884	6,884
Convertible secured note payable to Momona Capital due February 1, 2014. This note contains a cross default provision. This note contains a cross-default provision, and is secured by a majority of the Company's assets. This note bears interest at the rate of 8% per annum. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.	25,310	25,310
	10,124	10,124

Convertible secured note payable to Lane Ventures due February 1, 2014. This note bears interest at the rate of 8% per annum. This note contains a cross-default provision, and is secured by a majority of the Company’s assets. The note and accrued interest are convertible into common stock of the Company at a conversion price of $0.25 per share. This note was included in the 2012 Notes Payable Extension Agreement.		
Secured convertible promissory note payable for the acquisition of Artisan Specialty Foods, Inc. to Alpha Capital, dated May 11, 2012 in the face amount of $1,200,000 at a purchase price of $1,080,000. The note carries simple interest at an annual rate of 4.5% and is due in full by April 2015. The note is convertible into the registrant's common stock at a fixed conversion price of $1.00 per share. Principal and interest in the aggregate amount of $39,163 are payable on a monthly basis beginning in September 2012. The note allows for prepayments at any time. The note also includes cross-default provisions; is secured by all of the registrant's and its subsidiaries' assets; and is guaranteed by each of the subsidiaries. Interest expense in the amount of $30,921 and was accrued on this note during the years ended December 31, 2012 and 2011, respectively. During the three months ended June 30, 2013, the Company made payments in the aggregate amount of $117,491 on this note, consisting of $106,996 of principal and $10,495 of interest. During the six months ended June 30, 2013, the Company made payments in the aggregate amount of $234,983 on this note, consisting of $212,798 of principal and $22,185 of interest.	861,469	1,074,267

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	June 30, 2013	December 31, 2012
Secured vehicle lease payable at an effective interest rate of 9.96% for purchase of truck, payable in monthly installments (including principal and interest) of $614 through January 2015. During the three months ended June 30, 2013, the Company made payments in the aggregate amount of $1,842 on this note, consisting of $1,549 of principal and $293 of interest. During the six months ended June 30, 2013, the Company made payments in the aggregate amount of $3,684 on this note, consisting of $3,059 of principal and $625 of interest.	10,752	13,811
Secured vehicle lease payable at an effective interest rate of 8.26% for purchase of truck, payable in monthly installments (including principal and interest) of $519 through June 2015. During the three months ended June 30, 2013, the Company made payments in the aggregate amount of $1,558 on this note, consisting of $1,303 of principal and $254 of interest. During the six months ended June 30, 2013, the Company made payments in the aggregate amount of $3,116 on this note, consisting of $2,580 of principal and $535 of interest.	11,453	14,033
Secured mortgage note payable for the acquisition of land and building in Bonita Springs, Florida in the amount of $546,000. Principal payments of $4,550 and interest at the rate of Libor plus 3% are due monthly. The balance of the principal amount will be due March 2018. During the three months ended June 30, 2013, the Company made payments in the aggregate amount of $18,046 on this note, consisting of $13,650 of principal and $4,396 of interest. During the six months ended June 30, 2013, the Company made payments in the aggregate amount of $23,956 on this note, consisting of $18,200 of principal and $5,756 of interest.	$ 527,800	-
Total	$ 2,434,956	$ 2,175,593
Less: Discount	(1,230,819)	(1,868,482)
Net	$ 1,204,137	$ 307,111

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2013	2012	2013	2012
Discount on Notes Payable amortized to interest expense:	$332,617	$1,308	$637,665	$1,308

The Company calculates the fair value of any beneficial conversion features embedded in its convertible notes via the Black-Scholes valuation method. The Company also calculates the fair value of any detachable warrants offered with its convertible notes via the Black-Scholes valuation method. The instruments were considered discounts to the notes, to the extent the aggregate value of the warrants and conversion features did not exceed the face value of the notes. These discounts were amortized to interest expense via the effective interest method over the term of the notes. The fair value of these instruments was charged to interest expense to the extent that the value of these instruments exceeds the face value of the notes.

The Company revalued the conversion options at each reporting period, and charged any change in value to operations. During the three months ended June 30, 2013 and 2012, the Company recorded a loss of $0 and $89,569 respectively, due to the change in value of the conversion option liability. During the six months ended June 30, 2013 and 2012, the Company recorded a loss of $0 and $468,004, respectively, due to the change in value of the conversion option liability.

When convertible notes payable are satisfied by payment or by conversion to equity, the Company revalues the related conversion option liability at the time of the payment or conversion. The conversion option liability is then relieved by this amount, which is charged to additional paid-in capital. During the three months ended June 30, 2013 and 2012, conversion option liabilities in the amounts of $0 and $0, respectively, were transferred from liability to equity due to the conversion or payment of the related convertible notes payable. During the six months ended June 30, 2013 and 2012, conversion option liabilities in the amounts of $0 and $20,046, respectively, were transferred from liability to equity due to the conversion or payment of the related convertible notes payable.

From September 2005 through December 26, 2012, the Company accounted for conversion options embedded in convertible notes in accordance with FASB ASC 815-10-05. ASC 815-10-05 generally requires companies to bifurcate conversion options embedded in convertible notes from their host instruments and to account for them as free standing derivative financial instruments in accordance with ASC 815-40-05.

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Effective December 27, 2012, the Company entered into agreements (the "2012 Notes Payable Extension Agreement") with certain convertible note holders regarding twenty-five convertible notes in the aggregate amount of $2,037,249 in principal and $719,187 in accrued interest. Pursuant to the 2012 Notes Payable Extension Agreement, the maturity date of each note and accrued interest was extended to February 1, 2014 (unless the original maturity date is beyond the extended date, in which case the original maturity date will not change); the expiration date of each warrant associated with each of the notes was extended to August 1, 2015 (unless the original expiration date of each warrant was beyond August 1, 2015, in which case the original expiration date will not change); the minimum conversion price of the note and accrued interest, in the case of any adjustment to such price, was set to be $0.05 per share. The Company also agreed that for as long as the convertible notes are held by the existing note holders, it will not issue any common stock or other securities convertible into or exercisable for shares of common stock at a price of less than $0.05 per share. Accordingly, the conversion option and warrants were reclassified from liability to equity since the conversion and exercise prices were fixed and all other conditions were met to classify the conversion feature and warrants as equity.

The Company revalued its derivative equity instruments at December 27, 2012 using the Black-Scholes valuation method, and recorded losses on revaluation in the amount of $478,822 for the conversion options, $566,063 for the warrants, and $103,248 for stock options. This resulted in liabilities in the amount of $2,088,475 for the value of the warrants, $1,708,528 for the value of the conversion options, and $411,792 for the stock options. The value of the warrants and conversion options (a total of $3,797,001) was eliminated, and recorded as a gain on extinguishment of debt. The value of the stock options of $411,792 was eliminated, and recorded as a charge to additional paid-in capital.

Pursuant to debt extinguishment accounting, the Company charged to interest expense the unamortized amount of the discount on the related convertible notes at December 27, 2012 in the amount of $824,286. Prior to December 27, 2012, the Company had amortized $13,899 of the discount. At December 27, 2012, the Company recorded a new discount on the convertible notes in the aggregate amount of $1,918,993, which was charged to additional paid-in capital.

At December 27, 2012, the aggregate value of the unamortized discount on the notes payable affected by the 2012 Notes payable Extension Agreement was $830,837 which amount was charged to operations. The Company recorded new discounts on notes payable in the aggregate amount of $1,918,993, which was recorded as an increase in additional paid-in capital.

During the year ended December 31, 2012, the Company calculated an original issue discount ("OID") related to the acquisition of Artisan Specialty Foods, Inc. in the amount of $120,000 on a note payable in the total principal amount of $1,200,000. During the three and six months ended June 30, 2013, this discount was amortized to interest expense in the amount of $2,028 and $3,409, respectively.

At June 30, 2013 and 2012, the Company had unamortized discounts to notes payable in the aggregate amount of $1,230,819 and $0, respectively.

The following table illustrates certain key information regarding our conversion option valuation assumptions at June 30, 2013 and 2012:

June 30,

	2013			2012
Number of conversion options outstanding	4,955,397			5,573,924
Value at June 30,	N/A			1,957,383
Number of conversion options issued during the period	-			1,200,000
Value of conversion options issued during the period	N/A			263,664
Number of conversion options exercised or underlying notes paid during the period	-			-
Value of conversion options exercised or underlying notes paid during the period	-		$	-
Revaluation loss (gain) during the period	N/A		$	89,569
Black-Scholes model variables:				
Volatility	N/A	124.12	to	125.18%
Dividends	-			-
Risk-free interest rates	N/A			0.40%
Term (years)	N/A	3	to	10

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11. RELATED PARTY TRANSACTIONS

For the six months ended June 30, 2013:

Pursuant to the terms of the Artisan Acquisition Agreement, the Company made a payment in the amount of $37,500 to David Vohaska. Mr. Vohaska is currently an employee of the Company. The Company also accrued an additional payment in the amount of $37,500 to Mr. Vohaska during the six months ended June 30, 2013.

Pursuant to the terms of an employment agreement, the Company made cash payments to its Chief Executive Officer in the amount of $90,500 for previously-accrued bonuses. Also pursuant to the terms of his employment agreement, the Company issued options to its Chief Executive Officer as follows: Four year options to purchase 50,000 shares of the Company's common stock at a price of $0.40 per share which vest on December 31, 2014; four year options to purchase 50,000 shares of the Company's common stock at a price of $0.40 per share which vest on December 31, 2015; five year options to purchase 100,000 shares of the Company's common stock at a price of $0.57 per share which vest on December 31, 2014; five year options to purchase 62,500 shares of the Company's common stock at a price of $1.60 per share which vest on December 31, 2013; and five year options to purchase 62,500 shares of the Company's common stock at a price of $1.60 per share which vest on December 31, 2014. The Company also accrued the amount of $27,937 for the value of Restricted Stock Units ("RSU's") due to its Chief Executive Officer under the terms of his employment agreement.

Pursuant to the terms of an employment agreement, the Company made cash payments to its President in the amount of $90,500 for previously-accrued bonuses. Also pursuant to the terms of his employment agreement, the Company issued options to its President as follows: Four year options to purchase 50,000 shares of the Company's common stock at a price of $0.40 per share which vest on December 31, 2014; four year options to purchase 50,000 shares of the Company's common stock at a price of $0.40 per share which vest on December 31, 2015; five year options to purchase 100,000 shares of the Company's common stock at a price of $0.57 per share which vest on December 31, 2014; five year options to purchase 62,500 shares of the Company's common stock at a price of $1.60 per share which vest on December 31, 2013; and five year options to purchase 62,500 shares of the Company's common stock at a price of $1.60 per share which vest on December 31, 2014.

Pursuant to the terms of an employment agreement, the Company made cash payments to Chief Information and Principal Accounting Officer $25,000 for previously-accrued bonuses, Also pursuant to the terms of his employment agreement, the Company issued options to its Chief Information and Principal Accounting Officer as follows: Four year options to purchase 25,000 shares of the Company's common stock at a price of $0.40 per share which vested on January 1, 2013; four year options to purchase 25,000 shares of the Company's common stock at a price of $0.40 per share which vest on January 1, 2015; three year options to purchase 25,000 shares of the Company's common stock at a price of $0.40 per share which vest on January 1, 2016; five year options to purchase 25,000 shares of the Company's common stock at a price of $0.57 per share which vest on January 1, 2018; five year options to purchase 30,000 shares of the Company's common stock at a price of $1.60 per share which vest on January 1, 2014; and five year options to purchase 30,000 shares of the Company's common stock at a price of $1.60 per share which are scheduled to vest on January 1, 2015.

For the six months ended June 30, 2012:

Pursuant to the terms of an employment agreement, the Company made cash payments to its Chief Executive Officer in the amount of $34,650 for previously-accrued bonuses.

Pursuant to the terms of an employment agreement, the Company made cash payments to its President in the amount of $34,650 for previously-accrued bonuses.

12. CONTINGENT LIABILITY

Pursuant to the Artisan acquisition, the Company may be obligated to pay up to another $300,000 in the event certain financial milestones are met by April 30, 2014 (see note 3). This obligation had a fair value of $131,000 at the time of the Artisan acquisition. During the six months ended June 30, 2013, the Company made a payment in the amount of $37,500 against this liability, and accrued an additional $26,930. At June 30, 2013, the fair value of the contingent liability on the Company's balance sheet is $37,500. The amount ultimately payable to Mr. Vohaska pursuant to this obligation could increase in future periods to a maximum of an additional $187,500.

13. INCOME TAXES

Deferred income taxes result from the temporary differences arising from the use of accelerated depreciation methods for income tax purposes and the straight-line method for financial statement purposes, and an accumulation of net operating loss carryforwards for income tax purposes with a valuation allowance against the carryforwards for book purposes.

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In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. Included in deferred tax assets are Federal and State net operating loss carryforwards of approximately $3.2 million, which will expire beginning in 2025 through 2029. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Due to significant changes in the Company's ownership, the Company's future use of its existing net operating losses may be limited.

14. EQUITY

Reverse Stock Split

On June 13, 2012, the Company implemented a reverse split of its common stock (the “Reverse Split”) in the amount of 1-for-50. The number of shares issued and outstanding immediately before the Reverse Split was 293,692,189 and 282,956,546, respectively; the number of shares issued and outstanding immediately after the Reverse Split was 5,873,801 and 5,659,130, respectively. In addition, the proposal to authorize the Board of Directors to change the Company’s domicile from Florida to Delaware was approved. All share and per share data have been retroactively restated to reflect the reverse split.

Common Stock

During the six months ended June 30, 2013, the Company issued 253,232 shares of common stock for settlement of a note. This issuance of shares was accrued in a prior period, and was carried as common stock subscribed in the Company’s balance sheet at December 31, 2012.

During the six months ended June 30, 2013, the Company issued 26,078 shares of common stock for settlement of a note. This issuance of shares was accrued in a prior period, and was carried as common stock subscribed in the Company’s balance sheet at December 31, 2012.

During the six months ended June 30, 2013, the Company issued 341,794 shares of common stock for the conversion of the principal of a convertible note in the amount or $50,000 and accrued interest in the amount of $35,449, for a total conversion value of $85,449.

Treasury Stock

During the six months ended June 30, 2013, the Company did not purchase any outstanding shares of the Company’s common stock.

Warrants

The following table summarizes the significant terms of warrants outstanding at June 30, 2013. These warrants may be settled in cash or via cashless conversion into shares of the Company’s common stock at the request of the warrant holder. These warrants were granted as part of a financing agreement:

Range of exercise Prices	Number of warrants Outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price of outstanding Warrants	Number of warrants Exercisable	Weighted average exercise price of exercisable Warrants
$ 0.010	1,500,000	6.88	$ 0.010	1,500,000	$ 0.010
$ 0.250	3,594,000	1.76	$ 0.250	3,594,000	$ 0.250
$ 0.550	370,000	1.76	$ 0.550	370,000	$ 0.550
$ 0.575	1,480,000	1.76	$ 0.575	1,480,000	$ 0.575
$ 0.600	20,000	0.21	$ 0.600	20,000	$ 0.600
	6,964,000	2.86	$ 0.284	6,964,000	$ 0.284

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Transactions involving warrants are summarized as follows:

	Number of Warrants	Weighted Average Exercise Price
Warrants exercisable at December 31, 2012	6,964,000	$ 0.284
Granted	-	-
Exercised	-	-
Cancelled / Expired	-	-
Warrants outstanding at June 30, 2013	6,964,000	$ 0.284

The Company did not issue any warrants during the six months ended June 30, 2013. During the three months ended June 30, 2012, the Company issued warrants to purchase 1,500,000 shares of common stock; the fair value of these warrants was $572,777. The Company also extended the term of warrants to purchase 5,440,000 shares of common stock from April 3, 2012 to April 3, 2015. The fair value of this extension of $842,100 was charged to operations during the three months ended June 30, 2012.

Options

The following table summarizes the changes outstanding and the related prices for the options to purchase shares of the Company's common stock issued by the Company:

Range of exercise Prices	Number of options Outstanding	Weighted average Remaining contractual life (years)	Weighted average exercise price of outstanding Options	Number of options Exercisable	Weighted average exercise price of exercisable Options
$ 0.350	1,140,000	4.05	$ 0.350	1,140,000	$ 0.350
$ 0.380	132,500	1.75	$ 0.380	132,500	$ 0.380
$ 0.400	275,000	3.51	$ 0.400	25,000	$ 0.400
$ 0.450	132,500	2.00	$ 0.450	132,500	$ 0.450
$ 0.474	132,500	2.25	$ 0.474	132,500	$ 0.474
$ 0.480	132,500	2.50	$ 0.480	132,500	$ 0.480
$ 0.570	225,000	4.51	$ 0.570	-	$ N/A

$	1.60	310,000	4.51	$	1.60	-	$	N/A
		2,480,000	3.68	$	0.552	1,695,000	$	0.381

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Transactions involving stock options are summarized as follows:

	Number of Shares	Weighted Average Exercise Price
Options outstanding at December 31, 2012	2,070,000	$ 0.290
Granted	810,000	$ 0.906
Exercised	-	-
Cancelled / Expired	(400,000)	$ 0.35
Options outstanding at June 30, 2013	2,480,000	$ 0.552

Aggregate intrinsic value of options outstanding and exercisable at June 30, 2013 and 2012 was $85,200 and $52,000, respectively. Aggregate intrinsic value represents the difference between the Company's closing stock price on the last trading day of the fiscal period, which was $0.38 and $0.40 as of June 30, 2013 and 2012, respectively, and the exercise price multiplied by the number of options outstanding.

During the three months ended June 30, 2013 and 2012, the Company charged $0 and $186,299, respectively, to operations related to recognized stock-based compensation expense for employee stock options. During the six months ended June 30, 2013 and 2012, the Company charged $35,662 and $186,299, respectively, to operations related to recognized stock-based compensation expense for employee stock options.

Accounting for warrants and stock options

In August 2005, the Company’s commitments to issue shares of common stock first exceeded its common stock authorized. At this time, the Company began to value its warrants and stock options via the liability method of accounting. Pursuant to guidance in ASC 718-40 the cost of these options was valued via the Black-Scholes valuation method when issued, and re-valued at each reporting period. The gain or loss from this revaluation was charged to compensation expense during the period. On December 27, 2012, the Company entered into the 2012 Notes Payable Extension Agreement with certain holders of its convertible notes which, among other things, created a minimum conversion price for the principal amount of the notes. Under accounting guidance provided by FASB ASC 815-40-05, this resulted in a change in accounting method for our derivative financial instruments to the equity method of accounting. We revalued our derivative liabilities at December 27, 2012, and charged the gain or loss from this revaluation to compensation expense during the period.

The Company valued warrants and options using the Black-Scholes valuation model utilizing the following variables:

	June 30, 2013	December 31, 2012
Volatility	189.28 %	92.52 - 114.30 %
Dividends	$ -	$ - -
Risk-free interest rates	0.37 %	0.06 - 0.17 %
Term (years)	4	0.01 - 5.00

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15. EMPLOYMENT AGREEMENTS

Chief Executive Officer

On January 1, 2013, the Company entered into an employment agreement with its Chief Executive Officer (the "2013 CEO Employment Agreement"). The 2013 CEO Employment Agreement is for a term of three years, and provides a base compensation in the amount of $198,312 in cash plus an additional $27,937 in restricted stock units for year one, $223,987 in cash plus an additional $24,875 in restricted stock units for year two, and $260,075 in cash plus an additional $13,688 in restricted stock units for year three. The 2013 CEO Employment Agreement also provides the CEO with a four year option to purchase 100,000 shares of the Company's common stock at a price of $0.40 per share; a five year option to purchase 100,000 shares of the Company's common stock at a price of $0.57 per share; and a six year option to purchase 125,000 shares of the Company's common stock at a price of $1.60 per share; various performance-based bonus provisions; and a stock grant of 200,000 shares of the Company's common stock which vest only if the 30 day average trading price of the Company's common stock equals or exceeds $1.75 per share and has average volume of at least 25,000 shares per day for 30 consecutive days.

President

On January 1, 2013, the Company entered into an employment agreement with its President (the "2013 President Employment Agreement"). The 2013 President Employment Agreement is for a term of three years, and provides a base compensation in the amount of $226,250 per annum for year one, $248,875 per annum for year two, and $273,763 per annum for year three. The 2013 President Employment Agreement also provides the President with a four year option to purchase 100,000 shares of the Company's common stock at a price of $0.40 per share; a five year option to purchase 100,000 shares of the Company's common stock at a price of $0.57 per share; and a six year option to purchase 125,000 shares of the Company's common stock at a price of $1.60 per share; various performance-based bonus provisions; and a stock grant of 75,000 shares of the Company's common stock which vest only if the 30 day average trading price of the Company's common stock equals or exceeds $1.75 per share and has average volume of at least 25,000 shares per day for 30 consecutive days.

Principal Accounting Officer and Chief Information Officer

On January 1, 2013, the Company entered into an employment agreement with its Principal Accounting Officer and Chief Information officer (the "2013 PAO – CIO Employment Agreement"). The 2013 PAO – CIO Employment Agreement is for a term of two years, and provides a base compensation in the amount of $135,000 per annum for year one and $151,200 per annum for year two. The 2013 PAO – CIO Employment Agreement also provides a four year option to purchase 75,000 shares of the Company's common stock at a price of $0.40 per share; a five year option to purchase 25,000 shares of the Company's common stock at a price of $0.57 per share; and a five year option to purchase 60,000 shares of the Company's common stock at a price of $1.60 per share; various performance-based bonus provisions; and a stock grant in the amount of $15,000 in shares of the Company's common stock.

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

FORWARD LOOKING STATEMENTS

The following discussion should be read in conjunction with the consolidated financial statements and the related notes thereto, as well as all other related notes, and financial and operational references, appearing elsewhere in this document.

Certain information contained in this discussion and elsewhere in this report may include "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, and is subject to the safe harbor created by that act. The safe harbor created by the Private Securities Litigation Reform Act will not apply to certain "forward looking statements" because we issued "penny stock" (as defined in Section 3(a)(51) of the Securities Exchange Act of 1934 and Rule 3(a)(51-1) under the Exchange Act) during the three year period preceding the date(s) on which those forward looking statements were first made, except to the extent otherwise specifically provided by rule, regulation or order of the Securities and Exchange Commission. We caution readers that certain important factors may affect our actual results and could cause such results to differ materially from any forward-looking statements which may be deemed to have been made in this Report or which are otherwise made by or on our behalf. For this purpose, any statements contained in this report that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the generality of the foregoing, words such as "may", "will", "expect", "believe", "explore", "consider", "anticipate", "intend", "could", "estimate", "plan", "propose" or "continue" or the negative variations of those words or comparable terminology are intended to identify forward-looking statements. Factors that may affect our results include, but are not limited to, the risks and uncertainties associated with:

Our ability to raise capital necessary to sustain our anticipated operations and implement our business plan,

Our ability to implement our business plan,

Our ability to generate sufficient cash to pay our lenders and other creditors,

Our dependence on one major customer,

Our ability to employ and retain qualified management and employees,

Our dependence on the efforts and abilities of our current employees and executive officers,

Changes in government regulations that are applicable to our current or anticipated business,

Changes in the demand for our services,

The degree and nature of our competition,

The lack of diversification of our business plan,

The general volatility of the capital markets and the establishment of a market for our shares, and

Disruption in the economic and financial conditions primarily from the impact of past terrorist attacks in the United States, threats of future attacks, police and military activities overseas and other disruptive worldwide political and economic events and weather conditions.

We are also subject to other risks detailed from time to time in our other Securities and Exchange Commission filings and elsewhere in this report. Any one or more of these uncertainties, risks and other influences could materially affect our results of operations and whether forward-looking statements made by us ultimately prove to be accurate. Our actual results, performance and achievements could differ materially from those expressed or implied in these forward-looking statements. We undertake no obligation to publicly update or revise any forward-looking statements, whether from new information, future events or otherwise.

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Critical Accounting Policy and Estimates

Use of Estimates in the Preparation of Financial Statements

The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. These estimates include certain assumptions related to doubtful accounts receivable, stock-based services, valuation of financial instruments, and income taxes. On an on-going basis, we evaluate these estimates, including those related to revenue recognition and concentration of credit risk. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. We believe our estimates have not been materially inaccurate in past years, and our assumptions are not likely to change in the foreseeable future.

On August 25, 2005, the Company entered into contracts which obligated the Company under certain circumstances to issue shares of common stock in excess of the number of shares of common stock authorized. Under accounting guidance provided by FASB ASC 815-40-05, effective August 25, 2005 the Company began to account for all derivative financial instruments, including warrants, conversion features embedded in notes payable, and stock options, via the liability method of accounting. Accordingly, all these instruments were valued at issuance utilizing the Black-Scholes valuation method, and were re-valued at each period ending date, also using the Black-Scholes valuation method. Any gain or loss from revaluation was charged to operations during the period.

On December 27, 2012, the Company entered into agreements (the “2012 Notes Payable Extension Agreement”) affecting the terms of certain of its convertible notes payable. One of these changes established a minimum conversion price for these notes of $0.05. Under accounting guidance provided by FASB ASC 815-40-05, this resulted in a change in accounting method for these instruments from derivative accounting to equity accounting.   The Company revalued these instruments at December 27, 2012 using the Black-Scholes valuation method. Any gain or loss in value was charged to operations.

(a) Warrants:

The following table illustrates certain key information regarding our warrants and warrant valuation assumptions at June 30, 2013, and 2012:

	June 30,		
	2013		2012
Number of warrants outstanding	6,964,000		6,964,000
Value at June 30,	N/A	$	2,185,068
Number of warrants issued during the period	-		1,500,000
Value of warrants issued during the period	-	$	572,777
Value of warrants extended during the period	-	$	842,100
Revaluation loss during the period	N/A	$	75,356
Black-Scholes model variables:			
Volatility	N/A		%

			117.77 -126.6
Dividends	N/A	$	-
Risk-free interest rates	N/A		0.41 –1.11%
Term (years)	N/A		2.9 – 1.11

(b) Embedded conversion features of notes payable:

The Company accounts for conversion options embedded in convertible notes in accordance with ASC 815-10-05. ASC 815-10-05 generally requires companies to bifurcate conversion options embedded in convertible notes and preferred shares from their host instruments and to account for them as free standing derivative financial instruments in accordance with ASC 815-40-05.

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The Company values embedded conversion features utilizing the Black-Scholes valuation model. Conversion options are valued upon issuance, and re-valued at each financial statement reporting date. Any change in value is charged to income or expense during the period. The following table illustrates certain key information regarding our Conversion options and conversion option valuation assumptions at June 30, 2013 and 2012:

	June 30,		
	2013		2012
Number of conversion options outstanding	4,955,397		5,573,924
Value at June 30,	N/A	$	1,957,383
Number of conversion options issued during the period	-		1,200,000
Value of conversion options issued during the period	N/A	$	263,664
Number of conversion options exercised or underlying notes paid during the period	-		-
Value of conversion options exercised or underlying notes paid during the period	-	$	-
Revaluation loss during the period	N/A	$	86,569
Black-Scholes model variables:			
Volatility	N/A		125.18%
Dividends	-		-
Risk-free interest rates	N/A		0.17 to 0.41.%
Term (years)	N/A		2.9-10

(c) Stock options:

The Company accounts for options in accordance FASB ASC 718-40. Options are valued upon issuance, and re-valued at each financial statement reporting date, utilizing the Black-Scholes valuation model. Option expense is recognized over the requisite service period of the related option award. Any change in value is charged to income or expense during the period. The following table illustrates certain key information regarding our options and option assumptions at June 30, 2013 and 2012:

		June 30,		
		2013		2012
Number of vested options outstanding		1,695,000		1,570,000
Value at June 30,	$	N/A	$	419,832
Number of options issued during the period		810,000		600,000
Number of options vested during the period		25,000		186,299
Value of options vested during the period	$	-		-
Number of options recognized during the period pursuant to SFAS 123(R)		-		-
Value of options recognized during the period pursuant to SFAS 123(R)	$	-	$	-

Revaluation (gain) during the period	$	(39,938)	$	16,763
Black-Scholes model variables:				
Volatility		214.36%		125.18 %
Dividends	$	-	$	-
Risk-free interest rates		0.14-0.41%		0.16 – 1.11%
Term (years)		0.75 -4.59		0.75 – 4.85

Background

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

In January 2004, we changed our state of incorporation by merging into Innovative Food Holdings, Inc. ("IVFH"), a Florida shell corporation. As a result of the merger we changed our name to that of Innovative Food Holdings, Inc. In February 2004 we also acquired Food Innovations, Inc. ("FII") a Delaware corporation incorporated on January 9, 2002 and through FII and our other subsidiaries we are in the business of national food distribution and sales using third-party shippers.

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On May 18, 2012, the Company executed a Stock Purchase Agreement to acquire all of the issued and outstanding shares of Artisan Specialty Foods, Inc., an Illinois corporation ("Artisan"), from its owner, Mr. David Vohaska. The purchase price was $1.2 million, with up to another $300,000 (with a fair value of $131,000) payable in the event certain financial milestones are met by April 30, 2014. The purchase price was primarily financed via a loan from Alpha Capital in the principal amount of $1,200,000. Prior to the acquisition, Artisan was a vendor and had sold products to the Company.

Transactions With a Major Customer

Transactions with a major customer and related economic dependence information is set forth (1) following our discussion of Liquidity and Capital Resources, (2) Concentrations of Credit Risk in Note 2 to the Condensed Consolidated Financial Statements, and (3) as the fourth item under Risk Factors.

Relationship with U.S. Foods

In February 2010, one of our subsidiaries, Food Innovations, signed a new contract with U.S. Foods ("USF"). This contract with USF expired on December 31, 2012. However, the contract provides that it automatically renews for an additional 12-month term unless either party notifies the other in writing 30 days prior to the end date of its intent not to renew. Inasmuch as neither party gave the requisite notice, the agreement was automatically extended through December 31, 2013. We believe that although a significant portion of our sales occurs through the USF sales force, the success of the program is less contingent on a contract then on the actual performance and quality of our products. Other than our business arrangements with USF, we are not affiliated with either USF or its subsidiary, Next Day Gourmet, L.P. During the three months ended June 30, 2013 and 2012, sales to USF accounted for 72% and 80% of total sales, respectively. During the six months ended June 30, 2013 and 2012, sales to USF accounted for 70% and 83% of total sales, respectively.

RESULTS OF OPERATIONS

The following is a discussion of our financial condition and results of operations for the three and six months ended June 30, 2013 and 2012.

This discussion may contain forward looking-statements that involve risks and uncertainties. Our future results could differ materially from the forward looking-statements discussed in this report. This discussion should be read in conjunction with our unaudited condensed consolidated financial statements, the notes thereto and other financial information included elsewhere in the report.

Three Months Ended June 30, 2013 Compared to Three Months Ended June 30, 2012

Revenue

Revenue increased by $1,166,078, or approximately 27%, to $5,518,949 for the three months ended June 30, 2013 from $4,352,871 in the prior year. $632,775, or approximately 54%, of the increase was attributable to the acquisition of Artisan, while $533,303, or approximately 46%, of the increase was attributable to year-over-year organic growth.

We continue to assess the potential of new revenue sources from the manufacture and sale of proprietary food products and additional sales channel opportunities and will implement that strategy if, based on our analysis, we deem it beneficial to us.

Any changes in the food distribution operating landscape that materially hinders our current ability and/or cost to deliver our products to our customers could potentially cause a material impact on our net revenue and gross margin and, therefore, our profitability and cash flows could be adversely affected.

Currently, a small portion of our revenues comes from imported products or international sales. Our current sales from such segments may be hampered and negatively impacted by any economic tariffs that may be imposed in the United States or in foreign countries.

See "Transactions with Major Customers" and the Securities and Exchange Commission's ("SEC") mandated FR-60 disclosures following the "Liquidity and Capital Resources" section for a further discussion of the significant customer concentrations, loss of significant customer, critical accounting policies and estimates, and other factors that could affect future results.

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Cost of goods sold

Our cost of goods sold for the three months ended June 30, 2013 was $4,031,096, an increase of $870,482 or approximately 27% compared to cost of goods sold of $3,160,614 for the three months ended June 30, 2012. Cost of goods sold is primarily made up of the following expenses for the three months ended June 30, 2013: cost of goods of specialty, meat, game, cheese poultry and other sales categories in the amount of $ 3,042,323; and shipping expenses in the amount of $870,832. The cost of goods sold increase is mainly associated with the increase in sales. Total gross margin was approximately 27% of sales in 2013, compared to 27% of sales in 2012.

In 2013, we continued to price our products in order to gain market share and increase the number of our end users. We were successful in both increasing sales and increasing market share. We currently expect, if market conditions and our product revenue mix remain constant, that our cost of goods sold will either remain stable or likely improve slightly.

Selling, general and administrative expenses

Selling, general, and administrative expenses increased by $86,171 or approximately 8% to $1,208,343 during the three months ended June 30, 2013 compared to $1,122,172 for the three months ended June 30, 2012. Selling, general and administrative expenses were primarily made up of the following for the three months ended June 30, 2013: payroll and related expenses, including employee benefits, in the amount of $774,230; amortization and depreciation in the amount of $99,697; facilities expense in the amount of $89,250; consulting and professional fees in the amount of $78,290; insurance expense in the amount of $58,895; bad debt expense in the amount of $27,104; travel and entertainment expenses in the amount of $23,941; banking and credit card fees expenses in the amount of $21,965; computer support expenses in the amount of $19,615; and advertising expense in the amount of $3,873. The increase in selling, general, and administrative expenses was primarily due to the acquisition of The Haley Group and the acquisition of Artisan Specialty Foods which has higher selling general and administrative expenses than Innovative Food Holdings' historical levels. We expect our selling, general, and administrative expenses to remain steady or slightly decrease in 2013.

Interest expense

Interest expense, net of interest income, increased by $319,310 or approximately 606% to $371,992 during the three months ended June 30, 2013, compared to $52,682 during the three months ended June 20, 2012. Approximately 11% or $39,376 of the interest expense was accrued or paid interest on the company's notes payable; approximately 89% or $332,616 of the interest was associated with the amortization of the discounts on the Company's notes payable.

Loss from change in fair value of warrant liability

On December 27, 2012, the Company entered into the 2012 Notes Payable Extension Agreement, which affected the terms of certain of its convertible notes payable. Under accounting guidance provided by FASB ASC 815-40-05, this resulted in a change in accounting method for the Company's warrants from derivative accounting to equity accounting. Accordingly, the Company did not revalue these instruments at June 30, 2013. The Company revalued these instruments at June 30, 2012 using the Black-Scholes valuation method. This revaluation resulted in a loss of $75,356 which the Company included in operations during the three months ended June 30, 2012. There was no such comparable gain or loss during the current period.

Loss from change in fair value of conversion option liability

On December 27, 2012, the Company entered into the 2012 Notes Payable Extension Agreement which affected the terms of certain of its convertible notes payable. Under accounting guidance provided by FASB ASC 815-40-05, this resulted in a change in accounting method for the Company's conversion options from derivative accounting to equity accounting. Accordingly, the Company did not revalue these instruments at June 30, 2013. The Company revalued these instruments at June 30, 2012 using the Black-Scholes valuation method. This revaluation resulted in a loss of $89,569, which the Company included in operations during the three months ended June 30, 2012. There was no such comparable gain or loss during the current period.

Cost of warrant extension

During the three months ended June 30, 2012, the Company extended the term of warrants to purchase 5,440,000 shares of common stock from April 3, 2012 to April 3, 2015. The fair value of this extension of $842,100 was charged to operations during the three months ended June 30, 2012. There was no comparable transaction during the three months ended June 30, 2013.

Net Loss

For the reasons above, the Company had a net loss for the three months ended June 30, 2013 of $92,482, a decrease of $897,140 compared to a net loss of $989,622 during the three months ended June 30, 2012.

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Six Months Ended June 30, 2013 Compared to Six Months Ended June 30, 2012

Revenue

Revenue increased by $3,488,092, or approximately 46%, to $11,126,270 for the six months ended June 30, 2013 from $7,638,178 in the prior year. $2,036,837, or approximately 58%, of the increase was attributable to the acquisition of Artisan, while $1,451,255, or approximately 42%, of the increase was attributable to year-over-year organic growth.

We continue to assess the potential of new revenue sources from the manufacture and sale of proprietary food products and additional sales channel opportunities and will implement that strategy if, based on our analysis, we deem it beneficial to us.

Any changes in the food distribution operating landscape that materially hinders our current ability and/or cost to deliver our products to our customers could potentially cause a material impact on our net revenue and gross margin and, therefore, our profitability and cash flows could be adversely affected.

Currently, a small portion of our revenues comes from imported products or international sales. Our current sales from such segments may be hampered and negatively impacted by any economic tariffs that may be imposed in the United States or in foreign countries.

See "Transactions with Major Customers" and the Securities and Exchange Commission's ("SEC") mandated FR-60 disclosures following the "Liquidity and Capital Resources" section for a further discussion of the significant customer concentrations, loss of significant customer, critical accounting policies and estimates, and other factors that could affect future results.

Cost of goods sold

Our cost of goods sold for the six months ended June 30, 2013 was $8,065,390, an increase of $2,292,794, or approximately 40%, compared to cost of goods sold of 5,772,596 for the six months ended June 30, 2012. Cost of goods sold is primarily made up of the following expenses for the six months ended June 30, 2013: cost of goods of specialty, meat, game, cheese poultry and other sales categories in the amount of $6,110,335; and shipping expenses in the amount of $1,705,117. The cost of goods sold increase is mainly associated with the increase in sales. Total gross margin improved to 27% of sales in 2013, compared to 24% of sales in 2012.

In 2013, we continued to price our products in order to gain market share and increase the number of our end users. We were successful in both increasing sales and increasing market share. We currently expect, if market conditions and our product revenue mix remain constant, that our cost of goods sold will either remain stable or likely improve slightly.

Selling, general and administrative expenses

Selling, general, and administrative expenses increased by $580,963 or approximately 33% to $2,408,957 during the six months ended June 30, 2013 compared to $1,781,809 for the six months ended June 30, 2012. Selling, general and administrative expenses were primarily made up of the following for the six months ended Jun 30, 2013: payroll and related expenses, including employee benefits, in the amount of $1,519,705; facilities expense in the amount of $235,524; amortization and depreciation in the amount of $127,685; insurance expense in the amount of $117,963; consulting and professional fees in the amount of $102,712; bad debt expense in the amount of $87,918; computer support expenses in the amount of $52,129; banking and credit card fees in the amount of $45,581; travel and

entertainment expenses in the amount of $42,634; share based compensation in the amount of $35,662; and advertising expense in the amount of $8,738. The increase in selling, general, and administrative expenses was primarily due to increases in volume, and the acquisition of Artisan Specialty Foods which has higher selling general and administrative expenses than Innovative Food Holdings' historical levels. We expect our selling, general, and administrative expenses to remain steady or slightly decrease in 2013.

Interest expense

Interest expense, net of interest income, increased by $615,806 or approximately 624% to $714,557 during the six months ended June 30, 2013, compared to $98,751 during the six months ended June 30, 2012. Approximately 11% or $76,894 of the interest expense was accrued or paid interest on the company's notes payable; approximately 89% or $637,663 of the interest was associated with the amortization of the discounts on the Company's notes payable.

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Loss from change in fair value of warrant liability

On December 27, 2012, the Company entered into the 2012 Notes Payable Extension Agreement, which affected the terms of certain of its convertible notes payable. Under accounting guidance provided by FASB ASC 815-40-05, this resulted in a change in accounting method for the Company's warrants from derivative accounting to equity accounting. Accordingly, the Company did not revalue these instruments at June 30, 2013. The Company revalued these instruments at June 30, 2012 using the Black-Scholes valuation method. This revaluation resulted in a loss of $269,177 which the Company included in operations during the six months ended June 30, 2012. There was no such comparable gain or loss during the current period.

Gain and loss from change in fair value of conversion option liability

On December 27, 2012, the Company entered into the 2012 Notes Payable Extension Agreement which affected the terms of certain of its convertible notes payable. Under accounting guidance provided by FASB ASC 815-40-05, this resulted in a change in accounting method for the Company's conversion options from derivative accounting to equity accounting. Accordingly, the Company did not revalue these instruments at June 30, 2013. The Company revalued these instruments at June 30, 2012 using the Black-Scholes valuation method. This revaluation resulted in a loss of $468,004, which the Company included in operations during the six months ended June 30, 2012. There was no such comparable gain or loss during the current period.

Cost of warrant extension

During the six months ended June 30, 2012, the Company extended the term of warrants to purchase 5,440,000 shares of common stock from April 3, 2012 to April 3, 2015. The fair value of this extension of $842,100 was charged to operations during the six months ended June 30, 2012. There was no comparable transaction during the six months ended June 30, 2013.

Net Income (loss)

For the reasons above, the Company had a net loss for the six months ended June 30, 2013 of $62,634 a decrease of $1,531,625 compared to a net loss of $1,594,259 during the six months ended June 30, 2012.

Liquidity and Capital Resources

As of June 30, 2013, the Company had current assets of $2,751,092 consisting of cash of $970,439, trade accounts receivable of $1,073,465, inventory of $692,605, and other current assets of $14,583. Also at June 30, 2013, the Company had current liabilities of $2,922,522, consisting of accounts payable and accrued liabilities of $1,423,751 (of which $103,217 is payable to related parties); accrued interest of $771,494 (of which $44,251 is payable to related parties: current portion of notes payable, net of discounts, of $579,277; current portion of notes payable – related parties, net of discounts of $110,500; and a contingent purchase price liability of $37,500.

During the six months ended June 30, 2013, the Company generated cash from operating activities in the amount of $169,724. This consisted of the Company's net loss of $(62,634), offset by non-cash charges for the amortization of discount on notes payable of $637,665; depreciation and amortization of $127,686; and non-cash compensation in the amount of $35,662. The Company's cash position was also reduced by $568,655 as a result of changes in the components of current assets and current liabilities as well as a result of the payment of bonuses owed for 2012. The acquisition of Artisan had an effect on the components of the Company's working capital. The following amounts were associated with Artisan at June 30, 2013: cash of $95,041; accounts receivable of $581,679; inventory of $616,048; other current assets of $8,333; accounts payable and accrued liabilities of $419,295; and current portion of

lease payable of $12,084.

The Company had cash used by investing activities of $309,676 for the six months ended June 30, 2013, which consisted of cash paid for the acquisition of land, building, and related furniture and fixtures. The Company had cash used by financing activities of $236,638 for the six months ended June 30, 2013, which consisted of principal payments on notes payable of $230,998 and principal payments on notes payable to a related party of $5,640.

The Company had net working deficit of $171,430 as of June 30, 2013. We have generated positive cash flow from operations during the years ended December 31, 2012 and 2011. In addition, the Company's auditors removed the going concern qualification to the audit opinion on the Company's financial statements for the year ended December 31, 2012. The Company intends to continue to focus on increasing market share and cash flow from operations by focusing its sales activities on specific market segments and new product lines. Currently, we do not have any material long-term obligations other than those described in Note 10 to the financial statements included in this report. As we seek to increase our sales of perishables, as well as identify new and other consumer and food service oriented products and services, we may use existing cash reserves, long-term financing, or other means to finance such diversification.

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If the Company's cash flow from operations is insufficient, the Company may require additional financing in order to execute its operating plan and continue as a going concern. The Company cannot predict whether this additional financing will be in the form of equity or debt, or be in another form. The Company may not be able to obtain the necessary additional capital on a timely basis, on acceptable terms, or at all. The Company expects that any sale of additional equity securities or convertible debt will result in additional dilution to our stockholders.

In any of these events, the Company may be unable to implement its current plans for expansion, repay its debt obligations as they become due or respond to competitive pressures, any of which circumstances would have a material adverse effect on its business, prospects, financial condition and results of operations. The Company has not made any adjustments to the financial statements which would be necessary should the Company not be able to continue as a going concern.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues, or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

Inflation

In the opinion of management, inflation has not had a material effect on the Company's financial condition or results of its operations.

RISK FACTORS

The Company's business and success is subject to numerous risk factors as detailed in its Annual Report on Form 10-K for the year ended December 31, 2012 which is available at no cost at www.sec.gov.

ITEM 4 - CONTROLS AND PROCEDURES

Disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit pursuant to the requirements of the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, among other things, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file under the Exchange Act is accumulated and communicated to our management, including our principal executive and financial officers, as appropriate, to allow timely decisions regarding required disclosure.

(a) Evaluation of disclosure controls and procedures

Our Principal Executive Officer and Principal Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this Quarterly Report, have concluded that as of that date, our disclosure controls and procedures were adequate and effective to ensure that information required to be disclosed by us in the reports we file or submit with the Securities and Exchange Commission is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. The conclusions notwithstanding, you are advised that no system is foolproof.

(b) Changes in internal control over financial reporting

There were no changes in our internal control over financial reporting identified in connection with the evaluation required by Exchange Act Rules 13a-15(d) and 15d-15 that occurred during the period covered by this Quarterly Report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

None.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

31.1 Section 302 Certification

31.2 Section 302 Certification

32.1 Section 906 Certification

32.2 Section 906 Certification

101.INS* XBRL Instance Document

101.SCH* XBRL Taxonomy Extension Schema

101.CAL* XBRL Taxonomy Extension Calculation Linkbase

101.DEF* XBRL Taxonomy Extension Definition Linkbase

101.LAB* XBRL Taxonomy Extension Label Linkbase

101.PRE* XBRL Taxonomy Extension Presentation Linkbase

* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability.

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SIGNATURES

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

SIGNATURE	TITLE	DATE
/s/Sam Klepfish Sam Klepfish	Chief Executive Officer	August 14, 2013
/s/ John McDonald John McDonald	Principal Financial Officer	August 14, 2013

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