MAJESCO ENTERTAINMENT CO
Form 10-Q/A
February 01, 2007

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

FORM 10-Q/A

(Amendment No. 1)

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

For the quarterly period ended July 31, 2006 | Commission File No. 000-51128

Majesco Entertainment Company

(Exact name of registrant as specified in its charter)

DELAWARE	606-1529524
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

160 Raritan Center Parkway, Edison, NJ 08837
(Address of principal executive offices)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (732) 225-8910

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark 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 period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of ''accelerated filer and large accelerated filer'' in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

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

Yes No

As of January 30, 2007, there were 23,445,219 shares of the Registrant's common stock outstanding.

MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY
July 31, 2006 QUARTERLY REPORT ON FORM 10-Q
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EXPLANATORY NOTE

Majesco Entertainment Company hereby files this Amendment No. 1 to its Quarterly Report on Form 10-Q for the quarterly period ended July 31, 2006, solely to reclassify certain customer allowances in its Condensed Consolidated Statement of Operations in accordance with EITF 01-9 ''Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendors Products)''.

The impact of the adjustment was to: reduce net revenues and gross profit by $267 and $3,092 (in thousands) for the three and nine months ended July 31, 2006, respectively; and decrease sales and marketing expenses and total expenses by $267 and $3,092 (in thousands) for the three and nine months ended July 31, 2006, respectively.

The reclassifications have no impact on operating loss, net loss, or net loss attributable to common shareholders per share for the period reported. The Company has reflected the reclassification in the annual and quarterly results contained in its annual financial statements filed on Form 10-K on January 29, 2007.

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SIGNATURES

CERTIFICATIONS

MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEET (RESTATED)
(in thousands, except share amounts)

	July 31, 2006 (unaudited)	October 31, 2005
ASSETS		
Current assets		
Cash and cash equivalents	$ 3,612	$ 2,407
Due from factor	618	—
Other receivables	642	—
Income taxes receivable	551	826
Inventory — principally finished goods	3,689	8,058
Capitalized software development costs and prepaid license fees	4,056	17,278
Prepaid expenses	558	508
Total current assets	13,726	29,077
Property and equipment — net	758	862
Other assets	71	142
Total assets	$ 14,555	$ 30,081
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued expenses	$ 10,539	$ 18,493
Inventory financing payable	208	—
Due to factor	—	6,343
Advances from customers	307	484
Total current liabilities	11,054	25,320
Stockholders' equity:		
Common stock — $.001 par value; 250,000,000 shares authorized; 22,408,410 and 22,242,476 issued and outstanding at July 31, 2006 and October 31, 2005, respectively	22	22
Additional paid in capital	93,303	92,158
Accumulated deficit	(89,859)	(87,388)
Accumulated other comprehensive income (loss)	35	(31)
Total stockholders' equity	3,501	4,761
Total liabilities and stockholders' equity	$ 14,555	$ 30,081

See accompanying notes

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MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS (RESTATED)
(in thousands, except share amounts)

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2006	2005	2006	2005
	(Note 1A)		(Note 1A)	
	(unaudited)			
Net revenues	$ 12,363	$ 4,565	$ 45,186	$ 55,139
Cost of sales				
Product costs	5,461	5,002	20,550	30,358
Software development costs and license fees	2,784	15,748	9,056	21,587
	8,245	20,750	29,606	51,945
Gross profit (loss)	4,118	(16,185)	15,580	3,194
Operating expenses				
Research and development	556	721	1,953	2,517
Selling and marketing	2,159	8,479	8,484	17,594
General and administrative	3,061	3,822	8,021	8,922
(Gain) loss from settlement of liabilities and other	(1,410)	1,439	(4,507)	1,439
Loss on impairment of software development costs	—	6,115	2,375	6,115
Severance	—	1,360	—	1,360
Write-off of accounts receivable	—	322	—	322
Depreciation and amortization	84	188	347	765
	4,450	22,446	16,673	39,034
Operating loss	(332)	(38,631)	(1,093)	(35,840)
Other costs and expenses				
Interest expense and financing costs, net	392	241	1,378	1,502
Loss on foreign exchange contract	—	—	—	48
Loss before income taxes	(724)	(38,872)	(2,471)	(37,390)
Benefit for income taxes	—	(1,329)	—	(736)
Net loss	(724)	(37,543)	(2,471)	(36,654)
Fair value charge for warrants exercised at a discount	—	—	—	1,100
Net loss attributable to common stockholders	$ (724)	$ (37,543)	$ (2,471)	$ (37,754)
Net income (loss) attributable to common stockholders per share:				
Basic	$ (.03)	$ (1.69)	$ (.11)	$ (1.87)
Diluted	$ (.03)	$ (1.69)	$ (.11)	$ (1.87)
Weighted average shares outstanding				
Basic	22,408,410	22,231,075	22,345,021	20,162,747
Diluted	22,408,410	22,231,075	22,345,021	20,162,747

See accompanying notes

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MAJESCO ENTERTAINMENT COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS
(dollars in thousands)

	Nine Months Ended July 31,	
CASH FLOWS FROM OPERATING ACTIVITIES	2006	2005
	(unaudited)	
Net loss	$ (2,471)	$ (36,654)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities		
Depreciation and amortization	347	765
Impairment of software development costs	2,375	6,115
Non-cash compensation expense	1,020	1,341
Loss (gain) on settlement of liabilities and other gains	(4,507)	1,439
Write-off of accounts receivable.		322
Amortization of software development costs and prepaid license fees.	9,056	13,992
Changes in operating assets and liabilities		
Decrease (increase) in due from factor — net	(6,961)	8,333
Increase in other receivables	(642)	—
Decrease (increase) in inventory	4,369	(9)
Decrease (increase) in capitalized software development costs and prepaid license fees	1,791	(36,200)
Decrease in income tax receivable	275	—
Increase in prepaid expenses and other	(50)	(2,959)
Decrease in other assets	9	126
(Decrease) in accounts payable and accrued expenses.	(3,321)	(3,643)
Decrease in advances from customers	(177)	(589)
Net cash provided by (used in) operating activities	1,113	(47,621)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property and equipment	(182)	(349)
Net cash used in investing activities	(182)	(349)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net proceeds from secondary offering	—	41,898
Net proceeds from exercise of warrants at discount	—	6,482
Net proceeds from exercise of warrants	—	12,108
Inventory financing	208	(6,536)
Net cash provided by investing activities	208	53,952
Effect of exchange rates on cash and cash equivalents	66	127
Net increase in cash	1,205	6,109
Cash and cash equivalents — beginning of period	2,407	4,170
Cash and cash equivalents — end of period	$ 3,612	$ 10,279

SUPPLEMENTAL SCHEDULE OF NON CASH INVESTING AND FINANCING ACTIVITIES		
Fair value charge for warrants exercised at discount	—	$ 1,100

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CASH FLOWS FROM OPERATING ACTIVITIES	Nine Months Ended July 31, 2006	2005
	(unaudited)	
Issuance of common stock as a dividend on the preferred stock	—	$ 1,261
Accounts payable settled through the issuance of common stock	$ 125	—

See accompanying notes

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1. PRINCIPAL BUSINESS ACTIVITY AND BASIS OF PRESENTATION

Majesco Entertainment Company and subsidiary (‘‘Majesco’’ or ‘‘Company’’) is a provider of interactive entertainment products. The Company’s offerings include video game software and other digital entertainment products.

Majesco’s products provide it with opportunities to capitalize on the large and growing installed base of interactive entertainment platforms and an increasing number of interactive entertainment enthusiasts. The Company sells its products directly and through resellers primarily to U.S. retail chains, including Best Buy, GameStop/Electronics Boutique, Circuit City, Target, Toys ‘‘R’’ Us and Wal-Mart. Majesco also sells products internationally through partnerships with international publishers. The Company has developed retail and distribution network relationships over its more than 20-year history.

Majesco provides offerings for most major interactive entertainment hardware platforms, including Nintendo’s Game Boy Advance, or GBA, DS, Micro and GameCube, Sony’s PlayStation 2, or PS2, and PlayStation Portable, or PSP, Microsoft’s Xbox and the personal computer, or PC.

The Company’s offerings include video game software and other digital entertainment products. The Company’s operations involve similar products and customers worldwide. The products are developed and sold domestically and internationally. The Company is centrally managed and the chief operating decision makers, the chief executive and other officers, use consolidated financial information supplemented by sales information by product category, major product title and platform for making operational decisions and assessing financial performance. Accordingly, the Company operates in a single segment. Sales for the Company in the United States were $11.1 million or 88% and $39.7 million or 82% for the three and nine month periods ended July 31, 2006, respectively. Sales in Europe were $1.5 million or 12% and $8.5 million or 18% for the three and nine month periods ended July 31, 2006, respectively. During the same periods last year, there were no material sales in Europe.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. The Company has suffered losses that raise substantial doubt about its ability to continue as a going concern. Management's plan in regard to these matters is also described below. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As of July 31, 2006, assuming continued availability of funding at previous levels by the current factor or alternative sources, management believes that there will be sufficient capital resources from operations and financing arrangements for the next twelve months in order to meet our requirements for: development, production, marketing, purchases of equipment, and the acquisition of intellectual property rights for future products.

However, in the event that the Company is unable to generate the level of operating revenues in the business plan, the Company will be required to reduce operating expenditures or obtain additional sources of financing. There can be no assurance that additional sources of financing will be available on acceptable terms, if at all. If no additional sources of financing are available, it could create a material adverse effect on future operating prospects.

The accompanying interim consolidated financial statements of the Company are unaudited, but in the opinion of management, reflect all adjustments, consisting of normal recurring accruals, necessary for a fair presentation of the results for the interim period. Accordingly, they do not include all information and notes required by generally accepted accounting principles for complete financial statements. The results of operations for interim periods are not necessarily indicative of results to be expected for the entire fiscal year or any other period. The balance sheet at October 31, 2005 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. These interim consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and notes for the year ended October 31, 2005 filed on Form 10-K on February 1, 2006.

The statements contained in this Report on Form 10-Q, that are not purely historical, are forward-looking information and statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These include statements regarding our expectations, intentions, or strategies regarding future matters. All forward-looking statements included in this document are based on information available to us on the date hereof. It is important to note that our actual result could differ materially from those projected in such forward-looking statements contained in this Form 10-Q. The forward-looking statements contained herein are based on current expectations that involve numerous risks and uncertainties. Assumptions relating to the foregoing involve judgments regarding among other things, our ability to secure financing or investment for capital expenditures, future economic and competitive market conditions, and future business decisions. All these matters are difficult or impossible to predict accurately, many of which may be beyond our control. Although we believe that the assumptions underlying our forward-looking statements are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this Form 10-Q will prove to be accurate.

NOTE 1A – RESTATEMENT

As a result of a review of customer allowances issued during the year ended October 31, 2006, the company reclassified certain customer allowances in accordance with EITF 01-9 ‘‘Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendors Products)’’.

The impact of the adjustment was to reduce net revenues and gross profit and decrease sales and marketing expenses reported for the quarter ended July 31, 2006.

The reclassifications have no impact on operating loss, net loss, or net loss attributable to common shareholders per share for the period reported. The adjustment has no impact on the financial statements contained in its annual report filed on Form 10-K on January 29, 2007.

The table below summarizes the impact on operating results for the three and nine months ended July 31, 2006.

	Three Months Ended July 31, 2006			Nine Months Ended July 31, 2006		
	As Previously Reported	As Restated	difference	As Previously Reported	As Restated	difference
Net revenues	$ 12,630	$ 12,363	$ 267	$ 48,278	$ 45,186	$ 3,092
Gross profit	$ 4,385	$ 4,118	$ 267	$ 18,672	$ 15,580	$ 3,092
Selling and marketing	$ 2,426	$ 2,159	$ 267	$ 11,576	$ 8,484	$ 3,092
Total operating expense	$ 4,717	$ 4,450	$ 267	$ 19,765	$ 16,673	$ 3,092
Operating loss	$ (332)	$ (332)	No change	$ (1,093)	$ (1,093)	No change
Net loss	$ (724)	$ (724)	No change	$ (2,471)	$ (2,471)	No change

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Stock Based Compensation. In December 2004, the Financial Accounting Standards Board (‘‘FASB’’) issued Statement of Financial Accounting Standards No. 123 (R) (revised 2004), ‘‘Share-Based Payment’’ which revised Statement of Financial Accounting Standards No. 123, ‘‘Accounting for Stock-Based Compensation’’. This statement supersedes Opinion No. 25, ‘‘Accounting for Stock Issued to Employees.’’ The revised statement addresses the accounting for share-based payment transactions with employees and other third parties, eliminates the ability to account for share-based compensation transactions using APB 25 and requires that the compensation costs relating to such transactions be recognized in the statement of operations. The revised statement has been implemented by the Company effective November 1, 2005.

The implementation of FAS No. 123 (R) has resulted in charges of $404,000 and $858,000 for three and nine-month periods ended July 31, 2006, respectively

There is no impact on the basic or diluted earnings per share reported on the statement of operations. For the 2005 fiscal year the Company accounted for its employee incentive stock option

plans using the intrinsic value method in accordance with the recognition and measurement principles of Accounting Principles Board Opinion No. 25, ‘‘Accounting for Stock Issued to Employees.’’ Had the Company determined compensation expenses based on the fair value at the grant dates for those awards consistent with the method of SFAS 123, the Company’s net (loss) per share would have increased to the following pro forma amounts:

(in thousands, except per share amounts)	Three Months Ended July 31, 2005	Nine Months Ended July 31, 2005
Net income (loss) — as reported	$ (37,543)	$ (36,654)
Add: total stock based employee compensation expense determined under intrinsic value based methods for all awards	124	682
Less: stock based employee compensation determined under fair value based method net of income tax effect	(419)	(1,463)
Net income (loss) — pro forma	$ (37,838)	$ (37,435)
Net income (loss) attributable to common stockholders per share:		
Basic and diluted net loss per share as reported	$ (1.69)	$ (1.87)
Pro forma basic and diluted basic loss per share	$ (1.70)	$ (1.91)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	July 31, 2006	July 31, 2005
Risk free annual interest rate	4.30%	2.71% to 3.85%
Expected volatility	90%	30% to 90%
Expected life	5 years	5 years
Assumed dividends	None	None

Effective November 1, 2005, the Company adopted FAS No. 123 (R) utilizing the modified prospective method. FAS No. 123 (R) requires the recognition of stock-based compensation expense in the financial statements.

Under the modified prospective method, the provisions of FAS No. 123 (R) apply to all awards granted or modified after the date of adoption. In addition, the unrecognized expense of awards not yet vested at the date of adoption, determined under the original provisions of FAS 123, ''Accounting for Stock Based Compensation'', shall be recognized in net earnings in the periods after the date of adoption. Stock based compensation consists primarily of stock options. Stock options are granted to employees at exercise prices equal to the fair market value of the Company's stock at the dates of grant. Stock options generally vest over three years and have a term of seven years. Compensation expense for stock options is recognized on a straight line basis over the period for each separately vesting stock option award.

The fair value for options issued was estimated at the date of grant using a Black-Scholes option-pricing model. The risk free rate was derived from the U.S. Treasury yield curve in effect at the time of the grant. The volatility factor was determined based on a study done by an independent securities valuation firm. The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option-pricing models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

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A summary of the status of the Company's options for the nine months ended July 31, 2006 is as follows:

	Shares	Weighted Average Exercise Price	Remaining Life	Aggregate Intrinsic Value
Balance at beginning of period	1,820,550	$ 8.45	6.4	–
Granted	215,000	$ 1.47	6.3	–
Cancelled or Expired	(585,256)	$ 7.30	5.7	–
Exercised	–	–	–	–
Outstanding at end of period	1,450,294	$ 6.44	5.7	–
Exercisable at end of period	482,360	$ 8.74	5.4	–

A summary of the status of the Company's nonvested shares as of July 31, 2006, and changes during the nine months ended July 31, 2006 is presented below:

	Number of Shares	Weighted-Average Fair Value at Grant Date	Weighted-Average Remaining Contractual Term (in years)
Non-vested shares at October 31, 2005	1,581,260	$ 4.51	6.4
Options granted	215,000	$ 1.07	6.3
Options vested	(317,969)	$ 2.83	5.6
Options forfeited or expired	(510,357)	$ 3.78	5.7
Non-vested shares at July 31, 2006	967,934	$ 3.01	5.8

As of July 31, 2006, there was approximately $2.9 million of unrecognized compensation cost related to non-vested stock option awards, which is expected to be recognized over a remaining weighted-average vesting period of 1.7 years.

Estimates.   The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities or the disclosure of gain or loss contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Among the more significant estimates included in these financial statements are the estimated customer allowances, the valuation of inventory and the recoverability of advance payments for software development costs and intellectual property licenses. Actual results could differ from those estimates.

Earnings/(Loss) per share. Basic earnings/(loss) per common share is computed by dividing the net loss applicable to common stockholders by the weighted-average number of shares of common stock outstanding for the period. Diluted and basic earnings/(loss) per common share for the three month period ended July 31, 2006, and the nine month periods ended July 31, 2006 and 2005 are the same because the impact of the conversion or exercise, as applicable, of the warrants (2,070,687 at July 31, 2006 and 2005) and stock options (1,450,294 and 950,907 at July 31, 2006 and 2005, respectively) would be antdilutive.

Recent accounting pronouncements. In June 2006 the FASB issued interpretation No. 48, ''Accounting for Uncertainty in Income Taxes — an Interpretation of FASB Statement No. 109'' (''FIN 48''). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS No. 109, ''Accounting for Income Taxes.'' FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently reviewing this new standard to determine its effects, if any, on our results of operations or financial position.The Company does not believe that any other recently issued, but not yet effective accounting standards will have a material effect on the Company's consolidated financial position, results of operations or cash flows.

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3. DUE FROM FACTOR

Due from (to) factor consists of the following:

	July 31, 2006 (in thousands)	October 31, 2005 (in thousands)
Outstanding accounts receivable sold to factor	$ 7,313	$ 4,842
Less: allowance	(2,716)	(9,551)
Advances from factor	(3,979)	(1,634)
	$ 618	$ (6,343)

The following table sets forth the adjustments to the price protection and other customer sales incentive allowances included as a reduction of the amounts due from factor:

	Nine Months Ended July 31, (in thousands)	
	2006	2005
Balance — beginning of period	$ (9,551)	$ (4,860)
Add: provision	(2,231)	(12,711)
Less: amounts charged against allowance	9,066	6,773

Balance — end of period	$ (2,716)	$ (10,798)

4. OTHER RECEIVABLES

Other receivables consist of $0.5 million of legal fees due from insurance carriers and $0.1 of royalties receivables.

5. ACCOUNTS PAYABLE AND ACCRUED EXPENSES

Accounts payable and accrued expenses consist of the following (in thousands):

	July 31, 2006	October 31, 2005
Accounts payable — trade	$ 5,212	$ 9,563
Accrued expenses:		
Royalties — including accrued minimum guarantees	3,077	5,634
Salaries and other compensation	975	1,481
Sales commissions	209	467
Professional fees	496	311
Other accruals	570	1,037
	$ 10,539	$ 18,493

6. CONTINGENCIES AND COMMITMENTS

Commitments

At July 31, 2006, the Company had open letters of credit aggregating $1.7 million under the Company's purchase order assignment arrangements for inventory to be delivered during the subsequent quarter.

At July 31, 2006 the Company was committed under agreements with certain developers for future milestone and license fee payments aggregating $0.5 million, $0.2 million of which are payable through October 31, 2006. Milestone payments represent scheduled installments due to the Company's developers based upon the developers providing the Company certain deliverables, as predetermined in the Company's contracts. The milestone payments generally represent advances against royalties to the developers. These payments will be used to reduce future royalties due to the developers from sales of the Company's videogames.

The Company has entered into ''at will'' employment agreements with certain key executives. These employment agreements include provisions for, among other things, annual compensation, bonus arrangements and stock option grants. These agreements also contain provisions related to severance terms and change of control provisions.

Contingencies

In July 2006 the Company finalized and adopted an employee incentive plan that provides for cash payments aggregating $0.8 million to $2.2 million if the Company achieves certain adjusted net income targets for the year ending October 31, 2006. The Company has accrued $0.4 million under the plan as of July 31, 2006.

On December 2, 2005, a vendor filed a complaint against the Company in the Supreme Court of the State of New York, County of New York, alleging breach of contract and failure to pay in connection with services rendered and seeking approximately $2.6 million in damages and costs, including attorney's fees. On May 31, 2006 the Company entered into a settlement agreement with the vendor settling all claims relating to the action. Under the terms of the settlement agreement, the Company agreed to pay the vendor a total of $750 thousand as follows: $200 thousand upon execution of the settlement agreement, $175 thousand thirty days thereafter, and $375 thousand sixty days thereafter, in full settlement of all claims and liabilities between the parties relating to this action. The Company also agreed to indemnify and hold harmless the vendor for certain claims relating to the services performed by the vendor on our behalf. All payments have been made to the vendor under the settlement agreement.

On November 16, 2005, one of the Company's service providers instituted legal proceedings against the Company for $1.9 million in the United States District Court for the Central District of California alleging breach of contract. The Company believes that the claims are without merit and intends to vigorously defend this action.

In July 2005, four purported class action complaints were filed against the Company and several current and former directors and officers of the Company in the United States District Court for the District of New Jersey. On September 12, 2005, a fifth purported class action complaint was filed in the same court on behalf of a class of individuals who purchased shares of the Company common stock in the Company's January 26, 2005 offering of six million shares of common stock (the ''Offering''). The complaint named as defendants the Company, current and former officers of the Company, and certain financial institutions who served as underwriters with respect to the Offering.

On October 11, 2005, the Court consolidated the five cases and appointed a Lead Plaintiff. On December 14, 2005, the Lead Plaintiff filed an Amended Consolidated Complaint, which is now the operative Complaint. The Complaint names the following as defendants: the Company, Carl Yankowski, Jan E. Chason, Jesse Sutton, Joseph Sutton, Morris Sutton, Laurence Aronson, F. Peter Cuneo, James Halpin, Louis Lipschitz, Marc Weisman, RBC Capital Markets Corporation, JMP Securities LLC, Harris Nesbitt & Corp., Wedbush Morgan Securities Inc., and Goldstein Golub Kessler LLP.

The Complaint alleges that the Registration Statement and Prospectus filed with the SEC in connection with the Company's Offering and certain of the Company's press releases and other public filings contained material misstatements and omissions about the Company's financial condition and prospects as well as its products. The lead Plaintiff asserts a claim under Section 11 of the Securities Act against all the defendants on behalf of investors who purchased in the Offering. It asserts a Section 12(a)(2) claim against the Company and the financial institutions who served as underwriters in connection with the Offering, and a Section 15 control person claim against defendants Carl Yankowski, Jan Chason, Jesse Sutton, Joseph Sutton, and Morris Sutton (the ''Defendants''). Lead Plaintiff also asserts a claim under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated there under against the Company and the Defendants and a claim under Section 20(a) of the Exchange Act against the Defendants. The Complaint seeks damages in an unspecified amount. The proposed class period for the Exchange Act claims is December 8, 2004 through September 12, 2005. We will vigorously contest the action.

The Company is party to other routine claims and suits brought by the Company and against the Company in the ordinary course of business, including disputes arising over contractual claims and collection matters. In the opinion of management, after consultation with legal counsel, the outcome of such routine claims will not have a material adverse effect on the Company's business, financial condition, and results of operations or liquidity. However, the costs and other effects of pending or future litigation, governmental investigations, legal and administrative cases and proceedings (whether civil or criminal), settlements, judgments and investigations, claims and changes in those matters (including the matters described above), and developments or assertions by or against the Company relating to intellectual property rights and intellectual property licenses, could have a material adverse effect on the Company's business, financial condition, and results of operations or liquidity.

7. RELATED PARTIES

The Company receives printing and packaging services from a business of which the brother of Morris Sutton, the Company's Chairman Emeritus, is a principal. During the three and nine month periods ended July 31, 2006 the Company was charged $0.2 million and $1.0 million compared to $0.4 million and $2.1 million for the three and nine month periods ended July 31, 2005. These charges are included in product costs in the accompanying consolidated statement of operations. Such charges are, to the Company's knowledge, on terms no less favorable to what the Company could receive from providers of similar services.