INSIGNIA SYSTEMS INC/MN
Form 10-Q
August 11, 2006
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

for the quarterly period ended June 30, 2006

or

o 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: 1-13471

INSIGNIA SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Minnesota	**41-1656308**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

6470 Sycamore Court North

Maple Grove, MN 55369

(Address of principal executive offices)

(763) 392-6200

(Registrant s telephone number, including area code)

Not applicable.

(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. x Yes o 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 o Accelerated filer o Non-accelerated filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). o Yes x No

Number of shares outstanding of Common Stock, $.01 par value, as of July 31, 2006, was 15,100,646.

Insignia Systems, Inc.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements
Insignia Systems, Inc.

BALANCE SHEETS

(Unaudited)

	June 30, 2006	December 31, 2005
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 3,091,000	$ 2,711,000
Accounts receivable, net	2,987,000	2,294,000
Inventories	481,000	448,000
Prepaid expenses and other	859,000	811,000
Total Current Assets	7,418,000	6,264,000
Property and Equipment:		
Production tooling, machinery and equipment	1,765,000	1,657,000
Office furniture and fixtures	191,000	191,000
Computer equipment and software	575,000	564,000
Leasehold improvements	330,000	327,000
	2,861,000	2,739,000
Accumulated depreciation and amortization	(2,425,000)	(2,330,000)
Net Property and Equipment	436,000	409,000
Total Assets	$ 7,854,000	$ 6,673,000
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities:		
Line of credit	$ 166,000	$ 132,000
Current maturities of long-term liabilities	229,000	201,000
Accounts payable	1,340,000	1,770,000
Accrued liabilities		
Compensation	495,000	496,000
Employee stock purchase plan	49,000	35,000
Legal	70,000	92,000
Retailer guarantees		271,000
Other	111,000	63,000
Deferred revenue	739,000	612,000
Total Current Liabilities	3,199,000	3,672,000
Long-Term Liabilities, less current maturities	811,000	929,000
Shareholders Equity:		
Common stock, par value $.01;		
Authorized shares 40,000,000 at June 30, 2006		

	June 30, 2006	December 31, 2005
and 20,000,000 at December 31, 2005		
Issued and outstanding shares 15,059,000 at June 30, 2006 and 15,002,000 at December 31, 2005	151,000	150,000
Additional paid-in capital	29,348,000	29,165,000
Accumulated deficit	(25,655,000)	(27,243,000)
Total Shareholders Equity	3,844,000	2,072,000
Total Liabilities and Shareholders Equity	$ 7,854,000	$ 6,673,000

See accompanying notes to financial statements.

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Insignia Systems, Inc.

STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended June 30		Six Months Ended June 30	
	2006	2005	2006	2005
Services revenues	$ 5,122,000	$ 4,641,000	$ 9,842,000	$ 8,778,000
Products sold	731,000	755,000	1,433,000	1,590,000
Total Net Sales	5,853,000	5,396,000	11,275,000	10,368,000
Cost of services	2,205,000	2,869,000	4,247,000	5,686,000
Cost of goods sold	416,000	419,000	822,000	842,000
Total Cost of Sales	2,621,000	3,288,000	5,069,000	6,528,000
Gross Profit	3,232,000	2,108,000	6,206,000	3,840,000
Operating Expenses:				
Selling	1,224,000	1,438,000	2,441,000	2,878,000
Marketing	241,000	332,000	489,000	665,000
General and administrative	902,000	851,000	1,751,000	1,876,000
Total Operating Expenses	2,367,000	2,621,000	4,681,000	5,419,000
Operating Income (Loss)	865,000	(513,000)	1,525,000	(1,579,000)
Other Income (Expense):				

	Three Months Ended June 30		Six Months Ended June 30	
Interest income	23,000	16,000	44,000	37,000
Interest expense	(39,000)	(12,000)	(81,000)	(24,000)
Other income	100,000	1,000	100,000	1,000
Total Other Income (Expense)	84,000	5,000	63,000	14,000
Net Income (Loss)	$ 949,000	$ (508,000)	$ 1,588,000	$ (1,565,000)
Net income (loss) per share:				
Basic	$ 0.06	$ (0.03)	$ 0.10	$ (0.10)
Diluted	$ 0.06	$ (0.03)	$ 0.10	$ (0.10)
Shares used in calculation of net income (loss) per share:				
Basic	15,059,000	15,002,000	15,059,000	15,002,000
Diluted	15,203,000	15,002,000	15,167,000	15,002,000

See accompanying notes to financial statements.

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Insignia Systems, Inc.

STATEMENTS OF CASH FLOWS

(Unaudited)

Six Months ended June 30	**2006**	**2005**
Operating Activities:		
Net income (loss)	$ 1,588,000	$ (1,565,000)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	100,000	124,000
Stock-based compensation	151,000	
Changes in operating assets and liabilities:		
Accounts receivable	(693,000)	(902,000)
Inventories	(33,000)	(3,000)
Prepaid expenses and other	(48,000)	(383,000)
Accounts payable	(430,000)	(137,000)
Accrued liabilities	(232,000)	(545,000)
Deferred revenue	127,000	50,000
Net cash provided by (used in) operating activities	530,000	(3,361,000)

Six Months ended June 30	2006	2005
Investing Activities:		
Purchases of property and equipment	(127,000)	(81,000)
Net cash used in investing activities	(127,000)	(81,000)
Financing Activities:		
Net change in line of credit	34,000	4,000
Payment of long-term liabilities	(90,000)	
Proceeds from issuance of common stock, net	33,000	52,000
Net cash provided by (used in) financing activities	(23,000)	56,000
Increase (decrease) in cash and cash equivalents	380,000	(3,386,000)
Cash and cash equivalents at beginning of period	2,711,000	6,156,000
Cash and cash equivalents at end of period	$ 3,091,000	$ 2,770,000
Supplemental disclosures for cash flow information:		
Cash paid during periods for interest	$ 51,000	$ 16,000

See accompanying notes to financial statements.

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Insignia Systems, Inc.

NOTES TO FINANCIAL STATEMENTS

(Unaudited)

1. **Summary of Significant Accounting Policies.**

Description of Business. Insignia Systems, Inc. (the Company) markets in-store advertising programs, services and products to retailers and consumer packaged goods manufacturers. The Company s services and products include the Insignia Point-of-Purchase Services (POPS) in-store advertising program, thermal sign card supplies for the Company s SIGNright and Impulse systems, Stylus software and laser printable cardstock and label supplies.

Basis of Presentation. Financial statements for the interim periods included herein are unaudited; however, they contain all adjustments, including normal recurring accruals, which in the opinion of management, are necessary to present fairly the financial position of the Company at June 30, 2006, and its results of operations and cash flows for the three and six months ended June 30, 2006 and 2005. Results of operations for the periods presented are not necessarily indicative of the results to be expected for the full year.

The financial statements do not include certain footnote disclosures and financial information normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America and, therefore, should be read in conjunction with the financial statements and notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

The Summary of Significant Accounting Policies in the Company s 2005 Annual Report on Form

10-K describes the Company s accounting policies.

Inventories. Inventories are primarily comprised of parts and supplies for Impulse and SIGNright machines, sign cards, and rollstock. Inventory is valued at the lower of cost or market using the first-in, first-out (FIFO) method, and consists of the following:

	June 30, 2006	December 31, 2005
Raw materials	$ 178,000	$ 164,000
Work-in-process	25,000	14,000
Finished goods	278,000	270,000
	$ 481,000	$ 448,000

Stock-Based Compensation. The Company has various types of stock-based compensation plans. These plans are administered by the Compensation Committee of the Board of Directors, which selects persons to receive awards and determines the number of shares subject to each award and the terms, conditions, performance measures and other provisions of the award. Readers should refer to Notes 1 and 6 of the Company s Financial Statements on Form 10-K for the year ended December 31, 2005, for additional information related to these stock-based compensation plans.

Effective January 1, 2006 the Company adopted Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (SFAS 123R), which requires companies to measure and recognize compensation expense for all stock-based payments at fair value. SFAS 123R is being applied on the modified prospective basis. Prior to the adoption of SFAS 123R, the Company accounted for its stock-based compensation plans under the intrinsic value method of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations, and accordingly, recognized no compensation expense related to the stock-based plans where the exercise price of options granted equaled the market value of the underlying common stock on the date of grant.

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Under the modified prospective approach, SFAS 123R applies to new awards and to awards that were outstanding on January 1, 2006 that are subsequently modified, repurchased or cancelled. Under the modified prospective approach, compensation cost recognized beginning in the first quarter of fiscal 2006 includes compensation cost for all share-based payments granted prior to, but not yet vested on January 1, 2006, and compensation cost for all share based payments granted subsequent to January 1, 2006 based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Prior periods were not restated to reflect the impact of adopting the new standard.

As a result of adopting SFAS 123R on January 1, 2006, the net income for the three months and six months ended June 30, 2006 were $64,000 and $151,000 lower, and net income per share for the three months and six months ended June 30, 2006 were unchanged, than if the Company had continued to account for stock-based compensation under APB Opinion No. 25. No deferred tax benefits were recognized for these costs due to a valuation allowance which has been established due to uncertainties regarding the realization of deferred tax assets based on the Company s lack of historical earrnings.

The below table summarizes the stock-based compensation expense which was recognized in the Statements of Operations for the three months and six months ended June 30, 2006:

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Cost of sales	$ 14,000	$ 28,000
Selling	16,000	47,000
Marketing	8,000	15,000
General and administrative	26,000	61,000
	$ 64,000	$ 151,000

The following table illustrates the effect on net loss and net loss per share had the Company accounted for stock-based compensation in accordance with SFAS 123R for the three months and six months ended June 30, 2005:

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net loss, as reported	$ (508,000)	$ (1,565,000)
Deduct: Total stock-based employee compensation expense determined under fair value based methods for all awards	145,000	314,000
Pro forma net loss	$ (653,000)	$ (1,879,000)
Basic and diluted net loss per share:		
As reported	$ (0.03)	$ (0.10)
Pro forma	$ (0.05)	$ (0.13)

The Company uses the Black-Scholes option-pricing model to estimate fair value of stock-based awards with the following weighted average assumptions:

Six Months Ended June 30	2006	2005
Stock Options:		
Expected life (years)	2.90	3.00
Expected volatility	62%	70%

Six Months Ended June 30	**2006**	**2005**
Dividend yield	0%	0%
Risk-free interest rate	4.96%	3.67%

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The expected terms of the options and employee stock purchase plan rights are based on evaluations of historical and expected future employee exercise behavior. The risk-free interest rate is based on the US Treasury rates at the date of grant with maturity dates approximately equal to the expected life at grant date. Volatility is based on historical and expected future volatility of the Company s stock. The Company has not historically issued any dividends and does not expect to in the future.

Stock option activity is summarized as follows:

	Plan Options Outstanding	**Exercise Price Range**	**Weighted Average Exercise Price Per Share**
Balance at December 31, 2005	1,859,329	$ 0.58 $ 11.36	$ 4.22
Granted	583,100	$ 0.84 $ 1.30	$ 1.14
Exercised			
Cancellations	(313,600)	$ 0.96 $ 8.25	$ 3.45
Balance at June 30, 2006	2,128,829	$ 0.58 $ 11.36	$ 3.49

The following table summarizes information about the stock options outstanding at June 30, 2006:

	Options Outstanding			**Options Exercisable**	
Ranges of Exercise Prices	**Number Outstanding**	**Weighted Average Remaining Contractual Life**	**Weighted Average Exercise Price Per Share**	**Number Exercisable at June 30, 2006**	**Weighted Average Exercise Price Per share**
$ 0.58 - $ 0.96	495,800	8.09 years	$ 0.88	193,528	$ 0.91
0.97 - 1.31	725,800	9.19 years	1.24	220,065	1.30
1.32 - 4.00	158,031	3.80 years	2.01	158,031	2.01
4.01 - 4.97	82,499	3.82 years	4.31	82,499	4.31
4.98 - 7.87	360,499	5.44 years	7.12	360,499	7.12
8.00 - 11.36	306,200	5.91 years	9.31	306,200	9.31
$ 0.58 - $11.36	2,128,829	7.22 years	$ 3.49	1,320,822	$ 4.96

Options outstanding under the Option Plans expire at various dates during the period September 2006 through June 2016.

As of June 30, 2006, there was $296,000 of total unrecognized compensation costs related to the outstanding stock options which is expected to be recognized over a weighted average period of 1.65 years.

At June 30, 2006, a total of 232,800 shares were available for grant under the stock option plans.

Net Income (Loss) Per Share. Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average shares outstanding and excludes any dilutive effects of options, warrants and convertible securities. Diluted net income per share gives effect to all diluted potential common shares outstanding during the period. Options and warrants to purchase approximately 1,962,000 and 1,748,000 shares of common stock with weighted average exercise prices of $3.98 and $4.91 were outstanding at June 30, 2006 and 2005 and were not included in the computation of common stock equivalents for the three months ended June 30, 2006 and 2005 because their exercise prices were higher than the average fair market value of the common shares during the reporting period. Options and warrants to purchase approximately 1,953,000 and 1,391,000 shares of common stock with weighted average exercise prices of $4.12 and $5.84 were outstanding at June 30, 2006 and 2005 and were not included in the computation of common stock equivalents for the six months ended June 30, 2006 and 2005 because their exercise prices were higher than the average fair market value of the common shares during the reporting period. For the three months and six months ended June 30, 2005, the effect of options and warrants was anti-dilutive due to the net loss incurred during the period. Had net income been achieved, approximately 211,000 and 413,000 of common stock equivalents would have been included in the computation of diluted net income per share.

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Weighted average common shares outstanding for the three and six months ended June 30, 2006 and 2005 were as follows:

	Three Months Ended June 30		**Six Months Ended June 30**	
	2006	**2005**	**2006**	**2005**
Denominator for basic net income (loss) per share weighted average shares	15,059,000	15,002,000	15,059,000	15,002,000
Effect of dilutive securities:				
Stock options and warrants	144,000		108,000	
Denominator for diluted net income (loss) per share adjusted weighted average shares	15,203,000	15,002,000	15,167,000	15,002,000

2. **Line of Credit.** On September 16, 2004, the Company entered into a Financing Agreement, Security Agreement and Revolving Note (collectively, the Credit Agreement) with Marquette Business Credit, Inc. that initially provided for borrowings up to $1,500,000 for twelve months, subject to collateral availability. The borrowings are secured by all of the Company s assets. The Credit Agreement provides that borrowings will bear interest at 2.5% over prime, with a minimum monthly interest charge of $2,500, and an annual fee of 1% of the Revolving Note payable. The Credit Agreement includes various other customary terms and conditions. On November 22, 2004 the Company entered into an amendment to the Credit Agreement to extend the term to April 30, 2006, and on May 8, 2006 the Company

entered into a second amendment to the Credit Agreement to extend the term to April 30, 2007. Borrowings of $166,000 were outstanding with an effective rate of 10.75% as of June 30, 2006.

3. **Commitments and Contingencies.**

Legal. In August 2000, News America Marketing In-Store, Inc. (News America), brought suit against the Company in U.S. District Court in New York, New York. The case was settled in November 2002. The terms of the settlement agreement are confidential. The settlement did not impact the Company s operating results.

In October 2003, News America brought suit against the Company in U.S. District Court in New York, New York, alleging that the Company has engaged in deceptive acts and practices, has interfered with existing business relationships with retailers and prospective economic advantage, and has engaged in unfair competition. The suit seeks unspecified damages and injunctive relief. The Company filed a motion to dismiss in February 2004. In June 2004 News America amended the suit against the Company and the Company filed an amended motion to dismiss in August 2004. The Company is awaiting decision by the Court. Discovery has been stayed in this action. If the Company is required to pay a significant amount in settlement or damages, it will have a material adverse effect on its operations and financial condition. In addition, a negative outcome of this litigation could affect long-term competitive aspects of the Company s business. Management believes the allegations are without merit and that the Company will prevail.

On September 23, 2004, the Company brought suit against News America, and Albertson s Inc. in Federal District Court in Minneapolis, Minnesota, for violations of federal and state antitrust and false advertising laws, alleging that News America has acquired and maintained monopoly power through various wrongful acts designed to harm the Company in the in-store advertising and promotion products and services market. The suit seeks injunctive relief sufficient to prevent further antitrust injury and an award of treble damages to be determined at trial for the harm caused to the Company. In August 2005 the Court dismissed the suit, but permitted the Company to file an amended complaint with more specific allegations regarding the illegal actions taken by the defendants. The Company filed the amended complaint on September 23, 2005 and News America and Albertson s Inc. refiled their motions to dismiss. The motions were heard on February 17, 2006 and on June 30, 2006 the Court denied the motions of News America and Albertson s to dismiss the suit.

Management currently expects the amount of legal fees that will be incurred in connection with the ongoing lawsuits to be significant throughout 2006. During the six months ended June 30, 2006, the Company incurred legal fees of $423,000 related to the News America litigation.

In September 2005, the Company brought a suit against Paul A. Richards and his company in Federal District Court in Minneapolis, Minnesota, alleging fraud and misrepresentation related to the 2002 VALUStix acquisition and asking that the acquisition be rescinded and all parties restored to their pre-acquisition status. The Company wrote off all of the goodwill associated with the acquisition in the fourth quarter of 2003 and the second quarter of 2004. The suit was settled in June 2006 with terms including mutual releases and payment of $100,000 to the Company in exchange for certain assets.

The Company is subject to various legal proceedings in the normal course of business. Management believes the outcome of these proceedings will not have a material adverse effect on the Company s financial position or results of operations.

Retailer Agreements. The Company has contracts in the normal course of business with various retailers, some of which provide for minimum annual program levels. If those minimum levels are not met, the Company is obligated to pay the contractual difference to the retailers. The Company calculates these estimated minimum payments based on actual activity to date. Due to the annual nature of these contracts, increased activity with these retailers in subsequent fiscal quarters could decrease the estimated payment amounts recorded in the current period. During the six months ended June 30, 2005 the Company incurred approximately $1,170,000 of costs related to these minimums. There was no expense in 2006 related to these minimums as the Company had met the minimum requirements. The amounts were recorded in Cost of Services in the Statements of Operations.

4. **Concentrations.** During the six months ended June 30, 2006 two customers accounted for 24% and 10% of the Company s total net sales. At June 30, 2006 these customers each represented 14% of the Company s total accounts receivable. During the six months ended June 30, 2005 these two customers accounted for 16% and 14% of the Company s total net sales and one other customer accounted for 11% of the Company s total net sales.

Although there are a number of customers that the Company sells to, the loss of a major customer could cause a delay in and possible loss of sales, which would adversely affect operating results.

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5. **Income Taxes.** At December 31, 2005 the Company had net operating loss carryforwards of approximately $24,000,000, which are available to offset future taxable income. These carryforwards are subject to the limitations of Internal Revenue Code Section 382 which provides limitations on the availability of net operating losses to offset current taxable income if an ownership change has occurred as defined by the Code. The Company has established a valuation allowance against all deferred tax assets due to the uncertainties regarding the realization of the deferred tax assets based upon the Company s lack of historical earnings. Readers should refer to Note 7 of the Company s Financial Statements on Form 10-K for the year ended December 31, 2005, for additional information related to income taxes.

   The Company recorded no income tax expense for the quarter and six months ended June 30, 2006 as it believes it has sufficient net operating losses available to offset taxable net income and continues to provide a full valuation allowance against all deferred tax assets as of June 30, 2006.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Overview

Insignia Systems, Inc. markets in-store advertising programs, services and products to retailers and consumer packaged goods manufacturers. The Company s services and products include the Insignia Point-of-Purchase Services (POPS) in-store advertising program, thermal sign card supplies for the Company s SIGNright and Impulse systems, Stylus software and laser printable cardstock and label supplies.

Results of Operations

The following table sets forth, for the periods indicated, certain items in the Company s Statements of Operations as a percentage of total net sales.

	Three Months Ended June 30		Six Months Ended June 30	
	2006	**2005**	**2006**	**2005**
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	44.8	60.9	45.0	63.0
Gross profit	55.2	39.1	55.0	37.0
Operating expenses:				
Selling	20.9	26.6	21.7	27.8
Marketing	4.1	6.2	4.3	6.4
General and administrative	15.4	15.8	15.5	18.1
Total operating expenses	40.4	48.6	41.5	52.3
Operating income (loss)	14.8	(9.5)	13.5	(15.3)
Other income	1.4	0.1	0.6	0.2
Net income (loss)	16.2%	(9.4)%	14.1%	(15.1)%

The Company experienced an increase in net sales in the first and second quarters of 2006 compared to the first and second quarters of 2005 due primarily to change in the sales mix towards higher-priced custom POPSign programs during the quarters which offset declines in products sold. Additionally, the Company instituted a number of cost reduction measures in late 2005 and renewed several retailer agreements in 2006 which resulted in reduced retailer payments. All of these factors contributed to profitability during the six months ended June 30, 2006, as compared to losses in the previous year.

Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Our significant accounting policies are described in Note 1 to the annual financial statements as of and for the year ended December 31, 2005, included in our Form 10-K filed with the Securities and Exchange Commission on March 30, 2006. We believe our most critical accounting policies and estimates include the following:

- revenue recognition;
- allowance for doubtful accounts;
- inventory valuation;
- accounting for deferred income taxes;
- valuation of long-lived and intangible assets;
- accounting for accrued retailer guarantees; and
- stock-based compensation.

Three and Six Months ended June 30, 2006 Compared to Three and Six Months Ended June 30, 2005

Net Sales. Net sales for the three months ended June 30, 2006 increased 8.5% to $5,853,000 compared to $5,396,000 for the three months ended June 30, 2005. Net sales for the six months ended June 30, 2006 increased 8.7% to $11,275,000 compared to $10,368,000 for the six months ended June 30, 2005.

Service revenues from our POPSign programs for the three months ended June 30, 2006 increased 10.4% to $5,122,000 compared to $4,641,000 for the three months ended June 30, 2005. Service revenues from our POPSign programs for the six months ended June 30, 2006 increased 12.1% to $9,842,000 compared to $8,778,000 for the six months ended June 30, 2005. The increases were primarily due to a change in the sales mix towards higher-priced custom POPSign programs sold to customers (consumer packaged goods manufacturers) during the periods.

Product sales for the three months ended June 30, 2006 decreased 3.2% to $731,000 compared to $755,000 for the three months ended June 30, 2005. Product sales for the six months ended June 30, 2006 decreased 9.9% to $1,433,000 compared to $1,590,000 for the six months ended June 30, 2005. The decreases were primarily due to decreasing sales of our other product categories based on decreased demand for those products from our customers.

Gross Profit. Gross profit for the three months ended June 30, 2006 increased 53.3% to $3,232,000 compared to $2,108,000 for the three months ended June 30, 2005. Gross profit for the six months ended June 30, 2006 increased 61.6% to $6,206,000 compared to $3,840,000 for the six months ended June 30, 2005. Gross profit as a percentage of total net sales increased to 55.2% for the three months ended June 30, 2006, compared to 39.1% for the three months ended June 30, 2005. Gross profit as a percentage of total net sales increased to 55.0% for the six months ended June 30, 2006, compared to 37.0% for the six months ended June 30, 2005.

Gross profit from our POPSign program revenues for the three months ended June 30, 2006 increased 64.6% to $2,917,000 compared to $1,772,000 for the three months ended June 30, 2005. Gross profit from our POPSign program revenues for the six months ended June 30, 2006 increased 81.0% to $5,595,000 compared to $3,092,000 for the six months ended June 30, 2005. The increases were primarily due to the effect of reduced retailer expense and other cost reductions combined with increased revenues. Gross profit as a percentage of POPSign program revenues for the three months ended June 30, 2006 increased to 57.0% compared to 38.2% for the three months ended June 30, 2005. Gross profit as a percentage of POPSign program revenues for the six months ended June 30, 2006 increased to 56.9%, compared to 35.2% for the six months ended June 30, 2005. The increases were due to the factors discussed above.

Gross profit from our product sales for the three months ended June 30, 2006 decreased 6.3% to $315,000 compared to $336,000 for the three months ended June 30, 2005. Gross profit from our product sales for the six months ended June 30, 2006 decreased 18.3% to $611,000 compared to $748,000 for the six months ended June 30, 2005. The decreases in gross profit were primarily due to decreased sales from our other product categories based on decreased demand for those products from our customers. Gross profit as a percentage of product sales was 43.1% for the three months ended June 30, 2006 compared to 44.5% for the three months ended June 30, 2005. Gross profit as a percentage of product sales was 42.6% for the six months ended June 30, 2006 compared to 47.0% for the six months ended June 30, 2005.

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Operating Expenses

Selling. Selling expenses for the three months ended June 30, 2006 decreased 14.9% to $1,224,000 compared to $1,438,000 for the three months ended June 30, 2005, primarily due to sales force reductions in December of 2005 and decreased third-party compliance costs, partially offset by increased sales commissions in 2006 due to increased sales and stock-based compensation costs recognized in 2006 due to the adoption of Statement of Financial Accounting Standards No. 123R (SFAS 123R). Selling expenses for the six months ended June 30, 2006 decreased 15.2% to $2,441,000 compared to $2,878,000 for the six months ended June 30, 2005, primarily due to the factors described above.

Selling expenses as a percentage of total net sales decreased to 20.9% for the three months ended June 30, 2006 compared to 26.6% for the three months ended June 30, 2005, due to the factors discussed above, net of the effect of higher net sales during the quarter. Selling expenses as a percentage of total net sales decreased to 21.7% for the six months ended June 30, 2006 compared to 27.8% for the six months ended June 30, 2005, due to factors described above.

Marketing. Marketing expenses for the three months ended June 30, 2006 decreased 27.4% to $241,000 compared to $332,000 for the three months ended June 30, 2005. Marketing expenses for the six months ended June 30, 2006 decreased 26.5% to $489,000 compared to $665,000 for the six months ended June 30, 2005. Decreases in both the quarter and six months were primarily due to reductions in staff, decreased data analysis and reduced advertising expense.

Marketing expenses as a percentage of total net sales decreased to 4.1% for the three months ended June 30, 2006 compared to 6.2% for the three months ended June 30, 2005. Marketing expenses as a percentage of total net sales decreased to 4.3% for the six months ended June 30, 2006 compared to 6.4% for the six months ended June 30, 2005. Decreases in both periods were primarily due to the factors discussed above, net of the effect of higher net sales during the quarter.

General and administrative. General and administrative expenses for the three months ended June 30, 2006 increased 6.0% to $902,000 compared to $851,000 for the three months ended June 30, 2005, primarily due to increased public relations expense and stock-based compensation costs recognized in 2006 due to the adoption of SFAS 123R. General and administrative expenses for the six months ended June 30, 2006 decreased 6.7% to $1,751,000 compared to $1,876,000 for the six months ended June 30, 2005, primarily due to decreased legal expense offset by increased public relations expense and stock-based compensation costs recognized in 2006 due to the adoption of SFAS 123R.

General and administrative expenses as a percentage of total net sales decreased to 15.4% for the three months ended June 30, 2006 compared to 15.8% for the three months ended June 30, 2005. General and administrative expenses as a percentage of total net sales decreased to15.5% for the six months ended June 30, 2006 compared to 18.1% for the six months ended June 30, 2005. Decreases in both periods were primarily due to factors discussed above and the effect of higher net sales during the quarter.

Legal fees for the three months ended June 30, 2006 were $279,000 compared to $270,000 for the three months ended June 30, 2005. Legal fees for the six months ended June 30, 2006 were $511,000 compared to $760,000 for the six months ended June 30, 2005. The legal fees in each period were incurred primarily in connection with two News America lawsuits described in Note 3 to the financial statements. We currently expect the amount of additional legal fees that will be incurred in connection with the ongoing lawsuits to be significant throughout the remainder of 2006. Also, if the Company is required to pay a significant amount in settlement or damages, it will have a material adverse effect on its operations and financial condition. In addition, a negative outcome of this litigation could affect long-term competitive aspects of the Company s business.

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Other Income (Expense). Other income for the three months ended June 30, 2006 was $84,000 compared to $5,000 for the three months ended June 30, 2005. Other income for the six months ended June 30, 2006 was $63,000 compared to $14,000 for the six months ended June 30, 2005. Other income for the three months and six months ended June 30, 2006 includes $100,000 from the sale of certain assets per the terms of the settlement agreement with Paul Richards and his company (see Note 3 to the financial statements). Interest expense in the three months and six months ended June 30, 2006 also includes interest expense related to an agreement reached with a retailer effective December 31, 2005 for the deferred payment of certain obligations.

Net Income (Loss). Our net income for the three months ended June 30, 2006 was $949,000 compared to a net loss of $(508,000) for the three months ended June 30, 2005. Our net income for the six months ended June 30, 2006 was $1,588,000 compared to a net loss of $(1,565,000) for the six months ended June 30, 2005.

Liquidity and Capital Resources

The Company has financed its operations with proceeds from public and private stock sales and sales of its services and products. At June 30, 2006, working capital was $4,219,000 compared to $2,592,000 at December 31, 2005. During the six months ended June 30, 2006, cash and cash equivalents increased $380,000 to $3,091,000.

Net cash provided by operating activities during the six months ended June 30, 2006 was $530,000. The increase was primarily due to net income during the period partially offset by the payment of retailer obligations which were recorded at December 31, 2005 and other changes in working capital items. Accounts receivable increased $693,000 during the six months ended June 30, 2006 due to higher net sales in May and June of 2006 compared to November and December of 2005. Accounts payable and accrued liabilities decreased $662,000 during the six month period primarily as a result of the payment of retailer obligations which were recorded at December 31, 2005. The Company expects accounts receivable and accounts payable to fluctuate during 2006 depending on the level of quarterly POPSign revenues.

Net cash of $127,000 was used in investing activities during the six months ended June 30, 2006 due to the purchase of property and equipment, primarily the purchase of two previously leased digital printers. The company expects to make capital expenditures in the second half of 2006 of between $100,000 to $150,000, primarily related to information technology hardware and software investments.

Net cash of $23,000 was used in financing activities during the six months ended June 30, 2006 as a result of the payment of $90,000 of principal on long-term liabilities offset partially by $34,000 of additional advances on the line of credit and $33,000 of proceeds from the issuance of common stock, net of expenses. The Company has maintained a line of credit balance sufficient to generate interest charges to cover the required monthly minimum fee. The issuance of common stock related to the issuance of shares related to the Employee Stock Purchase Plan.

The Company anticipates that its working capital needs for the remainder of 2006 will remain consistent with the first half of 2006. The Company believes that based upon current business conditions, its existing cash balance, future cash from operations and borrowings on the line of credit will be sufficient for its cash requirements in the foreseeable future. However, there can be no assurances that this will occur or that the Company will be able to secure additional financing from public or private stock sales or from other financing agreements if needed.

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Cautionary Statement Regarding Forward Looking Information

Statements made in this quarterly report on Form 10-Q, in the Company s other SEC filings, in press releases and in oral statements to shareholders and securities analysts, which are not statements of historical or current facts, are forward looking statements. Such forward looking statements involve known and unknown risks, uncertainties and other factors which may cause the actual results or performance of the Company to be materially different from the results or performance expressed or implied by such forward looking statements. The words believes, expects, anticipates, seeks and similar expressions identify forward-looking statements. Readers are cautioned not to place undue reliance on these forward looking statements, which speak only as of the date the statement was made. These statements are subject to the risks and uncertainties that could cause actual results to differ materially and adversely from the forward looking statements. These risks and uncertainties include, but are not limited to, the risks presented in our Annual Report on Form 10-K for the year ended December 31, 2005 and updated in Part II, Item 1A of this Quarterly Report on Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

The Company s management carried out an evaluation, under the supervision and with the participation of the Company s Chief Executive Officer and the Company s Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report, pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Company s Chief Executive Officer and the Company s Chief Financial Officer concluded that the Company s disclosure controls and procedures are effective in timely alerting them to material information relating to the Company required to be included in the Company s periodic filings under the Exchange Act.

(b) Changes in Internal Controls Over Financial Reporting

There was no change in our internal controls over financial reporting that occurred during the last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In August 2000, News America Marketing In-Store, Inc. (News America), brought suit against the Company in U.S. District Court in New York, New York. The case was settled in November 2002. The terms of the settlement agreement are confidential. The settlement did not impact the Company s operating results.

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In October 2003, News America brought suit against the Company in U.S. District Court in New York, New York, alleging that the Company has engaged in deceptive acts and practices, has interfered with existing business relationships with certain retailers and prospective economic advantage, and has engaged in unfair competition. The suit seeks unspecified damages and injunctive relief. The Company filed a motion to dismiss in February 2004. In June 2004 News America amended the suit against the Company and the Company filed an amended motion to dismiss in August 2004. The Company is awaiting decision by the Court. Discovery has been stayed in this action. Management believes the allegations are without merit and that the Company will prevail.

On September 23, 2004, the Company brought suit against News America and Albertson s Inc. in Federal District Court in Minneapolis, Minnesota, for violations of federal and state antitrust and false advertising laws, alleging that News America has acquired and maintained monopoly power through various wrongful acts designed to harm the Company in the in-store advertising and promotion products and services market. The suit seeks injunctive relief sufficient to prevent further antitrust injury and an award of treble damages to be determined at trial for the harm caused to the Company. In August 2005 the Court dismissed the suit, but permitted the Company to file an amended complaint with more specific allegations regarding the illegal actions taken by the defendants. The Company filed the amended complaint on September 23, 2005 and News America and Albertson s Inc. refiled their motions to dismiss. The motions were heard on February 17, 2006 and on June 30, 2006 the Court denied the motions of News America and Albertson s to dismiss the suit.

In September 2005, the Company brought a suit against Paul A. Richards and his company in Federal District Court in Minneapolis, Minnesota, alleging fraud and misrepresentation related to the VALUStix acquisition and asking that the acquisition be rescinded and all parties restored to their pre-acquisition status. The suit was settled in June 2006 with terms including mutual releases and payment of $100,000 to the Company in exchange for certain assets.

Item 1A. Risk Factors

Not applicable.

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

None.