

VITACUBE SYSTEMS HOLDINGS INC
Form 10QSB
October 27, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-QSB

Quarterly Report Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934

For the quarterly period ended September 30, 2006

or

Transition Report Pursuant to Section 13 or 15 (d) of the
Securities Exchange Act of 1934

Commission file No. 000-50875

VITACUBE SYSTEMS HOLDINGS, INC.

(Exact name of small business issuer as specified in its charter)

Nevada

(State of incorporation)

**480 South Holly Street
Denver, CO 80246**

(Address of principal executive offices)

(303)-316-8577

(Issuer's telephone number)

84-1575085

(I.R.S. Employer Identification Number)

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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

YES NO

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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 October 25, 2006 the Company had 9,697,170 shares of its \$.001 par value common stock issued and outstanding.

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Part I FINANCIAL INFORMATION**Item 1 CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS****VITACUBE SYSTEMS HOLDINGS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS**

| | September 30, 2006 (unaudited) | December 31, 2005 |
|---|-----------------------------------|-------------------|
| ASSETS | | |
| Current assets: | | |
| Cash | \$ 464,127 | \$ 2,805,021 |
| Short term investments | | 110,000 |
| Accounts receivable, net of allowance for doubtful accounts of \$12,500 and \$5,500, respectively | 6,162 | 8,758 |
| Inventory, net of allowance for obsolescence of \$107,000 and \$17,000, respectively | 342,351 | 542,749 |
| Prepaid expenses and other current assets | 289,894 | 263,898 |
| Total current assets | 1,102,534 | 3,730,426 |
| Intangible assets, net | 11,487 | 36,219 |
| Property and equipment, net | 135,447 | 93,423 |
| Total assets | \$ 1,249,468 | \$ 3,860,068 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | \$ 553,041 | \$ 440,392 |
| Deferred Revenue | 85,334 | |
| Total Liabilities | 638,375 | 440,392 |
| Commitments and Contingencies | | |
| SHAREHOLDERS EQUITY: | | |
| Preferred stock, authorized 5,000,000 shares, \$.001 par value, none issued or outstanding | | |
| Common stock, authorized 50,000,000 shares, \$.001 par value, 9,697,170 and 9,618,900 issued and outstanding respectively | 9,697 | 9,619 |
| Additional paid in capital | 16,518,142 | 15,990,889 |
| Accumulated (deficit) | (15,916,746) | (12,580,832) |
| Total shareholders equity | 611,093 | 3,419,676 |
| Total liabilities and shareholders equity | \$ 1,249,468 | \$ 3,860,068 |

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

VITACUBE SYSTEMS HOLDINGS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)
Three and Nine Months Ended September 30, 2006 and 2005

| | For the Three Months Ended September 30, 2006 | For the Three Months Ended September 30, 2005 | For the Nine Months Ended September 30, 2006 | For the Nine Months Ended September 30, 2005 |
|--|---|---|--|--|
| Net sales | \$ 608,111 | \$ 323,400 | \$ 1,724,252 | \$ 783,126 |
| Cost of goods sold | 211,513 | 155,195 | 622,841 | 345,648 |
| Gross profit | 396,598 | 168,205 | 1,101,411 | 437,478 |
| Operating expenses: | | | | |
| Selling and marketing expenses | 571,160 | 996,736 | 2,214,842 | 1,901,503 |
| General and administrative expenses | 577,456 | 844,241 | 2,136,506 | 2,006,289 |
| Research and development expenses | 20,246 | 24,778 | 64,180 | 43,733 |
| Depreciation and amortization | 11,779 | 6,428 | 54,554 | 19,229 |
| Total operating expenses | 1,180,641 | 1,872,183 | 4,470,082 | 3,970,754 |
| Net (loss) from operations | (784,043 |) (1,703,978 |) (3,368,671 |) (3,533,276 |
| Other income (expense) | | | | |
| Interest income | 5,099 | 53,316 | 32,757 | 68,776 |
| Interest (expense) | | | | (2,841 |
| Total other income (expense) | 5,099 | 53,316 | 32,757 | 65,935 |
| Net (loss) | \$ (778,944 |) \$ (1,650,662 |) \$ (3,335,914 |) \$ (3,467,341 |
| Net (loss) per common share | | | | |
| Basic and diluted net (loss) per share | \$ (0.08 |) \$ (0.17 |) \$ (0.35 |) \$ (0.41 |
| Weighted average common shares outstanding, basic and diluted | 9,697,170 | 9,589,400 | 9,660,897 | 8,486,550 |

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

VITACUBE SYSTEMS HOLDINGS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
Nine Months Ended September 30, 2006 and 2005

| | September 30 2006 | September 30 2005 |
|--|----------------------|----------------------|
| Cash flows from operating activities: | | |
| Net income (loss) | \$ (3,335,914) | \$ (3,467,341) |
| Adjustments to reconcile | | |
| Depreciation and amortization | 54,554 | 19,229 |
| Stock and stock options issued for services | 527,332 | 383,998 |
| Change in allowance for doubtful accounts | 6,865 | 4,294 |
| Change in allowance for inventory obsolescence | 90,402 | 58,600 |
| Change in allowance for product returns | 24,718 | 15,170 |
| Changes in assets and liabilities: | | |
| Accounts receivable | (4,269) | (10,818) |
| Inventory | 109,995 | 114,118 |
| Other current assets | (10,392) | (475,851) |
| Accounts payable and accrued expenses | 157,661 | (188,878) |
| Net cash (used) by operating activities | (2,379,048) | (3,547,479) |
| Cash flows from investing activities: | | |
| Proceeds from maturity of investments | 110,000 | (4,184) |
| Capital expenditures | (71,846) |) |
| Net cash (used) by investing activities | 38,154 |) |
| Cash flow from financing: | | |
| Proceeds from loan to shareholder |) | 170,000 |
| Proceeds from notes payable |) | 195,000 |
| Repayments of loan to shareholder |) | (170,000) |
| Repayments of bridge financing |) | (195,000) |
| Issuance of common stock |) | 7,742,682 |
| Net cash from financing activities |) | 7,742,682 |
| NET INCREASE (DECREASE) IN CASH | (2,340,894) | 4,195,203 |
| CASH, BEGINNING OF THE PERIOD | 2,805,021 | 114,794 |
| CASH, END OF THE PERIOD | \$ 464,127 | \$ 4,309,997 |
| SUPPLEMENTAL CASH FLOW | | |
| Cash paid for interest | \$ | \$ 2,841 |

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

VITACUBE SYSTEMS HOLDINGS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - ORGANIZATION, OPERATIONS AND BASIS OF PRESENTATION

Organization and Business

The consolidated financial statements include those of VitaCube Systems Holdings, Inc., (VSHI) and its wholly owned subsidiaries, VitaCube Systems, Inc. and XELR8, Inc. (formerly VitaCube Network, Inc.). Collectively, they are referred to herein as the Company.

The Company is in the business of selling, marketing and distributing nutritional supplement products and functional foods. Our product lines consist of a sports hydration drink, a protein shake, a sports energy drink, a meal replacement drink, a functional food snack and a full product line of vitamins and minerals in the form of tablets, softgels or capsules, all of which are manufactured using our proprietary product formulations.

The Company sells and markets the products primarily through a direct selling channel, in which independent distributors sell our products through a network of customers and other distributors. These activities are conducted through XELR8, Inc., a wholly owned Colorado corporation, formed on July 9, 2003. In addition, we sell our products directly to professional and Olympic athletes and professional sports teams through VitaCube Systems Inc.

Basis of Presentation

The condensed interim financial statements included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures made are adequate to make the information presented not misleading. The condensed interim financial statements and notes thereto should be read in conjunction with the financial statements and the notes thereto, included in the Company's Annual Report to the Securities and Exchange Commission for the fiscal year ended December 31, 2005, filed on Form 10-KSB on March 31, 2006.

The accompanying condensed interim financial statements have been prepared, in all material respects, in conformity with the standards of accounting measurements set forth in Accounting Principles Board Opinion No. 28 and reflect, in the opinion of management, all adjustments necessary to summarize fairly the financial position and results of operations for such periods in accordance with accounting principles generally accepted in the United States of America. All adjustments are of a normal recurring nature. The results of operations for the most recent interim period are not necessarily indicative of the results to be expected for the full year.

Principles of Consolidation

The accompanying financial statements include the accounts of the Company and its wholly owned subsidiaries VitaCube Systems, Inc. and XELR8, Inc. All inter-company accounts and transactions have been eliminated in the preparation of these consolidated statements.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Management believes that the estimates utilized in the preparation of financial statements are prudent and reasonable. Actual results could differ from these estimates.

Revenue Recognition

The Company ships its products by common carrier and receives payment in the form of cash, credit card payment or approved credit terms. The Company offers a 60-day money back guarantee on orders placed by first-time customers and distributors. After 60 days and for all subsequent orders place by customers and distributors, the Company allows resalable products to be returned within 12 months of the purchase date for a 100% sales price refund, subject to a 10% restocking fee. During the nine months ended September 30, 2006 and for the year ended December 31, 2005, returns as a percentage of net sales were 6.3% and 3.8%, respectively. Sales revenue and estimated returns are recorded when the merchandise is shipped since performance by the Company is considered met when products are in the hands of the common carrier. Amounts received for unshipped merchandise are recorded as customer deposits and are included in accrued liabilities. Additionally, the Company collects an annual website fee from Distributors that is deferred on receipt and recognized as income on a straight-line basis over the subsequent twelve-month period.

Inventory

Inventory is stated at the lower of cost or market on a FIFO (first-in first-out) basis. Provision is made to reduce excess or obsolete inventory to the estimated net realizable value. The Company purchases for resale a sports energy drink, a protein shake, an appetite suppressant chew and other vitamins and nutritional supplements, which it packages in various forms and containers.

Inventory is comprised of the following:

| | September 30, 2006 | December 31, 2005 |
|----------------------------------|--------------------|-------------------|
| Raw materials | \$ 203,584 | \$ 237,226 |
| Finished goods | 245,767 | 322,523 |
| Provision for obsolete inventory | (107,000) | (17,000) |
| | \$ 342,351 | \$ 542,749 |

A summary of the reserve for obsolete and excess inventory is as follows:

| | September 30, 2006 | December 31, 2005 |
|---------------------------------|--------------------|-------------------|
| Balance as of January 1 | \$ 17,000 | \$ 43,300 |
| Addition to provision | 92,500 | 70,456 |
| Write-off of obsolete inventory | (2,500) | (96,756) |
| | \$ 107,000 | \$ 17,000 |

Stock-Based Compensation

Effective January 1, 2006, the company adopted SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R), which requires compensation costs related to share-based transactions, including employee stock options, to be recognized in the financial statements based on fair value. SFAS 123R revises SFAS No. 123, *Accounting for Stock-Based Compensation*, (SFAS 123) and supersedes Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*. In March 2005, the Securities and Exchange Commission (the SEC) issued Staff Accounting Bulletin No. 107 (SAB 107) regarding the SEC's interpretation of SFAS 123R and the valuation of share-based payments for public companies. The Company has applied the provisions of SAB 107 in its adoption of SFAS 123R.

The Company adopted the provisions of SFAS 123R using the modified prospective transition method. In accordance with this transition method, the company's consolidated financial statements for prior periods have not been restated to reflect the impact of SFAS 123R. Under the modified prospective transition method, share-based compensation expense for the first quarter of 2006 includes compensation expense for all share-based compensation awards granted prior to, but for which the requisite service has not yet been performed as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123. Share-based compensation expense for all share-based

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compensation awards granted after January 1, 2006 is based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. The company recognizes compensation costs net of an assumed forfeiture rate and recognizes the compensation costs for nonqualified stock options expected to vest on a straight-line basis over the requisite service period of the award. The company estimates the forfeiture rate based on its historical experience.

Total share-based compensation expense, for all of the company's share-based awards recognized for the nine months ended September 30, 2006, was \$527,332 or \$0.06 per share basic and diluted compared with the \$984,922 or \$0.09 per share reported in the Notes to the financial statements for the same period in 2005.

The company uses a Black-Scholes option-pricing model (Black-Scholes model) to estimate the fair value of the stock option grant. The use of a valuation model requires the company to make certain assumptions with respect to selected model inputs. Expected volatility was calculated based on the historical volatility of the company's stock price. In the future the average expected life will be based on the contractual term of the option and expected employee exercise and post-vesting employment termination behavior. Currently it is based on the simplified approach provided by SAB 107. The risk-free interest rate is based on U.S. Treasury zero-coupon issues with a remaining term equal to the expected life assumed at the date of the grant. The following were the factors used in the Black Scholes model in the quarters to calculate the compensation cost:

| | Nine months ended September 30, 2006 | |
|--------------------------|---|---|
| Stock price volatility | 92.9% to 94.1 | % |
| Risk-free rate of return | 4.76% to 5.27 | % |
| Annual dividend yield | 0 | % |
| Expected life | 3 to 5 Years | |

Prior to the adoption of SFAS 123R, the company recognized share-based compensation expense in accordance with APB 25. The company provided pro forma disclosure amounts in accordance with SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure* (SFAS 148), as if the fair value method defined by SFAS 123 had been applied to its share-based compensation. The pro forma table below reflects net earnings and basic and diluted net earnings per share for the three months and nine months ended September 30, 2005, had the company applied the fair value recognition provisions of SFAS 123:

| | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2005 |
|--|--|---|
| Net loss, as reported | \$ (1,650,662) | \$ (3,467,341) |
| Add: Stock-based compensation expense included in reported net income, net of related tax effects | 226,417 | 234,417 |
| Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects | (521,016) | (984,922) |
| Pro forma net loss | \$ (1,945,261) | \$ (4,217,846) |
| Earnings per share: | | |
| Basic and diluted earnings (loss) per common share | | |
| As reported | (.17) | (.41) |
| Pro forma | (.20) | (.50) |

Net Loss Per Share

Earnings per share require presentation of both basic earnings per common share and diluted earnings per common share. Since the Company has a net loss for all periods presented since inception, common stock equivalents are not included in the weighted average calculation since their effect would be anti-dilutive.

NOTE 2 - SHAREHOLDERS EQUITY

On June 28, 2006, the Company renewed and extended the Strategic Alliance Agreement with UTEK dated May 20, 2005 for a term of July 1, 2006 through October 31, 2007. The monthly payments shall be as follows: For the first three months 1,471 shares (valued at \$1,000) will vest per month and beginning October 14,706 shares (valued at \$10,000) shall vest per month. The fair values are based on the closing price of the Company's common stock as quoted on June 27, 2006. See Note 3 Subsequent Events for further details regarding the status of this agreement.

NOTE 3 SUBSEQUENT EVENTS

Effective October 18, 2006 the Strategic Alliance Agreement between UTEK and the company was terminated. As a result of the termination, the company only issued 33,825 shares to UTEK of the total 180,885 that were to be paid for the 18 month agreement.

On October 11, 2006, Earnest Mathis, Jr. resigned from his position as Chief Executive Officer. Mr. Mathis will continue to serve as the Chairman of the company's Board of Directors. Mr. Mathis. On October 11, 2006, John Pougnet was appointed as Chief Executive Officer. Mr. Pougnet is currently the Chief Financial Officer of the company and will continue to serve in this capacity.

Item 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

Cautionary Note Regarding Forward-Looking Statements

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 and is subject to the safe harbor created by those sections. We intend to identify forward-looking statements in this report by using words such as believes, intends, expects, may, will, should, plan, projected, contemplates, anticipates, potential, continue, or similar terminology. These statements are based on our beliefs as well as assumptions we made using information currently available to us. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise. Because these statements reflect our current views concerning future events, these statements involve risks, uncertainties, and assumptions. Actual future results may differ significantly from the results discussed in the forward-looking statements. These risks include changes in demand for our products, changes in the level of operating expenses, our ability to expand our network of distributors, changes in general economic conditions that impact consumer behavior and spending, product supply, the availability, amount, and cost of capital to us and our use of such capital, and other risks discussed in this report. Additional risks that may affect our performance are discussed under Risk Factors Associated with Our Business in our Registration Statement Form SB-2 declared effective April 5, 2005. Readers are cautioned not to place undue reliance on the forward-looking statements contained in this report.

Overview

We are in the business of developing, selling, marketing and distributing nutritional supplement products and functional foods. We market our products primarily through direct selling or network marketing, in which independent distributors sell our products. In addition, we sell our products directly to professional and Olympic athletes and professional sports teams.

Our product lines consist of four powdered beverages, 12 individual supplements packaged in our VitaCube®, and a functional food chew. Our PEAK PERFORMANCE System is a packaged product that consists of a protein drink, hydration drink and vitamin support pack all of which can be purchased as a system or individually. The SUPPORT pack has the vitamins for each serving individually packaged. The VitaCube® is an easy to use, compartmentalized box with instructions for which supplements to take and the proper times to take them. Our EAT, DRINK and SNACK System (EDS) is a packaged product that consists of functional foods and energy drinks that can be purchased as a whole system or individually.

As of September 30, 2006 we had 3,085 independent distributors and 651 customers (excluding professional athletes and sports teams) who had purchased our products within the prior twelve months.

We maintain an inventory of our products to insure that we can timely fill our customer orders. We can have large increases in inventory levels if we have multiple product reorders in the same period. In addition, our manufacturers typically may take up to 12 weeks to deliver products after we place an order, and they have minimum order requirements, which also adds to higher inventory levels. Our inventory, net of our allowance for obsolescence, was \$342,351 at September 30, 2006, a decrease from \$542,749 at December 31, 2005.

The decrease of inventory was a result of continued sales of the EDS and PEAK PERFORMANCE systems and a charge to inventory obsolescence in the third quarter for the continued declining demand for the Essential Vitacube product. Even though our inventory level currently is relatively high based on our sales for the nine months ended September 30, 2006, we believe our inventory is appropriately classified as a current asset based on the ongoing implementation of our new marketing plan which is designed to increase our distributor base and sales.

During the nine months ended September 30, 2006, we rebranded two of the original Vitacube products, eForce and VitaPro into the PEAK PERFORMANCE HYDRATE and BUILD products and discontinued the Basic VitaCube®, which was replaced by the SUPPORT product. This change resulted taking a charge against operations for obsolete inventory of \$92,500 as we had customers and distributors demanding more of the SUPPORT product and less of the Essential Vitacube®. Our allowance for obsolete inventory was increased from \$17,000 at December 31, 2005 compared to \$107,000 at September 30, 2006. We believe our reserve for obsolescence is reasonable because (i) substantially all of

our inventory has been recently purchased, (ii) the shelf life of our products averages three years, and (iii) we have no current plans to eliminate any of our products, instead choosing to repackage them in the new product branding strategy.

Our network marketing program is designed to provide an incentive for independent distributors to build, maintain and motivate a sales organization of customers and other independent distributors to enhance earning potential. Our independent distributors are compensated with commissions and bonuses on sales generated through their downline organization. Independent distributors advance in distributor levels as they develop their sales organization and increase their sales volume, which increases their compensation.

We recognize revenue when products are shipped to our customers. Revenue is reduced by product returns at the time we take the product either back into inventory or dispose of it. In addition, we estimate a reserve total for future returns. We also collect an annual website fee from Distributors that is deferred on receipt and recognized as income on a straight-line basis over the subsequent twelve-month period. Cost of our sales consists of expenses directly related to the production and distribution of the products and certain sales materials. Included in the sales and marketing expenses are independent distributor commissions, bonus and incentives along with other general selling expenses. We expect our independent distributor expenses, as a percentage of net revenues, to decrease as independent distributors require less additional incentives and rely on the incentives in our direct sales program. General and administrative expenses include salaries and benefits, rent and building expenses, legal, accounting, telephone and professional fees.

Our revenue will depend on the number and productivity of our independent distributors, who purchase products and sales materials from us for resale to their customers or for personal use. Because we will distribute substantially all of our products through our independent distributors, our failure to retain our existing distributors and recruit additional distributors could have an adverse effect on our revenue.

Due to the recent start-up of our direct sales program we believe that the number of our distributors is an important indicator to monitor. In addition, we will monitor the sales generated per independent distributor as well as the success of our independent distributors in recruiting new independent distributors.

With respect to industry and market factors that may affect us directly, we believe that industry credibility in both direct selling and nutritional supplements will be critical elements in whether we can increase revenues and become profitable. Any adverse developments in either of these two areas, to us or in our industry, could lead to a lower number of our independent distributors and reduced sales and recruiting efforts by existing distributors, as well as a loss or no increase in the number of sports celebrity endorsers of our products. We do not know what industry growth was for 2005 or will be for 2006 nor do we have enough experience in the direct sales channel to determine whether a slower industry growth rate, which occurred for several years leading up to 2003 and which has subsequently been slow, will adversely affect us.

Our operating plan for 2006 is focused on increasing the number of independent distributors, growing revenues, and generating gross profits. Due to the relatively recent commencement of our direct selling program through independent distributors, we cannot predict our revenue, gross profit, net income or loss or use of cash and cash equivalents; however, we expect net losses will continue for at least the next 12 months.

Our independent auditors have noted in their reports on our financial statements as of December 31, 2005 and 2004 and for the years then ended, that there is substantial doubt regarding our ability to continue as a going concern. To date this contingency has not affected our ability to secure funding for our operations; however, going forward, in the event this uncertainty is not resolved, we may experience more difficulty in raising funds to operate our Company if we are required to raise such capital.

Critical Accounting Policies and Estimates

Discussion and analysis of our financial condition and results of operations are based upon financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates; including those related to collection of receivables, inventory obsolescence, sales returns and non-monetary transactions such as stock and stock options issued for services and beneficial conversion features of notes payable. 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 the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements.

Revenue Recognition. In accordance with Staff Accounting Bulletin 104 Revenue Recognition in Financial Statements, revenue is recognized at the point of shipment, at which time title is passed. Net sales include sales of products, sales of marketing tools to independent distributors and freight and handling charges. With the exception of approved professional sports teams, we receive the net sales price from all of our orders in the form of cash or credit card payment prior to shipment. Professional sports teams with approved credit have been extended payment terms of net 30 days. Additionally, starting in March 2006 the Company collected an annual website fee from Distributors that is deferred on receipt and recognized as income on a straight-line basis over the subsequent twelve-month period. As of September 30, 2006 the Company had \$85,334 in deferred revenue.

Allowances for Product Returns. Allowances for product returns are recorded at the time product is shipped. These accruals are based upon the historical return rate since the inception of our network marketing program in the third quarter of 2003, and the specific historical return patterns by product. Our return rate since the third quarter of 2003 has varied from 1.7% to 7.5% of our net sales.

We offer a 60-day, 100% money back unconditional guarantee to all customers and independent distributors who have never before purchased products from us. As of September 30, 2006, orders shipped that are subject to our 60-day money back guarantee were approximately \$176,448. All other product may be returned to us by any customer or independent distributor if it is unopened and undamaged for a 100% sales price refund, less a 10% restocking fee, provided the product is returned within 12 months of purchase and is being sold by us at the time of return. We are not able to estimate the amount of revenue we have recognized that is held by these buyers of product and which is returnable, because it is not possible to determine the amount of product that is unopened and undamaged. Product damaged during shipment is replaced wholly at our cost, which historically has been negligible.

We monitor our return estimate on an ongoing basis and may revise allowances to reflect our experience. Our reserve for product returns at September 30, 2006 and December 31, 2005 was \$45,032 and \$20,314, respectively. To date, product expiration dates have not played any role in product returns, and we do not expect they will in the future because it is unlikely that we will ship product with an expiration date earlier than the latest allowable product return date.

Inventory Valuation. Inventories are stated at the lower of cost or market on a first-in first-out basis. A reserve for inventory obsolescence is maintained and is based upon assumptions about current and future product demand, inventory whose shelf life has expired and market conditions. A change in any of these variables may require additional reserves to be taken. We reserved \$107,000 for obsolete inventory as of September 30, 2006 and \$17,000 as of December 31, 2005.

Stock Based Compensation. Many equity instrument transactions are valued based on pricing models such as Black-Scholes-Merton, which require judgments by us. Values for such transactions can vary widely and are often material to the financial statements.

Effective January 1, 2006, we adopted SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), which requires compensation costs related to share-based transactions, including employee stock options, to be recognized in the financial statements based on fair value. SFAS 123R revises SFAS No. 123, Accounting for Stock-Based Compensation, (SFAS 123) and supersedes Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees. In March 2005, the Securities and Exchange Commission (the SEC) issued Staff Accounting Bulletin No. 107 (SAB 107) regarding the SEC's interpretation of SFAS 123R and the valuation of share-based payments for public companies. We have applied the provisions of SAB 107 in its adoption of SFAS 123R. We adopted the provisions of SFAS 123R using the modified prospective transition method. In accordance with this transition method, the company's consolidated financial statements for prior periods have not been restated to reflect the impact of SFAS 123R. Under the modified prospective transition method, share-based compensation expense for the first quarter of 2006 includes compensation expense for all share-based compensation awards granted prior to, but for which the requisite service has not yet been performed as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123. Share-based compensation expense for all share-based compensation awards granted after January 1, 2006 is based on the grant date fair value estimated in accordance with the provisions of SFAS 123R.

Results of Operations

For the three months ended September 30, 2006 compared to the three months ended September 30, 2005.

The discussion below first presents the results of the quarter ended September 30, 2006 followed by the results of the quarter ended September 30, 2005

Net sales. Net sales were \$608,111 an increase of 88% compared to \$323,400. The increase in net sales can be attributed to an increase in the number of independent distributors and customers along with greater brand recognition. The increase was also the result of the September 2005 introduction of the EDS system and the March 2006 rebranding of two products (HYDRATE and BUILD) and the introduction of a new product (SUPPORT) in the PEAK PERFORMANCE System.

The percentage that each product category represented of our net sales is as follows:

| Product Category | Three Months Ended | | September 30, | |
|---|--------------------|------------|---------------|------------|
| | 2006 | 2005 | 2006 | 2005 |
| | % of Sales | % of Sales | % of Sales | % of Sales |
| EAT | 17 | % | | |
| DRINK | 31 | % | | |
| SNACK (formerly sZone® snack) | 9 | % | 13 | % |
| HYDRATE (formerly eForce® sports drink) | 12 | % | 36 | % |
| Vitamins and minerals, including SUPPORT | 12 | % | 31 | % |
| BUILD (formerly VitaPro® nutrition shake) | 5 | % | 11 | % |
| Other-educational materials, apparel | 14 | % | 9 | % |

Gross Profit. Gross profit increased to \$396,598 compared to \$168,205, an increase of 136%. Gross profit as a percentage of revenue (gross margin) increased to 65% from 52%. The increase in gross profit reflects the increase in net sales. Gross margin increase is due to an increase in sales of higher margin items from the EDS system and the SUPPORT product and offset by the additional write-offs for inventory obsolescence.

Sales and marketing expenses. Sales and marketing expenses decreased to \$571,160 from \$996,736, a decrease of 43%. The decrease in sales and marketing expenses is a result decreased costs associated with our annual September distributor event, which was partially offset by the increased expenses related to compensating our distributors for the sales made. We expect to continue to incur higher sales and marketing expenses for the next 12 months as we continue to implement our plan.

General and administrative expenses. General and administrative expenses were \$577,456 a decrease of 32% compared to \$844,241. The decrease is a result of lower expenses in the current year associated with being a public company as the Company had incurred significant charges in the prior year as a the result of the stock offering; lower executive compensation; and lower consultant expense for computer development and the prior year payment to endorsers in stock based compensation in conjunction with the corporate rebranding. Executive compensation decreased as a result of amended employment agreements entered into with Mssrs. Greenberg, Mathis and Pougnet in June 2006. Additionally, in the comparable period in the prior year we were launching the EDS system and had incurred costs to consultants for web development and athletes for endorsement. As a result of the adoption of FAS 123R we recorded stock based compensation of \$116,905 which was previously only disclosed in the notes to the financial statements.

Research and development expenses. Research and development expenses decreased to \$20,246 from \$24,778 an decrease of 18%. We are continuing to research and develop ingredients and manufacturing technologies for our product line. We renewed the strategic alliance agreement with UTEK Corporation, a technology transfer company to assist us with

introductions to university research ingredients and processes at a significantly lower rate. This decrease was partially offset by the use of other internal and external research sources as we continue to develop a product with an anticipated launch in 2007.

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Depreciation and Amortization Expense. The expense was \$11,779 compared to \$6,428, an increase of 83%. The increase is a result of the increased depreciation of the computer software system that was placed in service in March 2006.

Net Loss. Our net loss was \$778,944 or (\$0.08) per share compared to \$1,650,662 or (\$0.17) per share, a decrease of net loss of \$.09 per share or 53% respectively. The decrease in net loss is associated with the increase in sales and decrease of Sales and marketing and General and administrative expenses.

For the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005.

The discussion below first presents the results of the nine months ended September 30, 2006 followed by the results of the nine months ended September 30, 2005

Net sales. Net sales were \$1,724,252 an increase of 120% compared to \$783,126. The increase in net sales can be attributed to an increase in the number of independent distributors and customers along with greater brand recognition. The increase was also the result of the September 2005 introduction of the EDS system and the March 2006 rebranding of two products (HYDRATE and BUILD) and the introduction of a new product (SUPPORT) in the PEAK PERFORMANCE System.

The percentage that each product category represented of our net sales is as follows:

| Product Category | Nine Months Ended September 30, | | | |
|---|------------------------------------|------|------------|------------|
| | 2006 | 2005 | % of Sales | % of Sales |
| EAT | 18 | % | | |
| DRINK | 26 | % | | |
| SNACK (formerly sZone® snack) | 10 | % | 10 | % |
| HYDRATE (formerly eForce® sports drink) | 12 | % | 31 | % |
| Vitamins and minerals, including SUPPORT | 13 | % | 39 | % |
| BUILD (formerly VitaPro® nutrition shake) | 5 | % | 12 | % |
| Other-educational materials, apparel | 16 | % | 8 | % |

Gross Profit. Gross profit increased to \$1,101,411 compared to \$437,478 an increase of 152%. Gross profit as a percentage of revenue (gross margin) increased to 64% from 56%. The increase in gross profit reflects the increase in net sales. Gross margin increase is due to an increase in sales of higher margin items from the EDS system and the SUPPORT product which was partially offset by the write-offs for inventory obsolescence.

Sales and marketing expenses. Sales and marketing expenses increased to \$2,214,842 from \$1,901,503, an increase of 16%. Sales and marketing expenses consist primarily of distributor commissions, costs associated with attracting experienced field leaders for our distributor network, events and training for the distributors, and sales associated costs such as employee compensation for customer service and warehouse personnel, credit card fees and order fulfillment costs. The independent distributor compensation increased to 47% of net sales for the current period compared to 37% for the comparable period. There were additionally increases for salaries related to our customer service department, and for the national event in March, the recognition event in July and the leadership event in September. These increases were partially offset by decreases in the cost incurred in the prior year related to the change in company name and a decrease in expenses related to leadership recruitment.

General and administrative expenses. General and administrative expenses were \$2,136,506 an increase of 6% compared to \$2,006,289. Our general and administrative expenses consist primarily of employee and compensation for executives and administrative personnel, legal and accounting fees, business consultants, rent and associated building costs, costs associated with being a public company, business insurance and office costs such as telephone, supplies, computer

hardware and software and hosting fees. The increase is the result of the adoption of FAS 123R as we recorded stock based compensation of \$504,332 which was previously only disclosed in the notes to the financial statements. This increase was partially offset by the decrease in consultants used by the company to develop website and computer support services; and the decrease in the expenses related to being a public company that the company incurred in the prior year as a result of the public offering.

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Research and development expenses. Research and development expenses increased to \$64,180 from \$43,733. This was primarily from the expense related to our technology provider and costs associated with attending a national product convention, as well as ongoing product research. The increase is a result of the additional expenses incurred in the development process of a new product that we anticipate launching in 2007. This increase is partially offset by the decrease in expense related to our Strategic Technology partner based on the renewed contract.

Depreciation and Amortization Expense. The expense was \$54,554 compared to \$19,229, an increase of 184%. In July 2006 we entered into a Consent Agreement for the use of the trademark name XELR8. Consequently we evaluated the carrying value of the existing trademarks that the company had and fully amortized these intangible balances. In March the company placed a new computer system in service and consequently increased the depreciation expense when compared to prior year.

Net Loss. Our net loss was \$3,335,914 or (\$0.35) per share compared to \$3,467,341 or (\$0.41) per share. Our net loss decreased by 4% was the result of higher revenue and gross margin which was partially offset by increased expenses for Sales and Marketing and General and Administrative. The change in the per share is mainly attributable to the weighted number of shares outstanding.

Liquidity and Capital Resources

To date, our operating funds have been provided primarily from sales of our common stock, \$11,280,587, and by loans from our founder, our Chairman and by various stockholders of \$3,989,209, through September 30, 2006, and to a lesser degree, cash flow provided by sales of our products.

During March 2005, we obtained a \$170,000 short-term loan from our Chairman, a \$25,000 short-term loan from a significant shareholder and a \$170,000 short-term loan from an unrelated party for a total of \$365,000. All of these loans provide for interest at 10% per annum. These loans were paid in full with accrued interest of \$2,841 on April 12, 2005 leaving us with no short-term or long-term debt at that time.

On April 8, 2005 we closed a public offering of 1,500,000 units that was comprised of two shares of common stock and one Class A common stock warrant to purchase common stock at \$4.50 and one Class B warrant to purchase common stock at \$6.00 for net proceeds of \$7,742,682.

We used \$2,379,048 of cash for operations in the nine months ended September 30, 2006 as compared to \$3,547,479 of cash for operations in the nine months ended September 30, 2005. The use of cash in our operations results from incurring and accruing expenses to suppliers necessary to generate business and service our customers at a time when revenues did not keep pace with expenses. During the first two quarters of 2006 we used \$1,905,556 to fund our operating activities and in the third quarter the cash used to fund operations was \$473,492. As of September 30, 2006, we had \$464,127 in cash and cash equivalents available to fund future operations. In the event that we are not able to increase sales and further reduce expenses from operations, our current cash position would only support ongoing operations at the current rate for approximately three months. In this event we would require additional capital to fund continuing operations. Net working capital decreased from \$3,290,034 at December 31, 2005, to \$549,493 at September 30, 2006. We spent \$71,846 to purchase a new computer system to support the Distributors back-office functions.

Our independent auditors have noted in their reports on our financial statements as of December 31, 2005 and 2004 and for the years then ended, that there is substantial doubt regarding our ability to continue as a going concern. To date this contingency has not affected our ability to secure funding for our operations; however, going forward, we may experience more difficulty in raising additional funds to operate our Company.

We believe that our current cash position would only support ongoing operations for approximately three months and therefore the Company will require further funding to remain in business for the next 12 months. In the event that we are successful in completing this financing we could continue to carry out our business plan of increasing the number of distributors, sales levels and consequently increased profitability. Once we have completed the financing, if our business operations do not result in increased product sales, our business viability, financial position, results of operations and cash flows will likely be adversely affected. We cannot predict the terms upon which we could raise such capital or if any capital would be available at all.

Customer Concentrations

We had no single customer that accounted for any substantial portion of our revenues.

Off-Balance Sheet Items

We have no off-balance sheet items as of September 30, 2006.

Item 3 CONTROLS AND PROCEDURES

Prior to the filing of this report, the Company's management carried out an evaluation, under the supervision and with the participation of its Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on this evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's controls and procedures were effective to ensure that information required to be disclosed by the Company in the reports filed by it under the Securities and Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and include controls and procedures designed to ensure that information required to be disclosed by the Company in such reports is accumulated and communicated to the Company's management, including the Chief Executive Officer and the Chief Financial Officer of the Company, as appropriate to allow timely decisions regarding required disclosure.

There has been no change in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that has materially affected or is reasonably likely to materially affect its internal control over financial reporting.

Part II OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

Effective July 6, 2006, the Registrant entered into a Consent Agreement with PouchTec Industries, L.L.C., a copy of which has been filed herewith. The Consent Agreement provides that PouchTec Industries, L.L.C. agrees that Vitacube Systems Holdings, Inc. is the rightful owner of the XELR8 mark and will not object to the application filed with the U.S. Patent and Trademark Office for the registration of the XELR8 mark by Vitacube Systems Holdings, Inc. In consideration of the consent VitaCube Systems Holdings, Inc. agrees to pay PouchTec Industries, L.L.C. for the years 2006 to 2010 an amount of 1% of net sales, subject to a minimum payment of \$35,000 and a maximum of \$80,000 per year. The minimum payment, of \$35,000, is due on the effective date of the Consent and on January 15th of the calendar years of 2007, 2008, 2009 and 2010 and the remainder, up to the annual maximum due within 45 days of the end of the calendar year.

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

Item 3. DEFAULTS UPON SENIOR SECURITIES

None.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

Item 5. OTHER INFORMATION

None.

Item 6. EXHIBITS

| Exhibit No. | Description |
|--------------------|---|
| 31.1 | Certification of CEO as Required by Rule 13a-14(a)/15d-14 |
| 31.2 | Certification of CFO as Required by Rule 13a-14(a)/15d-14 |
| 32.1 | Certification of CEO as Required by Rule 13a-14(a) and Rule 15d-14(b) (17 CFR 240.15d-14(b)) and Section 1350 of Chapter 63 of Title 18 of the United States Code |
| 32.2 | Certification of CFO as Required by Rule 13a-14(a) and Rule 15d-14(b) (17 CFR 240.15d-14(b)) and Section 1350 of Chapter 63 of Title 18 of the United States Code |
| 99.1 | Press Release |

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, in the City and County of Denver, State of Colorado, on October 27, 2006.

VITACUBE SYSTEMS HOLDINGS, INC.

By /s/ JOHN D. POUCKET
John D. Pougnet
Chief Executive Officer
Chief Financial Officer (Principal Accounting Officer)
