

DEFENSE INDUSTRIES INTERNATIONAL INC
Form 10QSB
August 21, 2006

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

- Quarterly report under Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended June 30, 2006
- Transition report under Section 13 or 15(d) of the Exchange Act for the transition period from ___ to ___

Commission file number: 0-30105

Defense Industries International, Inc.

(Exact Name of Small Business Issuer as Specified in Its Charter)

Nevada

(State of Incorporation)

84-1421483

(I.R.S. Employer Identification No.)

8 Brussels St. Sderot, P.O. Box 779, Ashkelon 78101, Israel

(Address of Principal Executive Offices)

(011) 972-8-689-1611

(Issuer's Telephone Number, Including Area Code)

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

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

Yes No

APPLICABLE ONLY TO CORPORATE ISSUERS

As of August 11, 2006 the Issuer had 28,793,198 shares of Common Stock, \$.0001 par value per share, outstanding.

Transitional Small Business Disclosure Format (check one):

Yes No

APPLICABLE ONLY TO CORPORATE ISSUERS

DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES

INDEX

	<u>Page</u>
<u>Part - Financial Information:</u>	ii
<u>Item 1. Condensed Consolidated Balance Sheets as of June 30, 2006 (Unaudited) and December 31, 2005</u>	1-2
<u>Condensed Consolidated Statements of Operations and Comprehensive Income for the Three and Six Months Ended June 30, 2006 and 2005 (Unaudited)</u>	3
<u>Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2006 and 2005 (Unaudited)</u>	4
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	6-16
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	17-22
<u>Item 3. Controls and Procedures</u>	22
<u>Part II - Other Information:</u>	23
<u>Item 1. Legal Proceedings</u>	23
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	23
<u>Item 3. Default Upon Senior Securities</u>	24
<u>Item 4. Submission of Matters to a Vote of Shareholders</u>	24
<u>Item 6. Exhibits and Reports on Form 8-K</u>	24
<u>Signatures</u>	25

PART I FINANCIAL INFORMATION

INDEX

Item 1.

CONDENSED CONSOLIDATED BALANCE SHEETS AS OF JUNE 30, 2006 (UNAUDITED) AND DECEMBER 31, 2005	PAGES	1-2
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS) FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2006 AND 2005 (UNAUDITED)	PAGES	3
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE SIX MONTHS ENDED JUNE 30, 2006 AND 2005 (UNAUDITED)	PAGES	4-5
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AS OF JUNE 30, 2006 (UNAUDITED)	PAGES	6-12

ii

**DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARY COMPANIES**

CONDENSED CONSOLIDATED INTERIM BALANCE SHEETS

ASSETS

	<u>June 30, 2006</u> (Unaudited)	<u>December 31,</u> 2005
CURRENT ASSETS		
Cash and cash equivalents	\$ 1,280,352	\$ 1,581,967
Accounts receivable, net of allowance for doubtful accounts of \$180,984 and \$133,631, respectively	1,833,884	1,669,808
Accounts receivable - related parties, net of allowance for doubtful accounts of \$101,192 and \$95,489, respectively	238,354	320,250
Inventories	3,096,778	2,921,998
Trading securities	754,947	739,339
Deferred taxes	95,958	72,255
Other current assets	629,717	646,731
	<u>7,929,990</u>	<u>7,952,348</u>
PROPERTY, PLANT AND EQUIPMENT, NET	<u>2,275,929</u>	<u>2,270,455</u>
OTHER ASSETS		
Funds in respect of employee rights upon retirement	402,010	382,988
Deferred taxes, long-term	5,552	10,119
Intangible assets, net	96,103	102,499

	June 30, 2006 (Unaudited)	December 31, 2005
Total Other Assets	503,665	495,606
TOTAL ASSETS	\$ 10,709,584	\$ 10,718,409

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

1

**DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARIES**

CONDENSED CONSOLIDATED INTERIM BALANCE SHEETS

LIABILITIES AND SHAREHOLDERS' EQUITY

	June 30, 2006 (Unaudited)	December 31, 2005
CURRENT LIABILITIES		
Accounts payable	\$ 987,292	\$ 933,770
Short-term debt	1,217,834	961,738
Current portion of long-term debts	898,854	834,397
Common stock to be issued	40,000	40,000
Other current liabilities	527,336	564,038
Total Current Liabilities	3,671,316	3,333,943
LONG-TERM LIABILITIES		
Long-term portion of debts	1,003,083	712,940
Liability for employee rights upon retirement	301,079	272,190
Common stock to be issued	80,000	120,000
Embedded derivatives at fair value	128,417	166,777
Minority interest	806,340	889,086
Total long-term Liabilities	2,318,919	2,160,993
TOTAL LIABILITIES	5,990,235	5,494,936
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS' EQUITY		
Preferred stock, \$.0001 par value, 50,000,000 shares authorized, none issued and outstanding	--	--
Common stock, \$.0001 par value, 250,000,000 shares authorized, 28,793,198 issued and outstanding	2,879	2,730
Additional paid-in capital	2,552,738	2,512,887
Retained earnings	2,417,097	3,122,243

LIABILITIES AND SHAREHOLDERS' EQUITY

	June 30, 2006 (Unaudited)	December 31, 2005
Accumulated other comprehensive loss	(253,365)	(414,387)
Total Shareholders' Equity	4,719,349	5,223,473
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 10,709,584	\$ 10,718,409

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

**DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARY COMPANIES**

**CONDENSED CONSOLIDATED INTERIM STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME (LOSS)
(UNAUDITED)**

	For the Three Months Ended June 30, 2006	For the Three Months Ended June 30, 2005	For the Six Months Ended June 30, 2006	For the Six Months Ended June 30, 2005
NET REVENUES	\$ 1,831,027	\$ 3,907,691	\$ 3,664,398	\$ 7,592,171
COST OF SALES	1,613,383	2,733,221	3,137,856	5,762,604
GROSS PROFIT	217,644	1,174,470	526,542	1,829,567
OPERATING EXPENSES				
Selling	82,386	234,729	218,075	378,810
General and administrative	612,397	560,951	1,006,647	958,047
Total Operating Expenses	694,783	795,680	1,224,722	1,336,857
INCOME (LOSS) FROM OPERATIONS	(477,139)	378,790	(698,180)	492,710
OTHER INCOME (EXPENSES)				
Financial income (expenses), net	(150,708)	8,732	(158,091)	(35,437)
Gain on fair value adjustment to embedded derivatives	9,142	---	38,360	---
Other income (expenses), net	(16,199)	(15,514)	14,089	64,712
Total Other Income (expenses)	(157,765)	(6,782)	(105,642)	29,275

Edgar Filing: DEFENSE INDUSTRIES INTERNATIONAL INC - Form 10QSB

	For the Three Months Ended June 30, 2006	For the Three Months Ended June 30, 2005	For the Six Months Ended June 30, 2006	For the Six Months Ended June 30, 2005
INCOME (LOSS) BEFORE INCOME TAXES	(634,904)	372,008	(803,822)	521,985
Income tax (expenses) benefit	18,686	(133,015)	3,464	(182,029)
Income (loss) before minority interest	(616,218)	238,993	(800,358)	339,956
Minority interest income (loss)	67,082	(33,880)	95,212	(51,605)
NET INCOME (LOSS)	(549,136)	205,113	(705,146)	288,351
OTHER COMPREHENSIVE INCOME (LOSS)				
Foreign currency translation gain (loss), net of minority interest portion	257,320	(193,283)	161,022	(234,567)
Other comprehensive income (loss) before tax	257,320	(193,283)	161,022	(234,567)
Income tax (expenses) benefit related to items of other comprehensive income (loss)	(77,804)	69,393	(41,317)	86,072
TOTAL OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX	179,516	(123,890)	119,705	(148,495)
COMPREHENSIVE INCOME (LOSS)	\$ (369,620)	\$ 81,223	\$ (585,441)	\$ 139,856
Net income (loss) per share - basic and diluted	\$ (0.01)	\$ 0.01	\$ (0.02)	\$ 0.01
Weighted average number of shares outstanding - basic and diluted	27,689,553	25,375,929	27,498,954	25,363,094

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

**DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARY COMPANIES**

**CONDENSED CONSOLIDATED INTERIM STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED JUNE 30, 2006 AND 2005**

For The Six Months Ended June 30, 2006	For The Six Months Ended June 30, 2005
--	--

Edgar Filing: DEFENSE INDUSTRIES INTERNATIONAL INC - Form 10QSB

	For The Six Months Ended June 30, 2006	For The Six Months Ended June 30, 2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	\$ (705,146)	\$ 288,351
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Depreciation and amortization	211,669	170,944
Gain from sale of property, plant and equipment	---	(17,774)
Provision for doubtful accounts	53,056	18,232
Deferred private placement cost	---	(100,000)
Gain on fair value adjustment to embedded derivatives	(38,360)	---
Net realized and unrealized gain on trading securities	(7,055)	(46,940)
Minority interest in income (loss) of subsidiary	(95,212)	51,605
Increase in deferred taxes	(19,136)	(21,661)
Increase in accounts receivable	(135,235)	(740,157)
decrease in other assets	17,014	206,487
(Increase) decrease in inventories	(174,780)	267,568
Increase in accounts payable	53,521	18,550
Decrease in other liabilities	(36,702)	(15,567)
Increase (decrease) in liability for employee rights upon retirement	28,889	(28,436)
	<u> </u>	<u> </u>
Net Cash (used in) provided by Operating Activities	(847,477)	89,811
	<u> </u>	<u> </u>
CASH FLOWS USED IN INVESTING ACTIVITIES:		
(Increase) decrease in funds in respect of employee rights upon retirement	(19,022)	38,609
Purchases of property, plant and equipment	(158,736)	(384,393)
Proceeds from sale of property, plant and equipment	---	17,772
Proceeds from sale of trading securities	369,049	292,808
Cash acquired in acquisition of Own Mills	---	20,415
Purchases of trading securities	(350,460)	(276,727)
	<u> </u>	<u> </u>
Net Cash used in Investing Activities	(159,169)	(330,125)
	<u> </u>	<u> </u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Short-term debt, net	256,096	913,108
Payments on long-term debt	(536,877)	(258,306)
Proceeds from long term loan	855,856	54,409
	<u> </u>	<u> </u>
Net Cash provided by Financing Activities	575,075	709,211
	<u> </u>	<u> </u>
EFFECT OF CHANGES IN EXCHANGE RATES ON CASH	129,956	(230,430)
	<u> </u>	<u> </u>
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(301,615)	238,467
CASH AND CASH EQUIVALENTS - BEGINNING OF PERIOD	1,581,967	505,013
	<u> </u>	<u> </u>
<u>CASH AND CASH EQUIVALENTS - END OF PERIOD</u>	<u>\$ 1,280,352</u>	<u>\$ 743,480</u>
INTEREST PAID	<u>\$ 84,247</u>	<u>\$ 38,482</u>
TAXES PAID	<u>\$ 62,539</u>	<u>\$ 95,092</u>

CONDENSED CONSOLIDATED INTERIM STATEMENTS OF CASH FLOWS FOR THE THREE MONTHS ENDED

	For The Six Months Ended June 30, 2006	For The Six Months Ended June 30, 2005
--	--	--

4

**DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARY COMPANIES**

**CONDENSED CONSOLIDATED INTERIM STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED JUNE 30, 2006 AND 2005**

SUPPLEMENTAL SCHEDULE OF NON-CASH TRANSACTION AND INVESTING ACTIVITIES:

On February 28, 2005, the Company acquired all the outstanding shares of Owen Mills for an aggregate amount of \$372,401, see Note 2,

The following represents the fair value of assets acquired, net of liabilities assumed at the acquisition date:

Assets:

Cash and cash equivalent	\$	20,415
Accounts receivable - net		232,224
Other current assets		3,865
Property, plant and equipment		140,380
Inventories		179,306
Goodwill		80,900

Total assets acquired		657,090
-----------------------	--	---------

Liabilities:

Accounts payable		30,973
Loans		253,716

Total Liabilities assumed		284,689
---------------------------	--	---------

	\$	372,401
--	----	---------

On February 28, 2006 the Company issued 123,077 shares of its common stock having a fair value of \$40,000 at the date of issuance to the former shareholders of Owen Mills, pursuant to the acquisition agreement.

5

DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARY COMPANIES

NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 1 BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

- A. The accompanying unaudited interim consolidated financial statements as of June 30, 2006 and for the three and six months period then ended (the Interim Financial Statements) were prepared in a condensed form in accordance with the instructions for Form 10-Q and, therefore, do not include all disclosures necessary for a complete presentation of financial condition, results of operations, cash flows and all the data and notes which are required when preparing annual financial statements, in conformity with generally accepted accounting principles accepted in the United States of America.
- B. The accounting principles used in the presentation of the Interim Financial Statements are consistent with those principles used in the presentation of the latest annual financial statements. All significant accounting policies have been applied consistently with year ended December 31, 2005.
- C. The preparation of the Interim Financial Statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for fair presentation of the Interim Financial Statements have been included. The results of operations for the six months period ended June 30, 2006, are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. The Interim Financial Statements should be read in conjunction with the Company's annual financial statements as of December 31, 2005 and for the year then ended and the accompanying notes thereto.
- D. Principles of Consolidation**

The Interim Financial Statements include the accounts of Defense Industries International, Inc. and its wholly owned subsidiaries, Export Erez, USA, Inc., Export Erez, Ltd., Mayotex, Ltd. Dragonwear Trading Ltd. its 76% owned subsidiary Achidatex Nazareth Elite for all periods presented and Owen Mills since February 28, 2005(the acquisition date) (collectively, the Company). The minority interest represents the minority shareholders proportionate share of Achidatex. All intercompany accounts and transactions have been eliminated in consolidation.

6

DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARY COMPANIES

NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)

E. Earnings per common share

Basic and diluted earning per common share is presented in conformity with SFAS No.128, Earnings Per Share for all periods presented. Basic earnings per common share is computed by dividing net income, by the weighted average number of shares of outstanding common shares. Diluted earnings per common share is computed by dividing net income, by the weighted average number of shares of outstanding common shares adjusted to include incremental common shares that would have been outstanding if potentially dilutive common shares had been issued. Common equivalent shares are excluded from the computation in periods in which they have an antidilutive effect. For all reported periods, no potential common shares are included in the computation of a diluted per share amount since such potential common shares would not have a dilutive effect.

F. Goodwill and Other Intangible Assets

Edgar Filing: DEFENSE INDUSTRIES INTERNATIONAL INC - Form 10QSB

In accordance with Statement of Financial Accounting Standards (SFAS No. 141), the Company allocates the purchase price of its acquisitions to the tangible assets, liabilities and intangible assets acquired based on their estimated fair values. The excess purchase price over those fair values is recorded as goodwill. The fair value assigned to intangible assets acquired is either based on valuations prepared by independent third party appraisal firms using estimates and assumptions provided by management or negotiated at arms-length between the Company and the seller of the acquired assets. In accordance with SFAS No. 142, goodwill and purchased intangibles with indefinite lives are not amortized, but will be reviewed periodically for impairment. Purchased intangibles with finite lives will be amortized on a straight-line basis over their respective useful lives.

G. Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes . The Interpretation clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes . The Interpretation prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Interpretation also provides guidance on the related de-recognition, classification, interest and penalties, accounting for interim periods, disclosure and transition of uncertain tax positions. The Interpretation is effective for fiscal years beginning after December 15, 2006, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings.

7

DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARY COMPANIES

NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

Although the Company s analysis of the effect of FIN 48 has not been completed, the Company does not anticipate recording any material adjustment as a result of adopting this Interpretation.

NOTE 2 BUSINESS COMBINATION

Effective February 28, 2005, the Company acquired all of the outstanding shares of Rizzo Inc. (doing business as Owen Mills Company), a Los Angeles-based manufacturing and service company specializing in military and industrial sewing of marine and ballistic fabric products; for a consideration of \$400,000, consisting of \$200,000 note payable and shares of the Company s common stock having a value of \$200,000, based on the average closing price per share of the Company s common stock for the ten trading days preceding the issuance of such shares. The Company will pay the \$400,000 of consideration as follows: (i) \$3,333.33 each month commencing on March 31, 2005 and thereafter on the last business day of each successive month until Buyer has paid Shareholder a total of \$200,000; the present value of the payments is \$172,401 (ii) \$40,000 in the form shares of common stock of the Company payable within fifteen (15) business days from the date of the Agreement; and (iii) \$40,000 in the form of Company stock paid to the Seller on each of the last business days of February 2006, February 2007, February 2008, and of February 2009. The Company acquired assets totaling \$576,190 and assumed liabilities of \$284,689.

The following table reflects the unaudited pro forma combined results of operations for the six and three months ended June 30, 2005, assuming the acquisition had occurred at the beginning of 2005.

	For the six Months ended June 30, 2005	For the three Months ended June 30, 2005
Revenue	\$ 7,751,751	\$ 3,104,659
Net income	285,794	93,812
Net income per share - basic and diluted	0.01	0.00

For the six
Months ended June
30, 2005

For the three
Months ended June
30, 2005

8

**DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARY COMPANIES**

NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 3 INVENTORIES

Consist of:

	June 30, 2006	December 31, 2005
Raw materials	\$ 1,581,860	\$ 1,815,021
Work in progress	660,491	592,751
Finished goods	854,427	514,226
	\$ 3,096,778	\$ 2,921,998

NOTE 4 SHORT-TERM DEBT

Consist of:

	Interest Rates	June 30, 2006	December 31, 2005
Bank credit (1)	7% - 12%	\$ 694,626	\$ 501,793
Short-term bank loans (2)	6% - 7.5%	523,208	459,945
		\$ 1,217,834	\$ 961,738

- (1) The revolving credit facility is due on demand.

The revolving credit facility is utilized for the operational activities of the Company and for the costs associated with the evacuation from the Gaza Industrial Zone. The Company anticipates that the expenses related to Gaza Strip evacuation will be reimbursed by the Israeli Government. (See note 8)

- (2) On December 29, 2005, the Company borrowed \$22,523 at an interest rate of 4%. This loan is payable in 12 monthly payments commencing on January 28, 2006. Each payment consists of a fixed amount of principal and accrued interest. As of June 30, 2006, the balance of this loan was \$11,262.

Edgar Filing: DEFENSE INDUSTRIES INTERNATIONAL INC - Form 10QSB

On December 28, 2005, the Company borrowed \$33,784 at an interest rate of 7.75%. This loan will be paid in one payment on December 7, 2006. As of June 30, 2006, the balance of this loan was \$35,047.

On December 7, 2005, the Company borrowed \$191,441 at an interest rate of 7.3%. This loan will be paid in one payment on December 7, 2006. As of June 30, 2006, the balance of the loan was \$192,322.

9

**DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARY COMPANIES**

NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)

On April 26, 2006, the Company borrowed \$225,225 at an interest rate of 7.5%. This loan will be paid in one payment on July 26, 2006. As of June 30, 2006, the balance of this loan was \$228,230.

On June 29, 2006, the Company borrowed \$56,306 at an interest rate of 8.25%. The Loan is due on demand. As of June 30, 2006, the balance of this loan was \$56,344.

NOTE 5 LONG-TERM DEBT

On December 24, 2003, the Company borrowed \$388,216 at an interest rate of 7%. This loan is payable in 60 monthly payments commencing on January 24, 2004. Each payment consists of a fixed amount of principal and accrued interest. As of June 30, 2006, the balance of this loan was \$191,651, of which \$76,576 was included in the current portion of long-term debt.

On May 31, 2004, the Company entered into two loan agreements of \$92,850 each at an interest rate of 7.02%. These loans are payable in 56 monthly payments commencing on June 1, 2004. Each payment consists of a fixed amount of principal and accrued interest. As of June 30, 2006 the total balance of these loans was \$106,718 of which \$36,757, was included in the current portion of long-term debt.

On April 18, 2005, the Company borrowed \$21,909 at an interest rate of 5% linked to Israeli Consumer Price Index (C.P.I). This loan is payable in 48 monthly payments commencing on May 21, 2005. Each payment consists of a fixed amount of principal and accrued interest. As of June 30, 2006, the balance of this loan was \$16,595, of which \$5,576 was included in the current portion of long-term debt.

On April 18, 2005, the Company borrowed \$29,502 at an interest rate of 5% linked to Israeli C.P.I. The loan is payable in 48 monthly payments commencing May 21, 2005 Each payment consists of a fixed amount of principal and accrued interest. As of June 30, 2006, the balance of the loan was \$22,345, of which \$7,688 was included in the current portion of long-term debt.

On July 29, 2005, the Company borrowed \$543,125 at an interest rate of 6% linked to Israeli C.P.I. This loan is payable in 24 monthly payments commencing on August 29. Each payment consists of a fixed amount of principal and accrued interest. As of June 30, 2006, the balance of this loan was \$313,542, of which \$288,512 was included in the current portion of long-term debt.

10

**DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARY COMPANIES**

NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)

On July 31, 2005, the Company borrowed \$434,500 at an interest rate of 6.25% linked to Israeli C.P.I. This loan is payable in 34 monthly payments commencing on August 31, 2005. Each payment consists of a fixed amount of principal and accrued interest. As of June 30,

Edgar Filing: DEFENSE INDUSTRIES INTERNATIONAL INC - Form 10QSB

2006, the balance of this loan was \$250,729, of which \$230,809 was included in the current portion of long-term debt.

On December 29, 2005, the Company borrowed \$21,725 at an interest rate of 6.5% linked to Israeli C.P.I. This loan is payable in 36 monthly payments commencing on January 28, 2005. Each payment consists of a fixed amount of principal and accrued interest. As of June 30, 2006, the balance of the loan was \$19,193, of which \$7,277 was included in the current portion of long-term debt.

On May 24, 2006, the Company borrowed \$177,180 at an interest rate of 7.75% linked to Israeli C.P.I. This loan is payable in 36 monthly payments commencing on June 24, 2006. Each payment consists of a fixed amount of principal and accrued interest. As of June 30, 2006, the balance of this loan was \$175,982, of which \$55,843 was included in the current portion of long-term debt.

On April 10, 2006, the Company borrowed \$443,450 at an interest rate of 8.15% linked to Israeli C.P.I. This loan is payable in 60 monthly payments commencing on May 10, 2006. Each payment consists of a fixed amount of principal and accrued interest. As of June 30, 2006, the balance of the loan was \$440,057, of which \$73,784 was included in the current portion of long-term debt.

On May 17, 2006, the Company borrowed \$37,071 at an interest rate of 6.25% linked to Israeli C.P.I. This loan is payable in 48 monthly payments commencing on June 10, 2006. Each payment consists of a fixed amount of principal and accrued interest. As of June 30, 2006, the balance of this loan was \$36,389, of which \$8,464 was included in the current portion of long-term debt.

On May 23, 2006, the Company borrowed \$198,155 at an interest rate of 8.5% linked to Israeli C.P.I. This loan is payable in 36 monthly payments commencing on June 23, 2006 with each payment consisting of a fixed amount of principal along with accrued interest. As of June 30, 2006, the balance of this loan was \$197,394, of which \$67,568 was included in the current portion of long-term debt.

11

DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARY COMPANIES

NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

On February 28, 2005, the Company acquired all the outstanding shares of Owen Mills Company for an aggregate of \$372,401, consisting of a note payable of \$172,401 and \$200,000 in common stock of the Company, both of which are to be paid over five years. As of June 30, 2006 the balance of the note was \$131,347, of which \$40,000 was included in the current portion of long term debt.

All of the Company's long-term debt is collateralized by a floating guarantee on essentially all of the Company's assets.

NOTE 6 SECURITIES PURCHASE AGREEMENT

On June 15, 2005, the Company executed a Securities Purchase Agreement (the "Agreement") with a group of investors for a \$1.1 million private placement of its common stock. Pursuant to the Agreement, the Company agreed to issue 1,833,334 shares of its common stock to the investors at a price of \$0.60 per share. The Company also agreed to issue the investors 365,000 warrants to purchase its common stock at an exercise price of \$0.94 share, exercisable until June 30, 2007, and 182,500 warrants at an exercise price of \$2.40 per share, exercisable until June 30, 2010. The Agreement also provided for the issuance by the Company to the investors of an additional 1,368,191 shares of its common stock, on June 16, 2006, as a result of a decrease in the Company's share price from \$0.60 per share.

In addition, the Company agreed to issue 82,133 shares of its common stock, as well as 60,000 warrants at an exercise price of \$0.94 (exercisable until June 30, 2007) and 20,000 warrants at an exercise price of \$2.40 per share (exercisable until June 30, 2010) as a finder's fee for services provided in connection with the transaction.

The agreement also provides for liquidated damage payments after the Registration Statement has been declared effective by the SEC if sales of all of the registrable securities required to be included in such Registration Statement cannot be made pursuant to such Registration Statement. In such event, the Company is required to pay each holder of such registrable securities an amount in cash equal to 5% (five percent) per calendar month or portion thereof of the aggregate share purchase price paid by the holder. The maximum amount of cash payable for such liquidated damages is \$300,000.

The Company accounted for the warrants issued based on guidance from SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities and Emerging Issues Task Force (EITF) No. 00-19. Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company's Own stock. Accordingly, the warrants are treated as derivatives and classified as a liability.

12

**DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARY COMPANIES**

**NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)**

The Company allocated the proceeds from the private placement of \$1.1 millions between the common stock and the warrants based upon the fair value of the warrants at the transaction date using the Black-Scholes pricing model. This resulted in a liability being recorded at the transaction date for the warrants of \$171,597.

13

**DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARY COMPANIES**

**NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)**

The warrants are recorded at fair value, based on the Black-Scholes pricing model, and revalued each reporting period with the change in fair value recorded as other income (expenses). For the six months ended June 30, 2006 the fair value adjustment resulted in a gain of \$38,360.

NOTE 7 SEGMENT INFORMATION AND CONCENTRATION OF CREDIT RISK

The Company has two strategic business units: the civilian market and the military market. The military market is further broken down between local and export sales in order to better analyze trends in sales and profit margins. The Company does not allocate assets between segments because several assets are used in more than one segment and any allocation would be impractical.

A. Sales and Income from Operations:

	Civilian		Military		Consolidated
	Local		Local	Export	
<u>For the six months ended June 30, 2006</u>					
Revenue from sales	\$ 1,640,189	\$	1,116,121	\$ 908,088	\$ 3,664,398
Loss from operations	(374,279)		(180,384)	(143,517)	(698,180)
<u>For the six months ended June 30, 2005</u>					
Revenue from sales	\$ 1,158,790	\$	1,717,138	\$ 4,716,243	\$ 7,592,171
Income from operations	68,521		160,034	264,155	492,710

B. Revenues from Sales to Single Customers Exceeding 10% of Sales:

	<u>For the Six Months Ended June 30, 2006</u>	<u>For the Six Months Ended June 30, 2005</u>
Customer A (Military Export)	\$ --	\$ 1,172,166
Customer B (Military Export)	--	796,831
Customer C (Military Local)	860,682	1,138,100

14

**DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARY COMPANIES**

**NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)**

NOTE 8 COMMITMENTS AND CONTINGENCIES

A. Contingencies

The Company has an employment agreement with the President of the Company, pursuant to which the President is entitled to additional compensation of 1.5% of the growth in the Company's total sales since 2002. The President, at his option, may receive shares of common stock in lieu of cash. For the year ended December 31, 2004, the President was entitled to bonus compensation in the amount of \$21,102, or 42,204 shares of the Company's common stock in lieu of such compensation (having a fair value of \$48,957), which was accrued and included in other current liabilities and subsequently paid in 2005. For the six months ended June 30, 2006, there was no bonus due to the President of the Company.

B. Other Matters

Export Erez Ltd. and Mayotex Ltd., received a notification of audit from the Israeli Internal Revenue Service for the years ended December 31, 2002, 2003, and 2004. The audit is in the initial stage and the Company is unable to determine, what effect, if any, the audit will have on the consolidated financial statements.

C. Former Operations in Gaza Strip

During 2004, the Israeli Government decided to evacuate the Erez Industrial Zone in the Gaza Strip where part of the Company's operations were located. The Company had owned facilities, leased other facilities and maintained equipment and inventory within this area. In 2005, the Company moved its light cut and sew operation from the Erez Industrial Zone to Sderot as well as some of its webbing equipment to Nazareth. In August 2005, the Company evacuated its remaining operations and abandoned the buildings owned and leased in the Erez Industrial Zone. The Israeli Government's decision to evacuate the Gaza Strip was supported by certain resolutions, as well as the Evacuation Law that was adopted by the Israeli Parliament, to compensate the Israeli Gaza Strip settlers as well as business and property owners in the Gaza Strip and in the Erez Industrial Zone, however, the amount of the compensation has not been finalized.

15

**DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARY COMPANIES**

**NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)**

The Company incurred \$217,477 in costs related to the evacuation of its facilities located in the Erez Industrial Zone in the Gaza Strip, which includes \$89,612 in moving expenses and \$127,865, of net book value for the building that was abandoned. The Company believes that it will be reimbursed in full for all costs related to the evacuation as well as the fair market value of the abandoned facilities in the Erez Industrial Zone. As a result, the Company has reclassified the net book value of the abandoned assets as well as the evacuation costs to a receivable from the State of Israel in the amount of \$217,447 which is included in Other Current Assets in the Consolidated Balance Sheet at June 30, 2006 and December 31, 2005.

Since the Company believes that it will be reimbursed for the fair market value of the abandoned building, there is a potential gain contingency that will be recorded when and if realized.

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

This information should be read in conjunction with the condensed consolidated financial statements and notes included in Item 1 of Part I of this Quarterly Report and the audited consolidated financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations for the year ended December 31, 2005 contained in our 2005 Annual Report on Form 10-KSB. The discussion and analysis which follows may contain trend analysis and other forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 which reflect our current views with respect to future events and financial results. These include statements regarding our earnings, projected growth and forecasts, and similar matters that are not historical facts.

We remind shareholders that forward-looking statements are merely predictions and therefore are inherently subject to uncertainties and other factors that could cause the future results to differ materially from those described in the forward-looking statements

Critical Accounting Policies

We have identified the following policies as critical to the understanding of our condensed consolidated financial statements. The preparation of our consolidated financial statements 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 condensed consolidated financial statements and the reported amounts of sales and expenses during the reporting periods. Our condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States.

Revenues and Revenue Recognition. Revenues from sales of products are recognized upon shipment to customers. We provide a warranty on goods ranging from three to four years. Our policy is to consider the establishment of a reserve for warranty expenses. Based upon our historical experience, we have not established a reserve at June 30, 2006 and June 30, 2005. If we change any of our assumptions with regard to our recognition of revenues, or if there is a change with respect to warrant expenses our financial position and results of operations may change materially.

Foreign Currency Translation and Transactions. The functional currency of Export Erez, Ltd., Mayotex Ltd., and Achidatex Nazareth Elite is the New Israeli Shekel, or NIS. The functional currency of Dragonwear Trading Ltd. is the Cyprus Pound, or CYP. The financial statements of Dragonwear are translated into NIS. The financial statements for all of these entities are then translated into U.S. dollars from NIS at period-end exchange rates as to assets and liabilities and average exchange rates as to revenues and expenses. Capital accounts are translated at their historical exchange rates when the capital transactions occurred. Foreign currency transaction gains or losses from transactions denominated in currencies other than NIS are recognized in net income in the period the gain or loss occurs. Any change in exchange rates may have a material impact on our financial position and results of operations.

Accounts Receivable. Accounts receivable consist primarily of receivables from customers and institutions. We record a provision for doubtful accounts, when appropriate, to allow for any amounts which may be unrecoverable based upon an analysis of our prior collection experience, customer creditworthiness and current economic trends.

Inventories. Inventories are valued at the lower of cost or market value using the first-in first-out method. The cost includes expenses of freight-in transportation. The specific identification method is used for finished goods since all orders are custom orders for customers.

Edgar Filing: DEFENSE INDUSTRIES INTERNATIONAL INC - Form 10QSB

Inventories write-offs and write-down provisions are provided to cover risks arising from slow-moving items or technological obsolescence. Any change in our assumptions with respect to the need to write-off or write-down the value of our inventories may have material affect on our financial position or results of operations.

Property Plant and Equipment Fixed assets are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of three to twenty-five years. These long-lived assets are generally evaluated on an individual basis in making a determination as to whether such assets are impaired. Periodically, we review our long-lived assets for impairment based on estimated future non-discounted cash flows attributed to the assets. In the event such cash flows are not expected to be sufficient to recover the recorded value of the assets, the assets are written down to their estimated fair values. The use of different assumptions with respect to the expected cash flows from our assets and other economic variables, primarily the discount rate, may lead to different conclusions regarding the recoverability of our assets carrying values and to the potential need to record an impairment loss for our long lived assets.

Overview

We are a manufacturer and global provider of personal military and civilian protective equipment and supplies. Our products are used by military, law enforcement, border patrol enforcement, and other special security forces, corporations, non-governmental organizations and individuals throughout the world.

Our main products include body armor, bomb disposal suits, bullet proof vests and jackets, ballistic wall coverings, bullet proof ceramic and polyethylene panels, V.I.P. car armoring and lightweight armor kits for vehicles, personal military equipment, dry storage systems, liquid logistic products, tents and other camping and travel gear.

Material Trends

Local Military Market. The Israeli Military defense budget has been subject to reductions since the second half of 2003. As a result, the demand for our products declined in the second half of 2003 and stabilized at a lower level in 2004 and 2005. The trend worsened in the first six months of 2006. In 2005 and in the first six months of 2006 sales to the Israeli Ministry of Defense were \$2,099,918 and \$860,667, accounting for 18.3% and 23.5% of our sales.

18

In the second half of 2005, the Israeli Government evacuated the Gaza strip. As a result of the Israeli Government's decisions and the evacuation, the Israeli Defense Forces, or IDF, have indicated that they will slightly reduce their manpower and that equipment will be stored for long periods in environments that will promote battlefield readiness and the capability of quick deployment. In addition, as a result of the war between Israel and the Hezbollah in Lebanon, which started in July 2006, many Israeli reserve forces were activated, and a large amount of stored equipment was removed from dry-storage compartments and mobilized. In light of this situation, we believe that our local military business will grow as a result of an increase in the demand for our dry storage systems products and other military gear. However, we expect such increase to be reflected mainly in the forth quarter of 2006.

Export Military Market. Our customers in this market are military and law enforcement organizations, mostly in South America, North America and Europe. Their budgets fluctuate and as a result we cannot identify definite trends in these markets. In 2005 and in the first six months of 2006, we had sales of \$1,251,611 and \$248,587 in North America, sales of \$882,440 and \$291,857 in South America and sales of \$3,532,161 and \$504,444, in Europe, respectively. The decline in sales is primarily attributable to the general decline in sales of bullet-resistant vests.

On November 17, 2003, in response to concerns from the law enforcement community, the U.S. Department of Justice announced an initiative to address the reliability of body armor used by law enforcement personnel and to examine the future of bullet-resistant technology and testing. These concerns followed the failure of a relatively new Zylon®-based body armor vest worn by a Pennsylvania police officer. As part of this initiative, the American NIJ, examined Zylon®-based bullet-resistant vests (both new and used) and reviewed the existing process by which bullet-resistant vests are certified. Zylon® (or PBO fiber poly-p-phenylene benzobisoxazole) is a high-strength organic fiber produced by Toyobo Co., Ltd. On August 24, 2005, the American NIJ released a status report of its examination to the Department of Justice in which the American NIJ announced, among other things, that although the test results do not conclusively prove that all Zylon®-containing body armor models have performance problems, they show that used Zylon®-containing body armor may not provide the intended level of ballistic resistance. The test results also imply that a visual inspection of body armor and its ballistic panels does not indicate whether a particular piece of Zylon®-containing body armor has maintained its ballistic performance. On such date, the American NIJ also issued a Body Armor Standard Advisory Notice advising that it has identified Zylon® as a material that appears to create a risk of death or serious injury as a result of degraded ballistic performance when used in body armor. The American NIJ also introduced the American NIJ 2005 Interim Requirements for Bullet-Resistant Body Armor, or the American NIJ Interim Requirements, modifying and supplementing NIJ Standard 0101.04 (Ballistic

Resistance of Personal Body Armor), or the American NIJ Standard 0101.04.

Under the NIJ Interim Requirements, any body armor model that was found by NIJ to be compliant with NIJ Standard 0101.04 prior to the effective date of NIJ Interim Requirements must, in order to comply with NIJ Interim Requirements, obtain from NIJ a notice of compliance by, among other things, submitting to NIJ either: (i) evidence that demonstrates to the satisfaction of NIJ that the body armor model will maintain ballistic performance over its declared warranty period; or (ii) a written certification (the sufficiency of which will be determined by NIJ) that the model contains no material listed in an NIJ Body Armor Standard Advisory Notice in effect at the time of submission.

As a result of these developments, legal proceedings were filed against certain U.S. based manufacturers. In addition, certain major U.S. based manufacturers initiated exchange and upgrade programs for bullet-resistant vests resulting in increased expenses. These developments caused a general decline in sales of bullet-resistant vests.

Our products do not contain Zylon®. In accordance with the American NIJ Interim Requirements, we intend to apply to the American NIJ to obtain a notice of compliance with the NIJ Requirements with respect to our products that were previously found by the American NIJ to be compliant with the American NIJ Standard 0101.04, as soon as final regulations will be published by them.

As a result of the above, there is a general decline in sales of bullet-resistant vests in our markets, which have affected our sales of bullet-resistant vests and our results of operations since the last half of 2005. We expect that our export military business will continue to suffer in 2006, but that the trend will reverse thereafter.

Local Civilian Market. Our product range to the civilian market is diversified. In 2004 and 2005, our local market business grew as a result of the improvement of the economic situation in Israel. We expect a modest increase in this market in 2006 and in the future.

Gross Profit Margins. Our pricing policy, although slightly different for each product, is based on our existing overall gross margin. We do not expect a material change in our gross profit margins in the foreseeable future.

Backlog. We had approximately \$2.45 million of unfilled customer orders at June 30, 2006, out of which approximately \$890,000 was attributable to orders from military customers in South America, approximately \$550,000 was attributable to the U.S. civilian market, approximately \$368,000 was attributable to the local civilian market, approximately \$293,000 million was attributable to the Israeli military, approximately \$210,000 was attributable to orders from Europe, Asia and Africa and approximately \$145,000 was attributable to orders from Australia.

Operations in the Erez Industrial Zone

During 2004, the Israeli Government decided to evacuate the Erez Industrial Zone in the Gaza Strip where part of our operations were located. We evacuated our remaining operations from the Erez Industrial Zone in August 2005. The Israeli Government's decision to evacuate the Gaza Strip was supported by certain resolutions as well as the Israeli Evacuation Compensation Law (2005), that was adopted by the Israeli Parliament to compensate the Israeli Gaza Strip settlers as well as business and property owners in the Gaza Strip and in the Erez Industrial Zone.

During the second half of 2004, we prepared for the eventual evacuation by merging some of our existing production facilities. We moved one of our light cut and sew operations to Sderot and some of our webbing equipment to Nazareth.

At June 30, 2006 we recorded a receivable in the amount of \$217,447, which represents costs incurred related to the evacuation of the Erez Industrial Zone, which according to the Evacuation Law are recoverable from the State of Israel. Of these costs, \$127,865 represents the net book value of the facilities abandoned and \$89,612 represents all other moving costs. In February 2006, three of our subsidiaries, Export Erez Ltd., Mayotex Ltd. and Achidatex Nazareth Elite (1997) Ltd. filed a claim for compensation pursuant to the Evacuation Compensation Law. We cannot provide any assurance that the claim, which substantially exceeded the amount of our receivable, will be approved in full, or to what extent, or when the compensation will be paid.

Three Months Ended June 30, 2006 Compared with Three Months Ended June 30, 2005

Results of Operations

Net Revenues and Gross Profit Margin. Net revenues for the three months ended June 30, 2006 decreased to \$1,831,027 from \$3,907,691 in the same period in 2005, a decrease of 53.2%. The decrease is primarily attributable to the decrease in export sales, resulting mainly from the general decline in sales of bullet-resistant vests and from a reduction in sales to the IDF, due to the reduction of the IDF budget for 2006. The decrease in sales of bullet-resistant vests is due to the failure of the relatively new Zylon®-based body armor vest, and the uncertainty with respect to the future requirements of the American NIJ for certifying new bullet-resistant vests. In the three months ended June 30, 2006, Export Erez, Achidatex, and Owen Mills accounted for \$980,245 or 53.5%, \$646,805 or 35.3%, and \$203,977 or 11.2% of our revenues, respectively. In the three months ended June 30, 2005 Export Erez, Achidatex and Owen Mills accounted for \$2,189,968 or 56.0%, \$1,438,633 or 36.9% and \$279,090 or 7.1% of our revenues, respectively.

The following table sets forth the breakdown of sales by segment for the three months ended June 30, 2006 and 2005.

	Three months ended June 30,	
	2006	2005
Sales to the local civilian market	\$ 844,759	\$ 663,770
Sales to the local military market	575,348	1,135,671
Export military sales	410,920	2,072,250
Total	\$ 1,831,027	\$ 3,871,691

Gross profit for the three months ended June 30, 2006 was \$217,644 compared to \$1,174,470 for the same period in 2005. This decrease in gross profit is principally attributable to the decrease in our sales in the second quarter of 2006. In the three months ended June 30, 2006 Export Erez, Achidatex and Owen Mills accounted for 97.4%, 0% and 2.6%, of our gross profit, respectively. In the three months ended June 30, 2005 Export Erez, Achidatex and Owen Mills accounted for 44.5%, 51.0% and 4.5%, of our gross profit, respectively.

Selling Expenses. Selling expenses for the three months ended June 30, 2006 decreased to \$82,386 from \$234,729 for the same the same period in 2005. The decrease in our selling expenses was attributable to the decrease in export sales which resulted in lower sales commissions. Export Erez's selling expenses for the three months ended June 30, 2006 were \$60,318 compared to \$51,664 for the three months ended June 30, 2005. Achidatex's selling expenses for the three months ended June 30, 2006 were \$18,438 compared to \$183,065 for the three months ended June 30, 2005. Owen Mills selling expenses for the three months ended June 30, 2006 were \$3,630. Owen Mills did not record any selling expense for the three months ended June 30, 2005.

General and Administrative Expenses. General and administrative expenses for three months ended June 30, 2006 increased to \$612,397 from \$560,951 for the same period in 2005, mainly as a result of increase in auditing and legal fees.

Financial Expenses. We had financial expenses, net of \$150,708 for the three months ended June 30, 2006 as compared to income of \$8,732 for the same period in 2005. This increase is mainly attributable to the decrease in the exchange rate between the U.S. dollar and the NIS and an increase in the prevailing interest rate in Israel.

Gain on Fair Value Adjustment to Embedded Derivatives. Pursuant to a securities purchase agreement we executed with a group of investors on June 15, 2005, we issued to such investors warrants to purchase 627,500 shares of our common stock. Our accounting for the warrants was based on guidance from SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities and EITF No. 00-19, Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company's Own Stock. Accordingly, the warrants were treated as derivatives and classified as a liability. The warrants were recorded at fair value, based on the Black-Scholes pricing model, and will be revalued each reporting period with the change in fair value recorded as other income (expenses). For the three months ended June 30, 2006, the fair value adjustment resulted in a gain of \$9,142.

Edgar Filing: DEFENSE INDUSTRIES INTERNATIONAL INC - Form 10QSB

Other Expenses, Net. We had other expense, net for the three months ended June 30, 2006 of \$16,199 as compared to other expense of \$15,514 for the same period in 2005. The other expenses in 2006 is attributable to realized and unrealized gains from our sale of securities.

Income Tax Expense (Benefit). Our income tax benefit for the three months ended June 30, 2006 was \$18,686 as compared to a tax expense of \$133,015 for the comparable period in 2005. As an Israeli taxpayer, we are unable to include the losses of Owen Mills in our consolidated income tax filings in Israel. Export Erez's income tax expense for the three months ended June 30, 2006 was \$3,482 compared to income tax expense of \$57,397 for the three months ended June 30, 2005. Achidatex's income tax benefit for the three months ended June 30, 2006 was \$22,168 compared to a tax expense of \$65,801 for the three months ended June 30, 2005. Defense Industries did not have any tax expenses for the three months ended June 30, 2006 compared to a tax expense of \$9,816 for the three months ended June 30, 2005. Owen Mills did not have any tax expenses for the three months ended June 30, 2006 or the three months ended June 30, 2005.

Minority Interest. Minority interest in the profits and losses of one of our consolidated subsidiaries represents the minority shareholders share of the profits or losses in such majority owned subsidiary. For the three months ended June 30, 2006, we recognized and recorded minority share in our loss of \$67,082 compared with the minority share in our profit of \$33,880 for the three months ended June 30, 2005.

22

Net Income (Loss). In the three months ended June 30, 2006 we had a net loss of \$549,136 as compared to net income of \$205,113 for the three months ended June 30, 2005. Export Erez's net loss for the three months ended June 30, 2006 was \$126,706 compared to net income of \$138,090 for the three months ended June 30, 2005. Achidatex's net loss for the three months ended June 30, 2006 was \$248,452 compared to net income of \$71,241 for the three months ended June 30, 2005. Owen Mills' net loss for the three months ended June 30, 2006 was \$76,292 compared to \$25,992 for the three months ended June 30, 2005. Defense Industries' net loss for the three months ended June 30, 2006 was \$97,686 compared to net income of \$21,774 for the three months ended June 30, 2005.

Other Comprehensive Income (Loss). We had other comprehensive income, for the three months ended June 30, 2006 of \$179,516 as compared to other comprehensive loss of \$123,890 for the three months ended June 30, 2005. This income is principally attributable to the decrease of the exchange rate of U.S. dollar against the NIS.

Six Months Ended June 30, 2006 Compared with Six Months Ended June 30, 2005

Results of Operations

Net Revenues and Gross Profit Margin. Net revenues for the six months ended June 30, 2006 decreased to \$3,664,398 from \$7,592,171 in the same period in 2005, a decrease of 51.7%. The decrease is primarily attributable to the decrease in export sales, resulting mainly from the general decline in sales of bullet-resistant vests and from reduction in sales to the IDF, due to the reduction of the IDF budget for 2006. The decrease in sales of bullet-resistant vests is due to the failure of the relatively new Zylon®-based body armor vest, and the uncertainty with respect to the future requirements of the American NIJ for certifying new bullet-resistant vests. In the six months ended June 30, 2006, Export Erez, Achidatex and Owen Mills accounted for \$1,876,763 or 51.2%, \$1,329,302 or 36.3% and \$458,333 or 12.5% of our revenues, respectively. In the six months ended June 30, 2005 Export Erez, Achidatex and Owen Mills accounted for \$3,814,491 or 50.2%, \$3,416,477 or 45.0% and \$361,203 or 4.8% of our revenues, respectively.

The following table sets forth the breakdown of sales by segment for the six months ended June 30, 2006 and 2005.

	Six months ended June 30,	
	2006	2005
Sales to the local civilian market	\$ 1,640,189	\$ 1,158,790
Sales to the local military market	1,116,121	1,717,138
Export military sales	908,088	4,716,243
Total	\$ 3,664,398	\$ 7,592,171

Edgar Filing: DEFENSE INDUSTRIES INTERNATIONAL INC - Form 10QSB

The Israeli Military defense budget has been subject to reductions since the second half of 2003. As a result, the demand for our products declined. In the first six months of 2006 this trend continued and worsened. The decline in export military sales is primarily attributable to the general decline in sales of bullet-resistant vests.

23

Gross profit for the six months ended June 30, 2006 was \$526,542 compared to \$1,829,567 for the same period in 2005. This decrease in gross profit is principally attributable to the decrease in our sales in the first two quarters of 2006. In the six months ended June 30, 2006 Export Erez, Achidatex, and Owen Mills accounted for 76.1%, 13.6% and 10.3%, of our gross profit, respectively. In the six months ended June 30, 2005 Export Erez, Achidatex and Owen Mills accounted for 44.2%, 52.1% and 3.7%, of our gross profit, respectively.

Selling Expenses. Selling expenses for the six months ended June 30, 2006 decreased to \$218,075 from \$378,810 for the same the same period in 2005. The decrease in our selling expenses was attributable to the decrease in export sales, which resulted in lower selling commissions. Export Erez's selling expenses for the six months ended June 30, 2006 were \$105,818 compared to \$106,173 for the six months ended June 30, 2005. Achidatex's selling expenses for the six months ended June 30, 2006 were \$106,585 compared to \$272,637 for the six months ended June 30, 2005. Owen Mills selling expenses for the six months ended June 30, 2006 were \$5,672. Owen Mills did not record any selling expense for the six months ended June 30, 2005.

General and Administrative Expenses. General and administrative expenses for six months ended June 30, 2006 increased to \$1,006,647 from \$958,047 for the same period in 2005, mainly as a result of an increase in auditing and legal fees.

Financial Expenses. We had financial expenses, net of \$158,091 for the six months ended June 30, 2006 as compared to financial expenses, net of \$35,437 for the same period in 2005. This increase is mainly attributable to the decrease in the exchange rate between the U.S. dollar and the NIS and the increase in the prevailing interest rate in Israel.

Gain on Fair Value Adjustment to Embedded Derivatives. Pursuant to a securities purchase agreement we executed with a group of investors on June 15, 2005, we issued to such investors warrants to purchase 627,500 shares of our common stock. Our accounting for the warrants was based on guidance from SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities and EITF No. 00-19, Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company's Own Stock. Accordingly, the warrants were treated as derivatives and classified as a liability. The warrants were recorded at fair value, based on the Black-Scholes pricing model, and will be revalued each reporting period with the change in fair value recorded as other income (expenses). For the six months ended June 30, 2006, the fair value adjustment resulted in a gain of \$38,360.

Other Income, Net. We had other income, net for the six months ended June 30, 2006 of \$14,089 as compared to other income of \$64,712 for the same period in 2005. The other income in 2006 is attributable to realized and unrealized gains from our sale of securities.

Income Tax Expense (Benefit). Our income tax benefit for the six months ended June 30, 2006 was \$3,464 as compared to a tax expense of \$182,029 for the comparable period in 2005. As an Israeli tax payer, we are unable to include the losses of Owen Mills in our consolidated income tax filings in Israel. Export Erez's income tax expense for the six months ended June 30, 2006 was \$16,983 compared to income tax expense of \$80,466 for the six months ended June 30, 2005. Achidatex's income tax benefit for the six months ended June 30, 2006 was \$21,247 compared to tax expense of \$100,452 for the six months ended June 30, 2005. Defense Industries did not have any tax expenses for the six months ended June 30, 2006 compared to a tax income of \$1,111 for the six months ended June 30, 2005. Owen Mills' income tax expense for the six months ended June 30, 2006 was \$800. Owen Mills did not record any tax expense for the six months ended June 30, 2005.

24

Minority Interest. Minority interest in the profits and losses of one of our consolidated subsidiaries represents the minority shareholders share of the profits or losses in such majority owned subsidiary. For the six months ended June 30, 2006, we recognized and recorded minority share in our loss of \$95,212 compared with the minority share in our profit of \$51,605 for the six months ended June 30, 2005.

Net Income (Loss). In the six months ended June 30, 2006 we had a net loss of \$705,146 as compared to net income of \$288,351 for the six months ended June 30, 2005. Export Erez's net loss for the six months ended June 30, 2006 was \$140,927 compared to net income of \$226,026 for the six months ended June 30, 2005. Achidatex's net loss for the six months ended June 30, 2006 was \$373,555 compared to net income of \$91,344 for the six months ended June 30, 2005. Owen Mills' net loss for the six months ended June 30, 2006 was \$120,029 compared to \$35,317 for the six months ended June 30, 2005. Defense' net loss for the six months ended June 30, 2006 was \$70,635 compared to net income of \$6,298 for the six months ended June 30, 2005.

Edgar Filing: DEFENSE INDUSTRIES INTERNATIONAL INC - Form 10QSB

Other Comprehensive Income (Loss). We had other comprehensive income, for the six months ended June 30, 2006 of \$119,705 as compared to other comprehensive loss of \$148,495 for the six months ended June 30, 2005. This income is principally attributable to the decrease of the exchange rate of the U.S. dollar against the NIS.

Liquidity and Capital Resources

As of June 30, 2006, we had \$1,280,352 in cash and cash equivalents, \$754,947 in marketable securities and working capital of \$4,258,674 as compared to \$743,480 in cash and cash equivalents, \$739,339 in marketable securities and \$4,618,405 in working capital at December 31, 2005. The decrease in working capital is mainly due to the increase in short term debt, and our losses in 2006.

Cash Flows

The following table summarizes our cash flows for the periods presented:

	Six months ended June 30,	
	2006	2005
Net cash provided by (used in) operating activities	\$ (847,477)	\$ 89,811
Net cash provided by (used in) investing activities	(159,169)	(330,125)
Net cash provided by financing activities	575,075	709,211
Effect of exchange rate changes on cash and cash equivalents	129,956	(230,430)
Increase (decrease) in cash and cash equivalents	(301,615)	238,467
Cash and cash equivalents at the beginning of the period	1,581,967	505,013
Cash and cash equivalents at the end of the period	\$ 1,280,352	\$ 743,480

25

Net cash used in operating activities was \$847,477 for the six months ended June 30, 2006 as compared to \$89,811 provided from operating activities for the same period in 2005. This was primarily attributable to a net loss of \$705,146 in this period, a \$174,780 increase in inventory and a decrease in accounts receivable of \$135,235 and \$95,212 minority share in our loss, which was offset by an increase in accounts payable of \$53,521 and depreciation costs of \$211,669.

Net cash used in investing activities was \$159,169 for the six months ended June 30, 2006 as compared to \$330,125 in the six months ended June 30, 2005. During the six months ended June 30, 2006, \$158,736 (net of sales of fixed assets) was used to purchase fixed assets, while \$18,589 (net of purchases of trading securities) was provided from sales of our trading securities, and \$19,022 was used for the payment to employee retirement funds in respect to employee rights upon retirement.

Net cash provided by financing activities was \$575,075 for the six months ended June 30, 2006 as compared to \$709,211 in the six months ended June 30, 2005. During the six months ended June 30, 2006, we increased our short-term debt by \$256,096, and our long-term debt by \$318,979.

Most of our large purchase orders are supported by letters of credit. As a result, we believe that we have limited exposure to doubtful accounts receivables. We have historically achieved net profits on an annual basis, but our quarterly profits are not consistent on a quarter to quarter basis. Nevertheless, we have striven to balance our accounts payable and account receivable.

We believe that our spending for research and development in 2006 will be consistent with our spending in 2005 of \$70,000 per year.

We believe that we have sufficient working capital and borrowing capability to sustain our current level of operations for the next twelve months.

Recent Accounting Pronouncements

Edgar Filing: DEFENSE INDUSTRIES INTERNATIONAL INC - Form 10QSB

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS, No. 123 (revised 2004), Share-Based Payment , (SFAS 123R), a revision to SFAS No. 123, Accounting for Stock Based Compensation. SFAS No.123R superseded APB No.25 and amended SFAS No.95, Statement of Cash Flows . Effective January 1,2006, SFAS No. 123R requires that the Company measure the cost of employee services received in exchange for equity awards based on the grant date fair value of the awards, with the cost to be recognized as compensation expense in the Company s financial statements over the vesting period of the awards. Accordingly, the Company will recognize compensation cost for equity-based compensation for all new or modified grants issued after December 31, 2005. In addition, commencing January 1, 2006, the Company is required to recognize the unvested portion of the grant date fair value of awards issued prior to adoption of SFAS No. 123r based on the fair values previously calculated for disclosure SFAS No.123R based on the fair values previously calculated for disclosure purposes over the remaining vesting period of the outstanding stock options and warrants.

26

The Company adopted SFAS No. 123R effective January 1, 2006, and is using the modified prospective method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS No. 123R for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123R that the remain unvested on the effective date.

The Company has not granted stock options to purchase shares of its common stock for employee services currently or in the year ended December 31, 2005. Accordingly, the Company s Condensed Consolidated Financial Statements do not include any stock based compensation expense for the three months ended June 30, 2006 and is not required to disclose proforma stock based compensation expense for the three months ended June 30, 2005, nor does the Company have any unvested deferred compensation that must be amortized over any vesting periods.

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes . The Interpretation clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes . The Interpretation prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Interpretation also provides guidance on the related de-recognition, classification, interest and penalties, accounting for interim periods, disclosure and transition of uncertain tax positions. The Interpretation is effective for fiscal years beginning after December 15, 2006, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings.

Foreign Currency Exchange Risk

We develop products in Israel and sell them in North and South America, Asia and several European countries. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets.

Our foreign currency exposure with respect to our sales is mitigated, and we expect it will continue to be mitigated, through salaries, materials and support operations, in which part of these costs are denominated in NIS.

During 2005, the NIS devalued approximately 6.85% against the dollar. In the second quarter of 2006 the U.S. dollar devaluated in relation to the NIS by approximately 4.8 %. Among the factors contributing to the devaluation were the increase in the interest rate for NIS investments compared to interest rate for U.S. dollar investments. The inflation rate in Israel was approximately 0.96% for the three months ended June 30, 2006 compared to an annual inflation rate of 2.38% in 2005.

27

Since most of our sales are quoted in dollars, and a portion of our expenses are incurred in NIS, our results may be adversely affected by a change in the rate of inflation in Israel or if such change in the rate of inflation is not offset, or is offset on a lagging basis, by a corresponding devaluation of the NIS against the dollar and other foreign currencies. We will also be adversely affected if the dollar depreciates against the Euro, the currency used for many of our purchases of raw material.

We did not enter into any foreign exchange contracts in 2005 or the first six months of 2006.

Contractual Obligations

The following table summarizes our contractual obligations and commercial commitments as of June 30, 2006.

Contractual Obligations

Payments due by Period

Contractual Obligations

23

	Total	less than 1 year	2 -3 years	4 -5 years	more than 5 years
Long-term debt obligations	\$ 1,901,936	\$ 898,854	\$ 786,407	\$ 216,675	--
Capital (finance) lease obligations	--	--	--	--	--
Operating lease obligations	775,267	333,340	441,927	--	--
Purchase obligations	--	--	--	--	--
Other long-term liabilities reflected on the Company's balance sheet under U.S. GAAP	--	--	--	--	--
Total	\$ 2,677,203	\$ 1,232,194	\$ 1,228,334	\$ 216,675	--

Cautionary Statement Regarding Forward-Looking Information and Risk Factors

This report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as anticipate, expect, intend, plan, believe, seek, outlook and estimate as well as similar words and phrases signify forward-looking statements. Our forward-looking statements are not guarantees of future results and conditions and important factors, risks and uncertainties may cause our actual results to differ materially from those expressed in our forward-looking statements. These uncertainties and other factors include, but are not limited to, the following:

Our significant international operations subject us to financial and regulatory risks.

28

Currency exchange rate fluctuations in the world markets in which we conduct business could have a material adverse effect on our business, results of operations and financial condition.

Sales of our products are subject to governmental procurement procedures and practices; termination, reduction or modification of contracts with our customers, and especially with the government of Israel, or a substantial decrease in our customers' budgets may adversely affect on us.

The loss of one or more of our key customers would result in a loss of a significant amount of our revenues.

Our markets are highly competitive. Inability to compete effectively will adversely affect us.

Limited sources for some of our raw materials may significantly curtail our manufacturing operations.

Our resources may be insufficient to manage the demands imposed by any future growth.

Item 3. Controls and Procedures

Our management, including our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of the end of the period covered by this quarterly report on Form 10-QSB. Based upon that evaluation, our chief executive officer and chief financial officer have concluded that, the weaknesses in effectiveness of our disclosure controls and procedures which were previously identified in Controls and Procedures included in Item 8A of our Amended Annual Report on Form 10-KSB for the year ended December 31, 2005 and in Item 3 of our Quarterly Report on Form 10-QSB for the three months

ended March 31, 2006 have been remediated. Accordingly, as of such date, our disclosure controls and procedures were effective to ensure that information required to be disclosed by our company in reports that we file under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information was made known to them by others within the company, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Controls over Financial Reporting

There were no changes to our internal control over financial reporting that occurred during the period covered by this quarterly report on Form 10-QSB that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

29

PART II OTHER INFORMATION

DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES

Item 1. Legal Proceedings

We are not a party to any pending or to the best of our knowledge, any threatening legal proceedings. None of our directors, officers or affiliates, or owner of record of more than five percent (5%) of our shares, or any affiliate of any such director, officer or security holder is a party adverse to us or has a material interest adverse to us in reference to a pending litigation.

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

On June 15, 2005 we executed a securities purchase agreement, with Gov Financial Holdings, Avshalom Hershovich, Multi Concept Ltd. and Ruth Creative Business Ltd., all of which are accredited investors, for a \$1.1 million private placement of our common stock, along with 627,500 warrants to purchase our common stock. Pursuant to this agreement we issued 1,833,334 shares of our common stock at \$0.60 per share. The investors also received 365,000 warrants at an exercise price of \$0.94 per share exercisable until June 30, 2007 and 182,500 warrants at an exercise price of \$2.40 per share exercisable until June 30, 2010. The agreement also provided for the issuance by us of up to additional 1,368,191 shares of our common stock to the investors, a year after the closing, in the event of decrease in the share price. In addition, we agreed to issue 82,133 shares of our common stock, as well as 60,000 warrants at an exercise price of \$0.94 per share exercisable until June 30, 2007 and 20,000 warrants at an exercise price of \$2.40 per share exercisable until June 30, 2010, as finders' fees. The transaction was exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended, and Rule 506 of Regulation D. As part of the transaction, we filed a registration statement on Form SB-2 with the United States Securities and Exchange Commission for the purpose of registering for resale the common stock issued in the private placement and the shares underlying the warrants. Such Registration Statement was declared effective on December 9, 2005.

On February 28, 2005, we acquired all of the outstanding shares of Owen Mills, a company specializing in military and industrial sewing of marine and ballistic fabric products. Pursuant to the terms of the securities purchase agreement, we purchased all of the outstanding stock of Owen Mills in consideration for \$200,000 and shares of our common stock having a value of \$200,000, based on the average closing price per share of our common stock for the ten trading days preceding the issuance of such shares. Under the agreement the aggregate consideration of \$400,000 will be paid by us as follows: (i) \$3,333.33 each month commencing on June 30, 2005 and thereafter on the last business day of each successive month until the we have paid \$200,000 to the former shareholder of Owen Mills; (ii) \$40,000 in the form of shares of our common stock payable shortly after the closing of the transaction; and (iii) \$160,000 in the form of shares of our common stock to be issued in four installments beginning on the last business day in February 2006 and on the anniversary of such date for the following three years. In accordance with the agreement, we issued on April 27, 2005, and on April 3, 2006, 36,463 shares and 123,077 shares of our common stock respectively, each issuance having market value of \$40,000.

Item 3. Default Upon Senior Securities

None.

30

Item 4. Submission of Matters to a Vote of Shareholders

None.

Item 6. Exhibits

(a) Exhibits

- 31.1** Certification by Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2** Certification by Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1** Certification by Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2** Certification by Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

31

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

DEFENSE INDUSTRIES INTERNATIONAL, INC.
(Registrant)

By: /s/ Joseph Postbinder

Joseph Postbinder
Chief Executive Officer

By: /s/ Tsippy Moldovan

Tsippy Moldovan
Chief Accounting and Financial Officer

Date: August 18, 2006

32
