DALRADA FINANCIAL CORP
Form 10QSB
February 21, 2006

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

FORM 10-QSB

[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(D)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2005

or

|_| TRANSITION REPORT UNDER SECTION 13 OR 15(D)
OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file No. 0-12641

DALRADA FINANCIAL CORPORATION
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	38-3713274
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(IRS EMPLOYER ID NO.)

9449 BALBOA AVENUE, SUITE 211
SAN DIEGO, CA 92123
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

Registrant's telephone number, including area code: (858) 277-5300

N/A
(FORMER NAME AND ADDRESS, IF CHANGED SINCE LAST REPORT)

Check 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 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 [X] No [ ]

The number of shares outstanding of the registrant's common stock as of February 15, 2006 was 815,802,291.

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

Transitional Small Business Disclosure Format (check one): Yes [ ] No [X]

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PART I. - FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET
(IN THOUSANDS, EXCEPT SHARE DATA)
(UNAUDITED)

	DECEMBER 31, 2005 (unaudited)
ASSETS	
CURRENT ASSETS	
Cash and cash equivalents	$ 801
Accounts receivable, net of allowance of $61	2,230
Prepaid worker's compensation premiums	861
Other current assets	2,439
TOTAL CURRENT ASSETS	6,331

CUSTOMER LIST, net of accumulated amortization of $18	54
PROPERTY AND EQUIPMENT, net of accumulated depreciation of $2,116	261
WORKER'S COMPENSATION DEPOSIT	2,129
OTHER LONG-TERM ASSETS	15
TOTAL ASSETS	$ 8,790

LIABILITIES AND STOCKHOLDERS' DEFICIT

CURRENT LIABILITIES	
Cash overdraft	$ 572
Lines of credit	789
Notes payable, current portion (including related party note of $1,565)	3,603
Convertible debentures, net of discount of $112	1,382
Accounts payable	2,054
PEO payroll taxes and other payroll deductions	10,067
Other accrued expenses	11,073
Net liabilities of discontinued operations	78
TOTAL CURRENT LIABILITIES	29,618
NOTES PAYABLE, net of current portion (including related party note of $383)	614
TOTAL LIABILITIES	30,232
MINORITY INTEREST	-
COMMITMENTS AND CONTINGENCIES	-
STOCKHOLDERS' DEFICIT	
Series A convertible, redeemable preferred stock, $1,000 par value, 7,500 shares authorized 420.5 shares issued and outstanding	420
Common stock; $0.005 par value; 1,000,000,000 shares authorized; 791,606,769 shares issued and outstanding	3,958
Common stock warrants	475
Additional paid-in capital	82,441
Accumulated other comprehensive loss	-
Accumulated deficit	(108,736)
TOTAL STOCKHOLDERS' DEFICIT	(21,442)
TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT	$ 8,790

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

DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS AND OTHER COMPREHENSIVE LOSS
THREE AND SIX MONTHS ENDED DECEMBER 31, 2005 AND 2004

(IN THOUSANDS, EXCEPT SHARE DATA)
(UNAUDITED)

	THREE MONTHS ENDED		
	DECEMBER 31, 2005	DECEMBER 31, 2004	DECE
	(unaudited)	(unaudited)	(un
REVENUES			
Temporary staffing services	$ 17,002	$ 3,749	$
PEO Services	387	478	
Sales of products	443	688	
Software sales, licenses and royalties	2	13	
TOTAL REVENUES	17,834	4,928	
COST OF REVENUES			
Cost of temporary staffing	14,477	3,400	
Cost of PEO services	299	348	
Cost of products sold	7	442	
Cost of software sales, licenses and royalties	-	-	
TOTAL COST OF REVENUES	14,783	4,190	
GROSS PROFIT	3,051	738	
OPERATING EXPENSES			
Selling, general and administrative	2,537	996	
TOTAL OPERATING EXPENSES	2,537	996	
INCOME (LOSS) FROM OPERATIONS	514	(258)	
OTHER INCOME (EXPENSES):			
Interest expense	(140)	(345)	
Note payable settlement	(316)	-	
Gain on extinguishment of debt	4,262	260	
Penalties and interest	(294)	-	
Gain resulting from reconciliation of payroll tax liabilities to taxing authorities	-	536	
Other, net	(187)	-	
TOTAL OTHER INCOME (EXPENSE)	3,325	451	
INCOME (LOSS) BEFORE PROVISION FOR INCOME TAXES AND DISCONTINUED OPERATIONS	3,839	193	
PROVISION FOR INCOME TAXES	-	-	
INCOME (LOSS) BEFORE MINORITY INTEREST AND DISCONTINUED OPERATIONS	3,839	193	
MINORITY INTEREST IN SUBSIDIARY (INCOME) LOSS	-	-	

NET INCOME (LOSS) FROM CONTINUING OPERATIONS	3,839	193	
DISCONTINUED OPERATIONS:			
Loss from operations of discontinued operations	(420)	-	
	(420)	-	
NET INCOME (LOSS)	$ 3,419	$ 193	$
OTHER COMPREHENSIVE INCOME (LOSS)			
Foreign currency translation	3	-	
COMPREHENSIVE INCOME (LOSS)	$ 3,422	$ 193	$
PREFERRED STOCK DIVIDENDS	(5)	(5)	
NET INCOME (LOSS) ATTRIBUTED TO COMMON STOCKHOLDERS	$ 3,414	$ 188	$
NET INCOME (LOSS) PER SHARE - BASIC			
Continuing operations	$ 0.00	$ 0.00	$
Discontinued operations	(0.00)	-	
	$ 0.00	$ 0.00	$
WEIGHTED AVERAGE COMMON EQUIVALENT SHARES OUSTANDING - BASIC	771,827	640,378	

The accompanying notes are an integral part of these consolidated financial sta

DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF STOCKHOLDERS' DEFICIT
SIX MONTHS ENDED DECEMBER 31, 2005
(IN THOUSANDS, EXCEPT SHARE DATA)
(UNAUDITED)

	SERIES A PREFERRED STOCK		COMMON STOCK		COMMON STOCK WARRANT
	SHARES	AMOUNT	SHARES	AMOUNT	
BALANCE, JUNE 30, 2005	4,205	$ 420	735,248,867	$ 3,676	$
Issuance of common stock for:					

Services			5,000,000	25	
Convertible debentures			29,411,767	147	
Conversion of liabilities			21,946,135	110	
Foreign currency translation adjustment					
Net loss					
BALANCE, DECEMBER 31, 2005	4,205	$ 420	791,606,769	$ 3,958	$

	ACCUMULATED DEFICIT	TOTAL
BALANCE, JUNE 30, 2005	$ (111,895)	$ (24,695)
Issuance of common stock for:		
Services		15
Convertible debentures		50
Conversion of liabilities		29
Foreign currency translation adjustment		-
Net loss	3,159	3,159
BALANCE, DECEMBER 31, 2005	$ (108,736)	$ (21,442)

The accompanying notes are an integral part of these consolidated financia

DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
SIX MONTHS ENDED DECEMBER 31, 2005 AND 2004
(IN THOUSANDS, EXCEPT SHARE DATA)
(UNAUDITED)

	SIX MON
	DECEMBER 31, 2005
	(unaudited)
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net income (loss) from continuing operations	$ 3,679
Adjustment to reconcile net loss to net cash provided by (used in) operating activities from continuing operations	
Depreciation and amortization	57

Stock issued for services	15
Amortization of debt discounts	58
Gain resulting from reconciliation of payroll tax liabilities to taxing authorities	-
Gain on settlement of debt	(5,603
Changes in operating assets and liabilities:	
(Increase) decrease in:	
Accounts receivable	(816
Inventories	-
Prepaid worker's compensation premiums	269
Other current assets	(1,399
Worker's compensation deposit	496
Other assets	(4
Increase (decrease) in:	
Accounts payable and accrued expenses	4,903
PEO liabilities	1,292
Net cash provided by (used in) operating activities from continuing operations	2,947
Net cash used in operating activities of discontinued operations	(432
Net cash provided by (used in) operating activities	2,515
CASH FLOWS FROM INVESTING ACTIVITIES:	
Purchase of property and equipment	(68
Net cash used in investing activities from continuing operations	(68
Net cash used in investing activities of discontinued operations	-
Net cash used in investing activities	(68
CASH FLOWS FROM FINANCING ACTIVITIES:	
Change in cash overdraft, net	410
Line of credit, net	20
Proceeds from notes payable	821
Repayments of notes payable	(2,581
Repayments of borrowings under bank notes payable	(483
Repayments of capital lease obligations	(4
Net cash provided by (used in) financing activities from continuing operations	(1,817
Net cash used in financing activities of discontinued operations	-
Net cash provided by (used in) financing activities	(1,817
EFFECT OF EXCHANGE RATE CHANGES ON CASH	-
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	630
CASH AND CASH EQUIVALENTS, Beginning of period	171
CASH AND CASH EQUIVALENTS, End of period	$ 801

The accompanying notes are an integral part of these consolidated financial stateme

DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)
SIX MONTHS ENDED DECEMBER 31, 2005 AND 2004
(IN THOUSANDS, EXCEPT SHARE DATA)
(UNAUDITED)

	SIX MONTHS ENDED	
	DECEMBER 31, 2005 (unaudited)	DECEMBER 31, 2004 (unaudited)
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Interest paid	$ -	$ -
Income taxes paid	$ -	$ -
SUPPLEMENTAL NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Conversion of convertible debentures into common stock	$ 50	$ 175
Conversion of accounts payable and accrued liabilities into common stock	$ 29	$ 132

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

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DALRADA FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SIX MONTHS ENDED DECEMBER 31, 2005 AND 2004
(IN THOUSANDS, EXCEPT SHARE DATA)
(UNAUDITED)

NOTE 1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements of Dalrada Financial Corporation and Subsidiaries (the "Company" or "DRDF") have been prepared pursuant to the rules of the Securities and Exchange Commission (the "SEC") for quarterly reports on Form 10-QSB and do not include all of the information and note disclosures required by accounting principles generally accepted in the United States of America. These consolidated financial statements and notes herein are unaudited, but in the opinion of management, include all the adjustments (consisting only of normal recurring adjustments)

necessary for a fair presentation of the Company's financial position, results of operations, and cash flows for the periods presented. These consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements and notes thereto for the year ended June 30, 2005 included in the Company's annual report on Form 10-KSB filed with the SEC. Interim operating results are not necessarily indicative of operating results for any future interim period or for the full year. The consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. All inter-company transactions have been eliminated.

MINORITY INTEREST

On April 1, 2005, the Company contributed its wholly-owned subsidiary, Solvis (a Michigan corporation), to QPI (QPI subsequently changed its name to Solvis Group, Inc., a Nevada corporation). At that date, Solvis had a stockholders' equity of $393. As a result of the Company contributing Solvis to an 85% owned subsidiary, the Company recognized minority interest on its consolidated balance sheet in the amount of $59. During the year ended June 30, 2005, QPI incurred a net loss of which 15% is attributed to the minority interest. In the consolidated statement of operations for the year ended June 30, 2005, the Company has only recognized the minority interests' share of the net loss to the extent of the minority interest recorded on the consolidated balance sheet. During the six months ended December 31,2005, QPI incurred a net loss of which 15% is attributed to minority interest that has been included in the net loss in the accompanying statement of operations. Recognizing the minority interests' entire share of the net loss would have resulted in the recording of a minority interest receivable.

RECLASSIFICATIONS

Certain reclassifications have been made to the prior years' financial statements to conform to the current year presentation. These reclassifications had no effect on previously reported results of operations or retained earnings.

NOTE 2. GOING CONCERN CONSIDERATIONS

The accompanying unaudited consolidated financial statements have been prepared assuming that the Company will continue as a going concern. For the six months ended December 31, 2005, the Company had a loss from operations of $319. As of December 31, 2005, the Company had a working capital deficiency of $23,287 and had a stockholders' deficit of $21,442. In addition, the Company is in default on certain note payable obligations, delinquent on payroll tax obligations and is being sued by numerous trade creditors for nonpayment of amounts due. The Company is also delinquent in its payments relating to payroll tax liabilities. These conditions raise substantial doubt about its ability to continue as a going concern. Management believes that it can continue to raise debt and equity financing to support its operations.

The Company must obtain additional funds to provide adequate working capital and finance operations. However, there can be no assurance that the Company will be able to complete any additional debt or equity financings on favorable terms or at all, or that any such financings, if completed, will be adequate to meet the Company's capital requirements. Any additional equity or convertible debt financings could result in substantial dilution to the Company's stockholders. If adequate funds are not available, the Company may be required to delay, reduce or eliminate some or all of its planned activities. The Company's inability to fund its capital requirements would have a material adverse effect on the Company. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

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NOTE 3. STOCK BASED COMPENSATION

SFAS No. 123, "Accounting for Stock-Based Compensation," establishes and encourages the use of the fair value based method of accounting for stock-based compensation arrangements under which compensation cost is determined using the fair value of stock-based compensation determined as of the date of grant and is recognized over the periods in which the related services are rendered. The statement also permits companies to elect to continue using the current intrinsic value accounting method specified in Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," to account for stock-based compensation. The Company has elected to use the intrinsic value based method and has disclosed the pro forma effect of using the fair value based method to account for its stock-based compensation issued to employees. For options granted to employees where the exercise price is less than the fair value of the stock at the date of grant, the Company recognizes an expense in accordance with APB 25. For non-employee stock based compensation the Company recognizes an expense in accordance with SFAS No. 123 and values the equity securities based on the fair value of the security on the date of grant. For stock-based awards the value is based on the market value for the stock on the date of grant and if the stock has restrictions as to transferability a discount is provided for lack of tradability. Stock option awards are valued using the Black-Scholes option-pricing model.

The pro forma information regarding the effect on operations that is required by SFAS 123 has not been presented since there is no pro forma expense to be shown for the six months ended December 31, 2005 and 2004.

NOTE 4. EARNINGS (LOSS) PER COMMON SHARE

The Company reports earnings (loss) per share in accordance with SFAS No. 128, "Earnings per Share." Basic earnings (loss) per share are computed by dividing income (loss) available to common stockholders by the weighted average number of common shares available. Diluted earnings (loss) per share is computed similar to basic earnings (loss) per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if the potential common shares had been issued and if the additional common shares were dilutive. Diluted earnings (loss) per share have not been presented since the effect of the assumed conversion of options and warrants to purchase common shares would have an anti-dilutive effect. The following potential common shares have been excluded from the computation of diluted net loss per share for the six months ended December 31, 2005: warrants - 31,061and stock options - 31,500. All options and warrants are anti-dilutive at December 31, 2005 as the exercise price is greater than the Company stock price at December 31, 2005.

Below is a computation of earnings (loss) per share for the three and six months ended December 31, 2005 and 2004. Basic and diluted loss per share are the same for the six months ended December 31,2004:

	THREE MONTHS ENDED		
	2005		
	INCOME/	PER	I

	(LOSS)	SHARES	SHARE	(
BASIC EARNINGS (LOSS) PER SHARE				
Net income (loss) from continuing operations	$ 3,839			$
Preferred stock dividends	(5)			
	-----------			---
	3,834			
Discontinued operations	(420)			
	-----------			---
Net income (loss) attributed to common stockholders	$ 3,414			$
	===========			===
Weighed shares outstanding		771,827		
Continuing operations			$ 0.00	
Discontinued operations			$ (0.00)	

			$ 0.00	
			===========	

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DILUTED EARNINGS (LOSS) PER SHARE				
Net income (loss) from continuing operations	$ 3,839			$
Preferred stock dividends	(5)			
Interest on convertible debentures	30			
Amortization of discounts on convertible debentures	28			
	-----------			---
	3,892			
Discontinued operations	(420)			
	-----------			---
Net income (loss) attributed to common stockholders	$ 3,472			$
	===========			===
Weighed shares outstanding		771,827		
Conversion of convertible debentures into common stock		609,796		

		1,381,623		
		===========		
Continuing operations			$ 0.00	
Discontinued operations			$ (0.00)	

			$ 0.00	
			===========	

	SIX MONTHS ENDED D			
	2005			
	INCOME/ (LOSS)	SHARES	PER SHARE	I (
BASIC EARNINGS (LOSS) PER SHARE				

Net income (loss) from continuing operations	$ 3,679		$
Preferred stock dividends	(10)		
	3,669		
Discontinued operations	(520)		
Net income (loss) attributed to common stockholders	$ 3,149		$
Weighed shares outstanding		761,597	
Continuing operations			$ 0.00
Discontinued operations			$ (0.00)
			$ 0.00

DILUTED EARNINGS (LOSS) PER SHARE

Net income (loss) from continuing operations	$ 3,679		
Preferred stock dividends	(10)		
Interest on convertible debentures	60		
Amortization of discounts on convertible debentures	58		
	3,787		
Discontinued operations	(520)		
Net income (loss) attributed to common stockholders	$ 3,267		
Weighed shares outstanding		761,597	
Conversion of convertible debentures into common stock		609,796	
		1,371,393	
Continuing operations			$ 0.00
Discontinued operations			$ (0.00)
			$ 0.00

NOTE 5. BORROWINGS UNDER BANKS NOTES PAYABLE

The Company had outstanding two notes payable to Imperial Bank and Export-Import Bank in the amounts of $1,490 and $1,730, respectively. In December 2005, the Company entered into an agreement with these two banks whereby the Company paid a total of $483 as full satisfaction of all outstanding principal ($3,220) and accrued interest ($1,383) relating to these two notes payable. The Company recognized a gain on the settlement of debt related to this transaction of $4,120.

NOTE 6. FACTORING LINES OF CREDIT

The Company's temporary staffing division entered into a factoring agreement that expires in January 2007 and in renewable for successive periods of 12 months assuming certain conditions are met. The agreement provides for the Company to borrow against factored accounts receivables at a discount of approximately 2% for each 30 day period the balances remain unpaid. Customer payments are made directly to the factoring company and there is full recourse for uncollected accounts.

NOTE 7. CONVERTIBLE NOTES PAYABLE

Listed below is a roll-forward schedule of the convertible debentures:

(In Thousands)	
Balance at June 30, 2005	$ 1,110
Conversion of interest and penalties	264
Issuance of convertible debentures during the six months ended December 31, 2005	-
Increase in debt discount and beneficial conversion feature	-
Converted into common stock	(50)
Amortization of value of warrants and preferential conversion feature	58
Balance at December 31, 2005	$ 1,382

NOTE 8. NOTES PAYABLE

On August 9, 2005, the Company issued two secured promissory notes to two investors totaling $221. The notes are due on October 9, 2005 and accrue interest at a rate of 12% per annum. These two notes have not been repaid and are currently in default. In addition, on December 22, 2005, the Company issued a promissory note to an investor for $600. The note is due on January 6, 2006 and accrues interest at a rate of 15% per annum through February 1, 2006 and 24% per annum thereafter until the note is paid in full. This note was repaid from the proceeds of the February 13, 2006 funding (See Note 18).

The following summarizes notes payable at December 31, 2005:

Payable to investor, 8%	$ 150
Payable in connection with QPI acquisition	141
Payable to two investors, 40%	190
Payable to investor, 8%	37
Payable to investor, 15%	600
Payable to two investors, 12%	221
Payable to related party	448
Payable to bank related to financing of worker's compensation deposit	128
Payable to finance company related to financing of worker's compensation premium and deposit	796

Payable to equipment finance companies	6
Payable to a former director, 16%	1,500
	4,217
Less current portion	(3,603)
Long-term portion	$ 614

NOTE 9. STOCKHOLDERS' DEFICIENCY

Stock Issuances

During the six months ended December 31, 2005, DRDF issued the following:

- 21,946,135 shares of its common stock for penalties and accrued interest of $29;
- 29,411,767 shares of is common stock upon the $50 conversion of a convertible debenture; and
- 5,000,000 shares of its common stock for consulting services valued at $15.

NOTE 10. SEGMENT INFORMATION

The Company managed and internally reported the Company's business has four reportable segments, principally, (1) products and accessories, (2) software, (3) temporary staffing, and (4) PEO services.

Segment information for the six months ended December 31, 2005 is as follows:

(IN THOUSANDS)

	PRODUCTS	SOFTWARE	TEMPORARY STAFFING	PEO SERVICES	TOTAL
Six months ended December 31, 2005					
Revenues	$ 631	$ 5	$ 28,545	$ 682	$ 29,863
Operating income (loss)	(1,881)	(34)	1,543	53	(319)
Six months ended December 31, 2004					
Revenues	$ 813	$ 39	$ 7,654	$ 820	$ 9,356
Operating income (loss)	(437)	(45)	(116)	(95)	(693)

NOTE 11. RELATED PARTY TRANSACTIONS

Warning Management Services, Inc.

The Company's CEO and Chairman, Mr. Brian Bonar, is also the CEO and Chairman of Warning Management Services, Inc. In addition, the Company's CFO, Mr. Randall A. Jones, is also the CFO of Warning Management Services, Inc. Warning a public company, located in Southern California. Warning's operations consist of a modeling agency and providing temporary staffing services to government agencies and private companies.

GUARANTEE OF INDEBTEDNESS OF WARNING

As of September 8, 2004, Warning Management Services, Inc. ("Warning") purchased all of the issued and outstanding shares of Employment Systems, Inc. ("ESI") for $1,500. The purchase was $750 cash paid at the closing and a $750 note payable. In connection with this transaction, the Company agreed to be a guarantor of the $750 note payable. As inducement to enter into this guarantee, the Company was given a non-cancelable 2-year payroll processing contract with ESI. Management has evaluated this contingent liability and has determined that no loss is anticipated as a result of this guarantee.

WARNING HAS A MONTH-TO-MONTH LEASE WITH THE COMPANY

Warning leases offices for its ESI subsidiary, on a month-to-month basis from the Company that started in October 2004. Monthly rental expense will be approximately $3 per month.

PEO SERVICES AGREEMENT WITH WARNING PROVIDES FOR A FEE AT PREVAILING MARKET RATE

In April 2004, the Company entered into an Agreement to provide PEO services for Warning. The Company receives from Warning a monthly administrative fee. During the six months ended December 31, 2005, the Company has invoiced Warning $274 for management services and $0 for reimbursement of costs. As of December 31, 2005, the Company has a net amount payable to Warning in the amount of $790.

Kaire Holdings, Inc.

The Company's Source One subsidiary processes the payroll for Effective Health, Inc. which is a wholly-owned subsidiary of Kaire Holdings, Inc. The Company's CFO, Mr. Randall A. Jones, is also the CFO of Kaire Holding, Inc.

NOTE 12. OTHER ACCRUED EXPENSES

Other accrued expenses at December 31, 2005 consisted of the following as of:

Accrued interest and penalties	$ 2,730
Accrued judgments	1,756
Other taxes	127
Accrued salaries and related liabilities	4,675
Loss reserves	229
Accrued settlements	316
Other	1,240
	$ 11,073

NOTE 13. LITIGATION

The Company and its SourceOne Group ("SOG") subsidiary have been sued by the Arena Football 2 Operating Company, LLC ("Arena") in Wayne County Circuit Court, Michigan. The claims made by Arena against the Company and SOG are that SOG failed to perform under an agreement to procure and furnish workers' compensation insurance and that Arena incurred alleged damages in an amount no less than $709 as a result. Management has vigorously contested the claims made by Arena. In addition, the Company has filed claims against Arena and Arena's agent, Thilman and Filippini, based on, among other things, the representations made to SOG that let it to enter into the agreement with Arena. The case remains in the discovery phase.

The Company and SOG have been sued by Liberty Mutual Insurance Company ("Liberty") in the United States District Court for the Northern District of Illinois. The nature of the specific claims made by Liberty against the Company and SOG are that the Company and SOG were and are obligated to make additional premium payments to Liberty for workers' compensation insurance, which is related to the Arena litigation described above. The initial claim by Liberty was estimated by Liberty to be $829 and is now claimed to exceed $1,000. Management has vigorously contested the claims made by Liberty. The case remains in the discovery phase.

On February 10, 2005, Berryman & Henigar Enterprises ("Plaintiff"), filed a complaint in the Superior Court of California, County of San Diego, Case No. GIC842610, against Warning Model Management, Inc. for breach of a promissory note issued pursuant to terms and conditions of a certain stock purchase and sale agreement dated September 9, 2004. The Company and its subsidiary, Employment Systems, Inc. ("ESI"), each allegedly guaranteed payments on the underlying promissory note. Plaintiff seeks principal damages of $750 in that regard. Warning Model Management, Inc. has taken the position that Plaintiff failed to disclose certain material information in the underlying transaction which thereby negates the promissory note. Warning Model Management, Inc. reached a settlement, effective as of September 30, 2005 with the Plaintiff, which requires defendants, collectively, to pay Plaintiff the aggregate sum of $380. Defendants have made the initial two payments due under the settlement and the final payment in the sum of $80 will be due in April 2006.

On March 17, 2005, Greenland Corporation ("Plaintiff"), filed an amended complaint in the Superior Court of California, County of San Diego, Case No. GIC842605, against the Company and multiple other individuals and entities resulting from a transaction as evidenced by the "Agreement to Acquire Shares" dated August 9, 2002, whereby the Company obtained a controlling equity interest in Plaintiff. Plaintiff contends that the Company engaged in various forms of wrongdoing including breach of fiduciary duty, conversion, conspiracy and aiding and abetting. The Company has filed a cross-complaint alleging various causes of action against Plaintiff and its officers, directors and/or managing agents including Thomas J. Beener, Gene Cross, George Godwin, and Edward Sano. The subject cross-complaint seeks pecuniary and punitive damages resulting from various fraudulent transactions as well as legal malpractice against Mr. Beener. Trial, which was initially set for April 14, 2006, has now been continued to September 8, 2006. The Company has and will continue with its vigorous defense/prosecution of the allegations/claims.

On August 29, 2005, United Bank & Trust filed suit against the Company and other parties. The allegations of the lawsuit are that the Company guaranteed certain debt owed by InfoServices, Inc. and is liable in the amount of $678. The case is

in its early stages and discovery has not yet commenced. However, the Company intends to vigorously defend itself against the claims asserted.

Throughout fiscal 2004 and 2005, and through the date of this filing, trade creditors have made claims and/or filed actions alleging the failure of the Company to pay its obligations to them in a total amount exceeding $3,000. These actions are in various stages of litigation, with many resulting in judgments being entered against the Company. Several of those who have obtained judgments have filed judgment liens on the Company's assets. These claims range in value from less than $1 to just over $1,000, with the great majority being less than $20.

On September 7, 2005, the arbitrator from the American Arbitration Association awarded to Accord Human Resources a judgment against Greenland Corporation and the Company as the guarantor, an amount equaling $168. Legal counsel has estimated that the claim could amount to as much as $214. The Company has reserved $200 for the claim.

The Company was in a dispute with former creditors regarding the amount of debt converted into common stock. These creditors were seeking damages totaling $316. The Company proposed a settlement in the amount of $316, based on the advice of the Company's legal counsel. Consequently, $316 was charged to operations in the accompanying financial statements for the three and six months ended December 31, 2005. The plaintiffs have accepted the settlement offer.

NOTE 14. GAIN ON SETTLEMENT OF DEBT

During the six months ended December 31, 2005 and 2004, the Company recognized a gain on settlement of debt of $5,603 and $260, respectively. For the six months ended December 31, 2005, the recognized a gain of $4,120 related to the settlement of two notes payable to banks. (See Note 5) The remaining gain for the six months ended December 31, 2005 and the gain for the six months ended December 31, 2004 resulted primarily from the write off of stale accounts payable and judgments. The Company, based upon an opinion provided by independent legal counsel, has been released as the obligator of these liabilities. Accordingly, management has elected to adjust its accounts payable and to classify such adjustments as settlement of debt.

NOTE 15. GAIN RESULTING FROM RECONCILIATION OF PAYROLL TAX LIABILITIES TO TAXING AUTHORITIES

During the six months ended December 31, 2004, the Company recorded an adjustment to earnings of $536, resulting from a reconciliation with the Internal Revenue Service and certain State taxing authorities of the amounts due for delinquent payment of payroll tax liabilities. The Company continually updates its estimate of the amount due related to delinquent payroll taxes and penalties as it receives correspondence or settlement agreements with the Internal Revenue Service and State taxing authorities.

NOTE 16. DISCONTINUED OPERATIONS

In November 2005, the Company determined to discontinue operations of Master Staffing, its executive recruiting division. The decision was based on the Master Staffing lack of ability to generate sufficient revenue and the Company's

lack of expertise in the executive recruiting business. The Company is completely exiting the executive recruiting business. The Company plans to wind down the operations of Master Staffing and close its only office over the next few months.

For the six months ended December 31, 2005 and 2004, Master Staffing's revenues were $11 and $0, respectively, and its loss from operations were $520 and $0, respectively. The results of operations of Master Staffing have been reported separately as discontinued operations.

Master Staffing's net liabilities at December 31, 2005 were $78, which consisted of furniture and equipment of $19 and accrued liabilities of $97.

NOTE 17. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued SFAS No. 123 (Revised), entitled SHARE-BASED PAYMENT. This revised Statement eliminates the alternative to use APB Opinion No. 25's intrinsic value method of accounting that was provided in SFAS No. 123 as originally issued. Under Opinion 25, issuing stock options to employees generally resulted in recognition of no compensation cost. This Statement requires entities to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards. For public companies that file as a small business issuer, this Statement is effective as of the beginning of the first interim or annual reporting period that begins after December 15, 2005. The adoption of SFAS 123 (Revised) will impact the consolidated financial statements as the Company if the Company grants any equity instruments to employees in the future.

In May 2005, the FASB issued SFAS No. 154, entitled ACCOUNTING CHANGES AND ERROR CORRECTIONS--A REPLACEMENT OF APB OPINION NO. 20 AND FASB STATEMENT NO. 3. This Statement replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. Opinion 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle.

This Statement requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. This Statement defines RETROSPECTIVE APPLICATION as the application of a different accounting principle to prior accounting periods as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in the reporting entity. This Statement also redefines RESTATEMENT as the revising of previously issued financial statements to reflect the correction of an error. The adoption of SFAS 154 did not impact the consolidated financial statements.

In June 2005, the EITF reached consensus on Issue No. 05-6, Determining the Amortization Period for Leasehold Improvements ("EITF 05-6") EITF 05-6 provides guidance on determining the amortization period for leasehold improvements acquired in a business combination or acquired subsequent to lease inception.

The guidance in EITF 05-6 will be applied prospectively and is effective for periods beginning after June 29, 2005. EITF 05-6 is not expected to have a material effect on its consolidated financial position or results of operations.

NOTE 18. SUBSEQUENT EVENT

On February 13, 2006, the Company issued convertible notes in exchange for gross proceeds of $5,000, with $4,385 of net proceeds going to the Company. $1,758 of the net proceeds was used directly to pay debt settlements.

The convertible notes mature in two years, at a 15% per annum interest rate and call for monthly interest payments with the principal due on maturity. If the Company defaults on the interest payments, the investors will have the right to convert the notes into common shares at a seventy-five percent (75%) discount to market price. In addition, warrants for 1,352,000 shares of common stock with an exercise price of $.005 were issued to the investors as part of the funding. These warrants expire in seven years and have a cashless exercise provision.

Concurrent with the funding, certain of the Company's investors holding convertible notes exchanged such notes plus any related accrued interest and penalties, for new notes with the same terms as referenced above. These notes are valued at $2,545.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATIONS

(IN THOUSANDS, EXCEPT SHARE DATA)

The following discussion and analysis should be read in conjunction with the consolidated financial statements and notes thereto included in the Company Annual Report on Form 10-KSB for the year ended June 30, 2005. The statements contained in this Report on Form 10-QSB that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements regarding our expectations, hopes, intentions or strategies regarding the future. Forward-looking statements include statements regarding: future product or product development; future research and development spending and our product development strategies, and are generally identifiable by the use of the words "may", "should", "expect", "anticipate", "estimates", "believe", "intend", or "project" or the negative thereof or other variations thereon or comparable terminology. Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements (or industry results, performance or achievements) expressed or implied by these forward-looking statements to be materially different from those predicted. The factors that could affect our actual results include, but are not limited to, the following: general economic and business conditions, both nationally and in the regions in which we operate; competition; changes in business strategy or development plans; our inability to retain key employees; our inability to obtain sufficient financing to continue to expand operations; and changes in demand for products by our customers.

OVERVIEW

We provide a variety of financial services to small and medium-size businesses. These services allow our customers to outsource many human resources tasks,

including payroll processing, workers' compensation insurance, health insurance, employee benefits, 401k investment services, personal financial management, and income tax consultation. In November 2001, we began to provide these services to relieve some of the negative impact they have on the business operations of our existing and potential customers. To this end, through strategic acquisitions, we became a professional employer organization ("PEO").

We provide financial services principally through our wholly-owned SourceOne Group, Inc. ("SOG") subsidiary. These units provide a broad range of financial services, including: benefits and payroll administration, health and workers' compensation insurance programs, personnel records management, and employer liability management. Through our Jackson Staffing subsidiary (and MedicalHR and CallCenterHR operating units), we provide temporary staffing services to small and medium-sized businesses - primarily to call centers and medical facilities.

In January 2003, we completed the acquisition of controlling interest (approximately 85%) in the shares of Greenland Corporation whose shares are traded on the NASD Electronic Bulletin Board under the symbol GRLC. Subsequently, in March 2004, we entered into an agreement with Greenland to return most of our shares in Greenland in return for Greenland's forgiveness of certain DRDF indebtedness and business opportunities. We no longer have an affiliation with Greenland Corporation.

In January 2003, we completed the acquisition of a controlling interest (85%) in the shares of Quik Pix, Inc. ("QPI"). QPI shares are traded on the National Quotation Bureau Pink Sheets under the symbol QPIX. QPI is a visual marketing support firm located in Anaheim, California. Its principal service is to provide photographic and digital images mounted for customer displays in tradeshow and other displays .Its principal product, PhotoMotion is a patented color medium of multi-image transparencies. The process uses existing originals to create the illusion of movement, and allows for six to five distinct images to be displayed with an existing lightbox.

In September 2003, we hired two key persons and acquired the operations of the temporary staffing service then owned by Jackson Staffing, LLC. In order to formalize this arrangement, we entered into an acquisition agreement with Jackson Staffing effective September 1, 2003 and accordingly, the financial statements of Jackson Staffing from September 1, 2003 are included in our financial statements.

In April 2004, we transferred our ColorBlind software technology to QPI. ColorBlind software provides color management to improve the accuracy of color reproduction - especially as it relates to matching color between different devices in a network, such as monitors and printers. ColorBlind software products are marketed internationally through direct distribution, resellers, and on the internet through our color.com website.

Our business continues to experience operational and liquidity challenges. Accordingly, year-to-year financial comparisons may be of limited usefulness now and for the next several periods due to anticipated changes in our business as these changes relate to potential acquisitions of new businesses and changes in products and services.

On June 28, 2004, we completed an acquisition of certain assets of M&M Nursing (M&M"). The purchase price was 5,000,000 shares of our common stock valued at

$31 plus the assumption of $204 of liabilities. M&M is a temporary staffing agency primarily for nurses.

On April 4, 2005, we completed an acquisition of certain assets of Heritage Staffing Group, Inc. ("Heritage"). The purchase price was $80 consisting of $20 in cash, a $45 note payable to the owner of Heritage and 5,000,000 warrants to purchase shares of DRDF common stock valued at $14. Heritage is in the temporary staffing business and we acquired certain assets of Heritage to complement our other temporary staffing business.

On May 5, 2005 we established a self-insured worker's compensation program. In connection with this self-insured program, we were required to establish a worker's compensation deposit in the amount of $2,625. Our maximum exposure under this self-insured worker's compensation program is $4,200 and we are liable up to $250 per occurrence. We purchase coverage from a worker's compensation insurer to cover additional losses above the policy limits. We believe that we can expand our staffing business as a result of us establishing this self-insured worker's compensation program

Our current strategy is: to expand our financial services businesses, including PEO services and temporary staffing, and to continue to commercialize imaging technologies, including PhotoMotion Images and ColorBlind color management software through our QPI subsidiary.

To successfully execute our current strategy, we will need to improve our working capital position. The report of our independent auditors accompanying our June 30, 2005 consolidated financial statements includes an explanatory paragraph indicating there is a substantial doubt about our ability to continue as a going concern, due primarily to our recent loss from operations, the decreases in our working capital and net worth. In addition, we are late in our filing of payroll tax returns for certain of our PEO divisions and are delinquent on the payment of payroll tax withholdings. We plan to overcome the circumstances that impact our ability to remain a going concern through a combination of achieving profitability, raising additional debt and equity financing, and renegotiating existing obligations. In addition, we will continue to work with the Internal Revenue Service and State taxing Authorities to reconcile and resolve all open accounts and issues.

In recent years, we have been working to reduce costs through the reduction in staff and reorganizing our business activities. Additionally, we have sought to reduce our debt through debt to equity conversions. We continue to pursue the acquisition of businesses that will grow our business.

There can be no assurance that we will be able to complete any additional debt or equity financings on favorable terms or at all, or that any such financings, if completed, will be adequate to meet our capital requirements. Any additional equity or convertible debt financings could result in substantial dilution to our shareholders. If adequate funds are not available, we may be required to delay, reduce or eliminate some or all of our planned activities, including any potential mergers or acquisitions. Our inability to fund our capital requirements would have a material adverse effect on the Company.

SIGNIFICANT ACCOUNTING POLICIES AND ESTIMATES

Management's Discussion and Analysis or Plan of Operations discuss our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, we evaluate our estimates and judgments, including those related

to allowance for doubtful accounts, value of intangible assets and valuation of non-cash compensation. We base our estimates and judgments on historical experiences and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The most significant accounting estimates inherent in the preparation of our consolidated financial statements include estimates as to the appropriate carrying value of certain assets and liabilities

which are not readily apparent from other sources, primarily allowance for doubtful accounts, estimated fair value of equity instruments used for compensation, estimated tax liabilities from PEO operations and estimated liabilities associated with worker's compensation liabilities. These accounting policies are described at relevant sections in this discussion and analysis and in the notes to the consolidated financial statements included in our Annual Report on Form 10-KSB for the year ended June 30, 2005.

REVENUE RECOGNITION

PEO SERVICE FEES AND WORKSITE EMPLOYEE PAYROLL COSTS

We recognize our revenues associated with our PEO business pursuant to EITF 99-19 "Reporting Revenue Gross as a Principal versus Net as an Agent." Our revenues are reported net of worksite employee payroll cost (net method). Pursuant to discussions with the Securities and Exchange Commission staff, we changed our presentation of revenues from the gross method to an approach that presents our revenues net of worksite employee payroll costs (net method) primarily because we are not generally responsible for the output and quality of work performed by the worksite employees.

In determining the pricing of the markup component of the gross billings, we take into consideration our estimates of the costs directly associated with our worksite employees, including payroll taxes, benefits and workers' compensation costs, plus an acceptable gross profit margin. As a result, our operating results are significantly impacted by our ability to accurately estimate, control and manage our direct costs relative to the revenues derived from the markup component of our gross billings.

Consistent with our revenue recognition policy, our direct costs do not include the payroll cost of our worksite employees. Our direct costs associated with our revenue generating activities are comprised of all other costs related to our worksite employees, such as the employer portion of payroll-related taxes, employee benefit plan premiums and workers' compensation insurance premiums.

SALES OF PRODUCTS

Revenue is recognized when earned. Our revenue recognition policies are in compliance with all applicable accounting regulations, including American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, Software Revenue Recognition, and SOP 98-9, Modification of SOP 97-2, With Respect to Certain Transactions. Revenue from products licensed to original equipment manufacturers is recorded when OEMs ship licensed products while

revenue from certain license programs is recorded when the software has been delivered and the customer is invoiced. Revenue from packaged product sales to and through distributors and resellers is recorded when related products are shipped. Maintenance and subscription revenue is recognized ratably over the contract period. When the revenue recognition criteria required for distributor and reseller arrangements are not met, revenue is recognized as payments are received. Provisions are recorded for returns and bad debts. Our software arrangements do not contain multiple elements, and we do not offer post contract support.

TEMPORARY STAFFING

We record gross revenue for temporary staffing. We have concluded that gross reporting is appropriate because we (i) have the risk of identifying and hiring qualified employees, (ii) have the discretion to select the employees and establish their price and duties and (iii) bear the risk for services that are not fully paid for by customers. Temporary staffing revenues are recognized when the services are rendered by our temporary employees. Temporary employees placed by us are our legal employees while they are working on assignments. We pay all related costs of employment, including workers' compensation insurance, state and federal unemployment taxes, social security and certain fringe benefits. We assume the risk of acceptability of our employees to our customers.

RESULTS OF OPERATIONS (IN $000)

THREE MONTHS ENDED DECEMBER 31, 2005 COMPARED TO THREE MONTHS ENDED DECEMBER 31, 2004

REVENUES

Total revenues were $17,834 and $4,928 for the three months ended December 31, 2005 and 2004, respectively; an increase of $12,906 (262%). The principal reason for the increase is due to the expansion of our temporary staffing division with the acquisition of Heritage Staffing in April 2005 and the formation of our self-insured worker's compensation plan in May 2005.

TEMPORARY STAFFING

In September 2003, we entered into an agreement to purchase a temporary staffing business through the organization of CallCenterHR and MedicalHR and the acquisition of Jackson Staffing. In June 2004, we entered into an agreement to purchase certain assets of M&M Nursing, a temporary staffing agency for nurses. During fiscal 2005, Jackson Staffing and M&M Nursing were renamed Solvis Group, Inc. Temporary Staffing revenues were $17,002 and $3,749 for the three months ended December 31, 2005 and 2004, respectively; an increase of $13,253 (354%). The principal reason for the increase is due to the expansion of our temporary staffing division due to our focus to grow this segment of our business.

PEO SERVICES

PEO revenues were $387 and $478 for the three months ended December 31, 2005 and 2004, respectively; a decrease of $91 (19%) due primarily to the decrease in our

PEO customer base due to an increased focus by us to expand our temporary staffing business.

PRODUCTS

Sales of products were generated principally from our QPI subsidiary. Products revenues were $443 and $688 for the three months ended December 31, 2005 and 2004, respectively; an decrease of $245 (36%). The decrease is principally due to decreased sales of photographic and digital images though our QPI subsidiary.

SOFTWARE

Software revenues were $2 and $13 for the three months ended December 31, 2005 and 2004, respectively; a decrease of $11 (85%). Revenues from licenses and royalties for the periods were insignificant.

Royalties and licensing fees vary from quarter to quarter and are dependent on the sales of products sold by OEM customers using our technologies. These revenues continue to decline as we have elected to transfer our ColorBlind software to QPI, which has accelerated product development and begun to implement a more aggressive product sales program.

COST OF PRODUCTS SOLD

Costs of temporary staffing for the three months ended December 31, 2005 and 2004 was $14,477 (85% of temporary staffing revenue) and $3,400 (91% of temporary staffing revenue), respectively. The significant increase is due to the significant increase in temporary staffing revenue.

Cost of PEO services for the three months ended December 31, 2005 and 2004 was $299 (77% of PEO revenues) and $348 (73% of PEO revenues), respectively. The decrease in gross profit is not significant.

Cost of products sold for the three months ended December 31, 2005 and 2004 were $7 (2% of product sales) and $442 (64% of product sales), respectively. Cost of sales for products in not significant in terms of dollars.

Cost of software, licenses and royalties for the three months ended December 31, 2005 and 2004 were $0 (0% of software, license and royalties revenue) and $0 (0% of software, license and royalties revenue), respectively.

OPERATING EXPENSES

Operating expenses for the three months ended December 31, 2005 and 2004 were $2,537 and $996, respectively; an increase of $1,541 (155%). The increase is principally due to an overall increase in our temporary staffing business as reflected in the 354% increase in revenues for this segment of our business.

OTHER INCOME AND EXPENSE

Interest expense and financing costs for the three months ended December 31, 2005 and 2004 was $140 and $345 respectively; a decrease of $205 (59%). The decrease is principally due to a decreased write off of debt financing costs due to the fewer conversions of convertible debt to equity during the three months ended December 31, 2005.

SETTLEMENT WITH INVESTORS

Settlement with investors relates to disputes over the note balances, accrued interest and penalties on old debt. We reached a settlement with these investors by issuing new notes for an aggregate of $316.

GAIN ON EXTINGUISHMENT OF DEBT

Gain on the extinguishment of debt was $4,262 and $260 for the three months ended December 31, 2005 and 2004, respectively; an increase of $4,002 (1,539%). The significant increase is due to the gain recognized of $4,120 in December 2005 related to the settlement of two notes payable to banks. The remaining gains related to accounts payable, which had become stale and uncollectible under the Statute of Limitations in the State of California and upon obtaining a legal opinion with respect to the State of California Statute of Limitations.

PENALTIES AND INTEREST

Penalties and interest related to our past due payroll tax liabilities for the three months ended December 31, 2005 and 2004 was $294 and $0 respectively.

SIX MONTHS ENDED DECEMBER 31, 2005 COMPARED TO SIX MONTHS ENDED DECEMBER 31, 2004

REVENUES

Total revenues were $29,863 and $9,356 for the six months ended December 31, 2005 and 2004, respectively; an increase of $20,507 (219%). The principal reason for the increase is due to the expansion of our temporary staffing division with the acquisition of Heritage Staffing in April 2005 and the formation of our self-insured worker's compensation plan in May 2005.

TEMPORARY STAFFING

Temporary Staffing revenues were $28,545 and $7,654 for the six months ended December 31, 2005 and 2004, respectively; an increase of $20,891 (273%). The principal reason for the increase is due to the expansion of our temporary staffing division due to our focus to grow this segment of our business.

PEO SERVICES

PEO revenues were $682 and $850 for the six months ended December 31, 2005 and 2004, respectively; a decrease of $168 (20%) due primarily to the decrease in our PEO customer base due to an increased focus by us to expand our temporary staffing business.

PRODUCTS

Sales of products were generated principally from our QPI subsidiary. Products revenues were $631 and $813 for the six months ended December 31, 2005 and 2004, respectively; an decrease of $182 (22%). The decrease is principally due to decreased sales of photographic and digital images though our QPI subsidiary.

SOFTWARE

Software revenues were $5 and $39 for the six months ended December 31, 2005 and 2004, respectively; a decrease of $34 (87%). Revenues from licenses and royalties for the periods were insignificant.

COST OF PRODUCTS SOLD

Costs of temporary staffing for the six months ended December 31, 2005 and 2004 was $25,303 (89% of temporary staffing revenue) and $6,948 (91% of temporary staffing revenue), respectively. The significant increase is due to the significant increase in temporary staffing revenue.

Cost of PEO services for the six months ended December 31, 2005 and 2004 was $653 (96% of PEO revenues) and $628 (74% of PEO revenues), respectively. The decrease in gross profit is due primarily to us incurring additional employee benefit related costs.

Cost of products sold for the six months ended December 31, 2005 and 2004 were $18 (3% of product sales) and $465 (57% of product sales), respectively. Cost of sales for products in not significant in terms of dollars.

Cost of software, licenses and royalties for the six months ended December 31, 2005 and 2004 were $0 (0% of software, license and royalties revenue) and $3 (8% of software, license and royalties revenue), respectively. Cost of sales for software in not significant in terms of dollars.

OPERATING EXPENSES

Operating expenses for the six months ended December 31, 2005 and 2004 were $4,208 and $2,005, respectively; an increase of $2,203 (110%). The increase is principally due to an overall increase in our temporary staffing business as reflected in the 273% increase in revenues for this segment of our business.

OTHER INCOME AND EXPENSE

Interest expense and financing costs for the six months ended December 31, 2005 and 2004 was $564 and $828 respectively; a decrease of $264 (32%). The decrease is principally due to a decreased write off of debt financing costs due to the fewer conversions of convertible debt to equity during the six months ended December 31, 2005.

SETTLEMENT WITH INVESTORS

Settlement with investors relates to disputes over the note balances, accrued interest and penalties on old debt. We reached a settlement with these investors by issuing new notes for an aggregate of $316.

GAIN ON EXTINGUISHMENT OF DEBT

Gain on the extinguishment of debt was $5,603 and $260 for the six months ended December 31, 2005 and 2004, respectively; an increase of $5,343 (2,055%). The significant increase is due to the gain recognized of $4,120 in December 2005 related to the settlement of two notes payable to banks. The remaining gains related to accounts payable, which had become stale and uncollectible under the Statute of Limitations in the State of California and upon obtaining a legal opinion with respect to the State of California Statute of Limitations.

PENALTIES AND INTEREST

Penalties and interest related to our past due payroll tax liabilities for the six months ended December 31, 2005 and 2004 was $567 and $0 respectively.

GAIN FROM RECONCILIATION OF PAYROLL TAX LIABILITES TO TAXING AUTHORITIES

During the six months ended December 31, 2004, we recorded as other income an adjustment of accrued PEO payroll taxes payable of $536 resulting from reconciliations of certain liabilities with the Internal Revenue Service and certain State taxing authorities of amounts due for delinquent payment of payroll tax liabilities. We continually updates our estimate of the amount due related to delinquent payroll taxes and penalties as we receive correspondence or settlement agreements with the Internal Revenue Service and State taxing authorities.

DISCONTINUED OPERATIONS

In November 2005, we determined to discontinue operations of Master Staffing, our executive recruiting division. The decision was based on the Master Staffing lack of ability to generate sufficient revenue and our lack of expertise in the executive recruiting business. We are completely exiting the executive recruiting business. We plan to wind down the operations of Master Staffing and close its only office over the next few months.

For the six months ended December 31, 2005 and 2004, Master Staffing's revenues were $11 and $0, respectively, and its loss from operations were $520 and $0, respectively. The results of operations of Master Staffing have been reported separately as discontinued operations.

Master Staffing's net liabilities at December 31, 2005 were $78 which consisted of furniture and equipment of $19 and accrued liabilities of $97.

SUBSEQUENT EVENT

On February 13, 2006, we issued convertible notes in exchange for gross proceeds of $5,000, with $4,385 of net proceeds going to us. $1,758 of the net proceeds was used directly to pay debt settlements.

The convertible notes mature in two years, at a 15% per annum interest rate and call for monthly interest payments with the principal due on maturity. If we default on the interest payments, the investors will have the right to convert the notes into common shares at a seventy-five percent (75%) discount to market price. In addition, warrants for 1,352,000,000 shares of common stock with an exercise price of $.005 were issued to the investors as part of the funding. These warrants expire in seven years and have a cashless exercise provision.

Concurrent with the funding, certain of our investors holding convertible notes exchanged such notes plus any related accrued interest and penalties, for new notes with the same terms as referenced above. These notes are valued at $2,545.

LIQUIDITY AND CAPITAL RESOURCES

Historically, we have financed our operations primarily through cash generated from operations, debt financing, and the sale of equity securities. Additionally, in order to facilitate our growth and future liquidity, we have made some strategic acquisitions.

As of December 31, 2005, we had negative working capital of $23,287 as compared to negative working capital of $26,780 at June 30, 2005, an increase in working capital of $3,493 since June 30, 2005. The primary reason for the increase in working capital was the settlement of two notes payable to banks that resulted in increase in working capital of $4,120.

The Company is late on filing payroll tax returns and owes approximately $8.0 million in past due payroll taxes.

Net cash provided by operating activities was $2,515 for the six months ended December 31, 2005 as compared to net cash used in activities of $892 for the prior-year period; an increase of $3,407. The principal reason for the increase was the increase in account payable and accrued expenses and an increase in PEO liabilities.

Cash used in financing activities was $1,817 for the six months ended December 31, 2005 as compared to cash provided by financing activities of $901 for the six months ended December 31, 2004, a decrease of $2,718 from the prior-year period. The primary reason for the decrease was the pay down on $3,064 of notes payable during the six months ended December 31, 2005.

We have no material commitments for capital expenditures. Our 5% convertible preferred stock (which ranks prior to our common stock), carries cumulative dividends, when and as declared, at an annual rate of $50 per share. The aggregate amount of such dividends in arrears at December 31, 2005, was approximately $463.

Our capital requirements depend on numerous factors, including market acceptance of our products and services, the resources we devote to marketing and selling our products and services, and other factors. The report of our independent auditors accompanying our June 30, 2005 financial statements includes an explanatory paragraph indicating there is a substantial doubt about our ability to continue as a going concern, due primarily to the decreases in our working capital and net worth.

CONTINGENT LIABILITY

The Company accrues and discloses contingent liabilities in its consolidated financial statements in accordance with Statement of Financial Accounting Standards ("SFAS") No. 5, Accounting for Contingencies. SFAS No. 5 requires accrual of contingent liabilities that are considered probable to occur and that can be reasonably estimated. For contingent liabilities that are considered reasonably possible to occur, financial statement disclosure is required, including the range of possible loss if it can be reasonably determined. The Company has disclosed in its audited financial statements several issues that it believes are reasonably possible to occur, although it cannot determine the range of possible loss in all cases. As these issues develop, the Company will continue to evaluate the probability of future loss and the potential range of such losses. If such evaluation were to determine that a loss was probable and the loss could be reasonably estimated, the Company would be required to accrue its estimated loss, which would reduce net income in the period that such determination was made.

OFF-BALANCE ARRANGEMENTS

There are no off balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors, except for the following.. As of September 8, 2004, Warning Management Services, Inc. ("Warning") purchased all of the issued and outstanding shares of Employment Systems, Inc. ("ESI") for $1,500. The purchase was $750 cash paid at the closing and a $750 note payable. In connection with this transaction, the Company agreed to be a guarantor of the $750 note payable. Our CEO, Brian Bonar, is also the CEO of Warning. As inducement to enter into this guarantee, we were given a non-cancelable 2-year payroll processing contract with ESI. Currently the $750 note payable is in dispute. Warning is claiming that certain representations made by ESI were not correct and is proposing that the purchase price be reduced. Warning reached a settlement, effective as of September 30, 2005 with the Plaintiff, which requires defendants, collectively, to pay Plaintiff the aggregate sum of $380. Defendants have made the initial two payments due under the settlement and the final payment in the sum of $80 will be due in April 2006. Management has evaluated this contingent liability and has determined that no loss is anticipated as a result of this guarantee.

ITEM 3. CONTROLS AND PROCEDURES

Our Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15 and 15d-15 under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the period ended December 31, 2005, covered by this quarterly report (the "Evaluation Date"), and based on such evaluation, such officers have concluded, as of the Evaluation Date, that our disclosure controls and procedures were not effective in ensuring that all information required to be disclosed in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms.

The material weaknesses in internal control over financial reporting resulting from the Chief Executive Officer and Chief Financial Officer's evaluation are described below. In addition there are inherent limitations to the effectiveness of any system of disclosure controls and procedures. Even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives.

Except as described below, during our first quarter of fiscal 2006, there were no changes made in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Attached as Exhibits 31.1 and 31.2 to this annual report are certifications of the Chief Executive Officer and Chief Financial Officer required in accordance with Rule 13a-14(a) of the Exchange Act. This portion of the Company's quarterly report includes the information concerning the controls evaluation referred to in the certifications and should be read in conjunction with the certifications for a more complete understanding of the topics presented.

In conjunction with their audit of our fiscal year 2005 consolidated financial statements, PMB & Co., LLP (PMB), our independent registered public accounting firm, identified and orally reported to management and the Audit Committee the material weaknesses under standards established by the Public Company Accounting Oversight Board (PCAOB). A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects our ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is a more than a remote likelihood that a misstatement of our annual or interim financial statements that is more than inconsequential will not be prevented or detected.

The material weaknesses were identified as:

(1) Planning and implementation of our Accounting System; (2) Financial Statement closing process; (3) Ineffective Information Technology control environment, including the design of our information security and data protection controls; (4) Untimely detection and assessment of impairment of intangible assets (i.e., patents where indicators of impairment are present; (5) Inadequate review of the valuation of certain payroll tax liabilities that resulted in post-closing journal entries to properly reflect our payroll tax liabilities; (6) Proper recording of conversion of debt into shares of common stock, including the ability of certain managers to record journal entries without adequate review or supporting documentation and an inability by management to adequately review the issuance of common stock; and, (7) Lack of the necessary depth of personnel with sufficient technical accounting experience with U.S. GAAP to perform an adequate and effective secondary review of technical accounting matters. We will continue to evaluate the material weaknesses and will take all necessary action to correct the internal control deficiencies identified. We will also further develop and enhance our internal control policies, procedures, systems and staff to allow us to mitigate the risk that material accounting errors might go undetected and be included in our consolidated financial statements.

We contemplate undertaking a thorough review of our internal controls as part of our preparation for compliance with the requirements under Section 404 of the Sarbanes-Oxley Act of 2002 and we are using this review to further assist in identifying and correcting control deficiencies. At this time, we have not completed our review of the existing controls and their effectiveness. Unless and until the material weaknesses described above, or any identified during this review, are completely remedied, evaluated and tested, there can be no assurances that we will be able to assert that our internal control over financial reporting is effective, pursuant to the rules adopted by the SEC under Section 404, when those rules take effect.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

(IN THOUSANDS, EXCEPT SHARE DATA)

The Company and its SourceOne Group ("SOG") subsidiary have been sued by the Arena Football 2 Operating Company, LLC ("Arena") in Wayne County Circuit Court, Michigan. The claims made by Arena against the Company and SOG are that SOG failed to perform under an agreement to procure and furnish workers' compensation insurance and that Arena incurred alleged damages in an amount no less than $709 as a result. Management has vigorously contested the claims made

by Arena. In addition, the Company has filed claims against Arena and Arena's agent, Thilman and Filippini, based on, among other things, the representations made to SOG that let it to enter into the agreement with Arena. The case remains in the discovery phase.

The Company and SOG have been sued by Liberty Mutual Insurance Company ("Liberty") in the United States District Court for the Northern District of Illinois. The nature of the specific claims made by Liberty against the Company and SOG are that the Company and SOG were and are obligated to make additional premium payments to Liberty for workers' compensation insurance, which is related to the Arena litigation described above. The initial claim by Liberty was estimated by Liberty to be $829 and is now claimed to exceed $1,000. Management has vigorously contested the claims made by Liberty. The case remains in the discovery phase.

On February 10, 2005, Berryman & Henigar Enterprises ("Plaintiff"), filed a complaint in the Superior Court of California, County of San Diego, Case No. GIC842610, against Warning Model Management, Inc. for breach of a promissory note issued pursuant to terms and conditions of a certain stock purchase and sale agreement dated September 9, 2004. The Company and its subsidiary, Employment Systems, Inc. ("ESI"), each allegedly guaranteed payments on the underlying promissory note. Plaintiff seeks principal damages of $750 in that regard. Warning Model Management, Inc. has taken the position that Plaintiff failed to disclose certain material information in the underlying transaction which thereby negates the promissory note. Warning Model Management, Inc. reached a settlement, effective as of September 30, 2005 with the Plaintiff, which requires defendants, collectively, to pay Plaintiff the aggregate sum of $380. Defendants have made the initial two payments due under the settlement and the final payment in the sum of $80 will be due in April 2006.

On March 17, 2005, Greenland Corporation ("Plaintiff"), filed an amended complaint in the Superior Court of California, County of San Diego, Case No. GIC842605, against the Company and multiple other individuals and entities resulting from a transaction as evidenced by the "Agreement to Acquire Shares" dated August 9, 2002, whereby the Company obtained a controlling equity interest in Plaintiff. Plaintiff contends that the Company engaged in various forms of wrongdoing including breach of fiduciary duty, conversion, conspiracy and aiding and abetting. The Company has filed a cross-complaint alleging various causes of action against Plaintiff and its officers, directors and/or managing agents including Thomas J. Beener, Gene Cross, George Godwin, and Edward Sano. The subject cross-complaint seeks pecuniary and punitive damages resulting from various fraudulent transactions as well as legal malpractice against Mr. Beener. Trial, which was initially set for April 14, 2006, has now been continued to September 8, 2006. The Company has and will continue with its vigorous defense/prosecution of the allegations/claims.

On August 29, 2005, United Bank & Trust filed suit against the Company and other parties. The allegations of the lawsuit are that the Company guaranteed certain debt owed by InfoServices, Inc. and is liable in the amount of $678. The case is in its early stages and discovery has not yet commenced. However, the Company intends to vigorously defend itself against the claims asserted.

Throughout fiscal 2004 and 2005, and through the date of this filing, trade creditors have made claims and/or filed actions alleging the failure of the Company to pay its obligations to them in a total amount exceeding $3,000. These

actions are in various stages of litigation, with many resulting in judgments being entered against the Company. Several of those who have obtained judgments have filed judgment liens on the Company's assets. These claims range in value from less than $1 to just over $1,000, with the great majority being less than $20.

On September 7, 2005, the arbitrator from the American Arbitration Association awarded to Accord Human Resources a judgment against Greenland Corporation and the Company as the guarantor, an amount equaling $168. Legal counsel has estimated that the claim could amount to as much as $214. The Company has reserved $200 for the claim.

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

Common Stock

During the three months ended December 31, 2005, DRDF issued the following:

- 33,698,362 shares were issued to Balmore Funds S.A. at $0.0017 per share for conversion of a convertible debenture and accrued interest valued at $57,287.21. These shares were issued pursuant to the exempt provided by Section 4(2) of the Securities Act of 1933, as amended. We made a determination that Bristol Investment Fund, Ltd was a sophisticated investor with enough knowledge and experience in business to evaluate the risks and merits of the investment.

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

31.1 Rule 13a-14(a) Certification of CEO

31.2 Rule 13a-14(a) Certification of CFO

32.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 of CEO

32.2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 of CFO

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.

Dated: February 20, 2006

DALRADA FINANCIAL CORPORATION
(Registrant)

By: /S/ Brian Bonar

Brian Bonar
Chairman and Chief Executive Officer

By: /S/ Randall Jones

Randall Jones
Chief Financial Officer