UPGRADE INTERNATIONAL CORP /FL/
Form 10QSB
August 20, 2001

U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-QSB

(Mark One)

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

For the quarterly period ended JUNE 30, 2001

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File No. 0-27649

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

Washington	58-2441311
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1411 FOURTH AVENUE - SUITE 629 SEATTLE, WASHINGTON 98101
(Address of principal executive offices)

(206) 903-3116
(Issuer's telephone number, including area code)

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 x NO

State the number of shares outstanding of each of the issuer's classes of common equity as of the latest practicable date: As of July 31, 2001, 24,024,615 shares of common stock, $.0001 par value were outstanding.

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

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Upgrade International Corporation and Subsidiaries
(A development stage enterprise)

CONSOLIDATED BALANCE SHEETS

ASSETS

	September 30, 2000	June 30, 2001
		(unaudited
CURRENT ASSETS		
Cash and cash equivalents	$ 398,989	$ 107,919
Restricted deposit	805,687	300,000
Subscription receivable	32,725	-
Due from related party	-	130,000
Equipment held for resale	-	3,054,125
Prepaid expenses, deposits and other	121,491	358,245
Total current assets	1,358,892	3,950,289
PROPERTY AND EQUIPMENT - AT COST,		

less accumulated depreciation and amortization	1,791,257	2,093,076
EQUIPMENT UNDER CONSTRUCTION	3,301,625	-
ADVANCES TO THE PATHWAYS GROUP, INC less allowance for uncollectible advances of $0. and $3,399,780, respectively	1,900,825	-
ADVANCES TO ROCKSTER, INC.	-	950,000
OTHER ASSETS		
Intangible and deferred assets, net of accumulated amortization	370,206	622,606
Deposits & notes	328,051	332,845
Total assets	$ 9,050,856	$ 7,948,816
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 1,993,796	$ 4,496,134
Accrued liabilities	733,241	2,151,140
Bridge loans	799,177	434,259
Notes payable	-	431,453
Equipment purchase contract payable	2,307,025	1,850,000
Royalty fee payable to Card Tech, Inc., net	487,500	975,000
Payable to related parties	175,240	1,170,560
Total current liabilities	6,495,979	11,508,546
NOTES PAYABLE, net of unamortized discount	-	890,322
CONVERTIBLE DEBENTURES, net of unamortized discount	809,043	1,662,973
MINORITY INTEREST	-	-
COMMITMENTS AND CONTINGENCIES	-	-
STOCKHOLDERS' EQUITY (DEFICIT)		
Common stock - $.001 par value, 50,000,000 shares authorized	20,341	23,725
Stock subscriptions	323,640	711,012
Additional paid in capital	36,925,837	50,829,216
Receivable from stockholders of subsidiary	(266,621)	(266,621
Accumulated development stage deficit	(35,257,363)	(57,410,357
	1,745,834	(6,113,025
Total liabilities and stockholders' equity (deficit)	$ 9,050,856	$ 7,948,816

The accompanying notes are an integral part of these statements.

Upgrade International Corporation and Subsidiaries
(A development stage enterprise)

CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

	Nine months ended June 30, 2000	Nine months ended June 30, 2001	Three months ended June 30, 2000	Three months ended June 30, 2001
Costs and expenses				
Research and development	$ 2,523,486	$ 5,030,133	$ 654,359	$1,490,
Purchased in-process research and development	425,800	-	-	
Sales and marketing	1,115,910	1,276,559	187,375	140,
General and administrative	8,666,055	8,519,784	4,276,125	1,430,
	12,731,251	14,826,476	5,117,859	3,061,
Other expenses (income)				
Equity in losses of UltraCard	-	-	-	
Interest expense	588,858	3,733,448	68,214	2,706,
Provision for uncollectible advances	-	3,399,780		3,339,
Other, net	209,299	193,290	295,790	106,
	798,157	7,326,518	364,004	6,212,
Minority interest in losses of subsidiaries	(1,758,371)	-	(71,038)	
NET LOSS	$11,771,037	$22,152,994	$5,410,825	$9,274,
LOSS PER COMMON SHARE-BASIC AND DILUTED	$ 0.64	$ 1.01	$ 0.28	$ 0

The accompanying notes are an integral part of these statements.

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Upgrade International Corporation and Subsidiaries
(A development stage enterprise)

STATEMENT OF STOCKHOLDERS' EQUITY

Nine months ended June 30, 2001 (unaudited)

	Voting common stock Shares	Voting common stock Amount	Common stock subscribed Shares	Common stock subscribed Amount	Additional paid-in Capital	Receivab from Stockhold of subsidia
Balances at October 1, 2000	20,340,610	$20,341	102,609	$ 323,640	$36,925,837	$ (266,6
Issuance of shares in						

October 2000 subscribed to shares in May 2000	102,609	102	(102,609)	(323,640)	323,538
Issuance of common shares at $10.50 per share in October 2000, net of costs	142,860	143	-	-	1,349,857
Shares subscribed to at $6.00 per share in October 2000, net of costs	-	-	258,333	1,070,000	(100,000)
Allocation of debenture proceeds to common stock	167,768	168			444,435
Allocation of debenture proceeds to common stock warrants	-	-	-	-	829,551
Allocation of debenture proceeds to beneficial conversion feature	-	-	-	-	1,051,096
Allocation of promissory note proceeds to common stock	40,000	40	-	-	136,167
Common stock subscribed to at $4.00 per share in December 2000	-	-	125,000	500,000	-
Common shares subscribed at $2.00 per share in December 2000, net of issuance costs	-	-	389,129	778,257	(102,208)
Common shares subscribed in December 2000 at $0.25 through the exercise of stock warrants	-	-	20,000	5,000	-

"Continued"

Issuance of common shares at $2.02 per share pursuant to conversion of debentuer	107,981	108			218,014
Issuance of common					

shares pursuant to warrant exercise at $0.25 per share			200,000	50,000	
Shares subscribed to at $2.50 per share in January 2001, net of costs	-	-	200,000	500,000	(50,000)
Modification of warrants	-	-	-	-	2,414,000
Issuance of common shares at $1.43 per share pursuant to conversion of debentures	307,509	307	-	-	438,049
Shares subscribed to at $2.50 per share in February 2001 net of costs			80,000	200,000	(20,000)
Common shares subscribed at $3.75 per share as additional consideration on debt	-	-	16,267	61,001	
Common shares subscribed at $3.31 as additional consideration on debt			18,429	61,001	
Common stock issued in March 2001 for shares previously subscribed	253,334	254	(253,334)	(925,000)	924,746
Warrants issued with a strike price of $6.00 per share as additional compensation on debt	-	-			7,708
Warrants issued with a Strike price of $3.75 per share as additional compensation on debt	-	-			14,659
Warrants issued with a Strike price of $3.31 per share as additional compensation on debt		-	-	-	12,715
Issuance of common					

shares at $2.00 per share net of financing costs			828,496	1,656,992	(5,000)
Placement fees accrued on prior financings					(831,133)
Allocation of debenture Proceeds to beneficial Conversion feature	-	-	-	-	790,369
Adjustment to remeasurement of attorney stock options					(510,315)

The accompanying notes are an integral part of this statement.

"Continued"

Issuance of common Stock in April for shares previously subscribed	1,606,721	1,607	(1,606,721)	(3,703,442)	3,701,835
Common stock subscribed at $2.00 per share in April	-	-	15,000	30,000	-
Common stock subscribed at $1.74 per share pursuant to conversion of debentures in June 2001	-		12,784	22,203	-
Common stock subscribed at $2.70 per share in connection with debt in June 2001	-		50,000	135,000	-
Common stock subscribed at $2.32 to $2.83 per share from April through June 2001 as additional financing fees	-		47,490	125,000	-
Shares issued pursuant to conversion of debentures at $1.25 per share	82,000	82	-	-	102,418
Shares issued pursuant to conversion of debentures					

at $1.74	115,606	116	-	-	200,692	
Shares issued pursuant to conversion of debentures at $1.00	29,433	29	-	-	29,404	
Shares subscribed in April, 2001 for $2.00 per share pursuant to private placement net of stock issue costs	375,000	375	-	-	649,625	
Issuance of warrants issued at $2.03 to $3.75 as additional financing fees	-	-	-	-	1,383,353	
Allocation of debenture proceeds to beneficial conversion feature	-	-	-	-	281,843	
Allocation of debenture proceeds to cashless exercise warrants	-	-	-	-	48,487	
Common stock subscribed in lieu of loan origination fees	-	-	50,000	145,000	-	
Common stock issued at $3.19 per share from April through June 2001 as additional financing fees	53,185	53	-	-	169,474	
Net consolidated loss for the nine months ended June 30, 2001	-	-	-	-	-	
Balances June 30, 2001	23,724,616	$23,725	450,873	$ 711,012	50,829,216	$ (266,6

The accompanying notes are an integral part of this statement.

Upgrade International Corporation and Subsidiaries
(A development stage enterprise)

CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

	Nine months ended June 30,		
	2000	2001	s (Fe

Increase (Decrease) in Cash and Cash Equivalents			
Cash flows from operating activities			
Net loss	$(11,771,037)	$(22,152,994)	$
Adjustments to reconcile net loss to net cash used in operating activities			
Depreciation and amortization	159,888	531,544	
Amortization of beneficial conversion feature and debenture discount	522,208	1,884,151	
Allowance for potentially uncollectible advances	-	3,399,780	
Loss on sale of property and equipment	-	29,904	
Adjustment to receivables from subsidiary shareholders	-	-	
Write off of option costs	-	-	
Equity in loss of UltraCard	-	-	
Common stock subscribed for financing fees	-	416,529	
Purchased in-process research and development	425,800	-	
Warrants and options issued for services	1,387,170	1,903,685	
Warrants issued for interest on notes payable	-	-	
Warrants issued for financing fees	-	1,418,433	
Shares issued for services	242,900	-	
Expenses incurred through loan assumption	-	-	
Stock of subsidiary issued in exchange for contribution of intellectual property charged to expense	-	-	
Minority interest	(1,758,371)	-	
Changes in assets and liabilities:	-	-	
Prepaid expenses, deposits and other	(201,264)	(274,976)	
Accounts payable and accrued liabilities	315,435	4,400,180	
Net cash used in operating activities	(10,677,271)	(8,443,764)	
Cash flows from investing activities			
Advances to The Pathways Group, Inc.	-	(1,498,955)	
Advances to Rockster, Inc.	-	(950,000)	
Payments on equipment under construction	-	-	
Acquisition of property and equipment, net	(687,348)	(587,063)	
Acquisition of Centurion Technologies, Inc., net of cash acquired	-	-	
Acquisition of UltraCard, Inc., net of cash acquired	(260,300)	-	
Acquisition of additional equity interest in eForNet from a minority shareholder	(200,000)	-	
Note due from related party	-	(130,000)	
Proceeds from sale of property and equipment	-	-	
Acquisition deposit	(1,225,000)	(15,000)	
Additions to intangible assets	(71,927)	(66,470)	
Net cash used in investing activities	(2,444,575)	(3,247,488)	
Cash flows from financing activities			
Proceeds from sale of common stock and stock subscriptions	7,731,798	6,255,614	
Borrowings, net of loan costs and repayments	832,681	5,945,251	
Principal payments on borrowings	-	(1,361,370)	
Release of restricted cash	-	505,687	
Purchase of collateral on subsidary's letter of credit	-	-	
Proceeds from exercise of stock options and warrants	-	55,000	
Net cash provided by financing activities	8,564,479	11,400,182	

Net increase (decrease) in cash and cash equivalents	(4,557,367)	(291,070)	
Cash and cash equivalents at the beginning of the period	4,781,330	398,989	
Cash and cash equivalents at the end of the period	$ 223,963	$ 107,919	$

The accompanying notes are an integral part of these statements.

UPGRADE INTERNATIONAL CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2001 AND 2000
(UNAUDITED)

NOTE A - FINANCIAL STATEMENTS

The unaudited consolidated financial statements of the Company and its subsidiaries have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles (GAAP) have been condensed or omitted pursuant to such rules and regulations. The results of operations for interim periods are not necessarily indicative of the results to be expected for the entire fiscal year ending September 30, 2001. This form 10-QSB should be read in conjunction with the form 10-KSB that includes audited consolidated financial statements for the year ended September 30, 2000 and 1999 and the related consolidated statements of operations, stockholders' equity and cash flows for the years then ended and since inception (February 5, 1997) filed on January 16, 2001 and the form 10-QSB that included consolidated financial results for the six months ended March 31, 2001 and 2000, filed on May 21, 2001.

NOTE B - BASIS OF PRESENTATION

The Company consolidates all companies in which it has a controlling financial interest. This generally occurs when the Company owns more than 50% of the outstanding voting shares of the company. The Company also consolidates 50%-owned companies in which it has voting control through agreements with other shareholders. Investments in Companies where the Company has significant influence through ownership of 20% to 50% of the investors voting shares or contractual arrangements are accounted for by the equity method.

The balance sheet as of June 30, 2001 and September 30, 2000, reflects the consolidated financial position of the Company and its subsidiaries (Subsidiaries) as follows: UltraCard, Inc. (UltraCard); cQue Corporation (formerly Centurion Technologies, Inc.); CTI Acquisition Corporation (CTI); Global CyberSystems, Inc. (Global); EforNet Corporation (EforNet); Global Cybersystems SA. (GCSA) and Global Cybersystems PLC (GCPLC). The statements of operations and cash flows for the nine months ended June 30, 2001 and 2000 include the consolidated results of the Company and its Subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. Minority interest represents the minority stockholders' proportionate share in the equity of the Company's consolidated Subsidiaries. The losses incurred by a subsidiary are allocated on a proportionate basis to minority interest until the carrying amount of minority interest is eliminated.

Further losses are then included in the net loss of the Company.

Upgrade International Corporation and Subsidiaries
(A development stage enterprise)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2001 and 2000

NOTE C - LOSS PER COMMON SHARE

Basic loss per share is computed by dividing the net loss by the weighted average number of common shares outstanding during the period. The weighted average number of shares outstanding was 21,829,283 and 18,323,267 for the nine months ended June 30, 2001 and 2000, respectively, 23,610,401 and 19,324,375 for the three months ended June 30, 2001 and 2000, respectively and 12,481,773 since inception (February 5, 1997) through June 30, 2001. Diluted loss per share for all periods presented equaled basic loss per share due to antidilutive effect of the potentially issueable common stock equivalents. As of June 30, 2001, total warrants and options of 6,115,959 were not included in loss per share computations due to the antidilutive effect.

NOTE D - MANAGEMENT PLANS

The Company is a development stage enterprise as defined under Statement of Financial Accounting Standards No. 7. The Company is devoting its present efforts into establishing a new business in the information technology industry and, is currently in the process of identifying markets and establishing applications for its technologies. The process of commercialization of the Company's core technology is focused upon the development of that core technology, the UltraCard and read/write device. In addition, the Company is in the process of acquiring strategically aligned businesses to facilitate certain applications of the Company's core technology. To date, no operating revenues have been generated. The Company's operations to date have consumed substantial and increasing amounts of cash. The Company's negative cash flow from operations is expected to continue and to accelerate in the foreseeable future. The development of the Company's technology and potential products will continue to require a commitment of substantial funds. The Company expects that its existing and expected financings will be adequate to satisfy the requirements of its current and planned operations until the end of fiscal year 2001.

However, the rate at which the Company expends its resources is variable, may be accelerated, and will depend on many factors. The Company will need to raise substantial additional capital to fund its operations and may seek such additional funding through public or private equity or debt financing. There can be no assurance that such additional funding will be available on acceptable terms, if at all. The Company's continued existence as a going concern is ultimately dependent upon its ability to secure additional funding for completing and marketing its technology and the success of its future operations.

During the three months ended June 30, 2001, the Company completed the following debt and equity transactions:

During March and April 2001, the Company completed the issuance of convertible debentures aggregating $825,500, bearing interest at a rate of 8% per annum and convertible into the common stock of the Company at a conversion ratio of $1.25 per share. The convertible debentures are due October 15, 2001. During the period debentures aggregating $102,500 had been converted into common stock.

During April 2001, the Company completed a private placement of common stock aggregating $780,000 at a price of $2.00 per share. In addition UltraCard Inc. received proceeds pursuant to a subscription agreement aggregating $175,000 for the sale of common stock at a price of $7.00 per share.

During the month of June 2001, the Company borrowed a further $450,000 from existing shareholders pursuant to certain 30 day note agreements. Interest and penalties are required under the terms of the notes payable every 30 days comprised of 10% interest, 10% payable in share capital and warrants equal to 32.5% of the loan value at a current market strike price. In addition, as a cost of the financing, the Company granted a $50,000 note payable, 50,000 shares, and warrants entitling the holder to purchase 162,500 shares of common stock at $2.00 per share. The warrants are exercisable immediately and expire five years from the date of grant.

During June 2001, the Company completed a further issuance of convertible debentures aggregating $239,685, bearing interest at a rate of 8% per annum and convertible into the common stock of the Company at a conversion ratio of $1.50 per share. The convertible debentures are due October 15, 2001.

During the quarter ended June 30, 2001, additional bridge loans aggregating $354,675 were provided to the Company by shareholders, resulting in aggregate bridge loans of $436,859. These bridge loans are to be settled through the issuance of common stock, on terms to be determined.

In May and June 2001, the Company issued 29,433 and 115,606 shares of its common stock at $1.00 and $1.73 per share upon conversion of debentures.

Subsequent to the period end the Company borrowed a further $1.1 million from a related party. The loan is subject to 10% interest along with convertibility provisions to common stock of the Company on terms to be determined.

The Company is actively pursuing new investment into the Company. This financing may take the form of equity, convertible debentures and other types of debt.

NOTE E - ACQUISITIONS

On September 8, 2000 the Company signed an Agreement and Plan of Reorganization ("Agreement") to acquire 100% of The Pathways Group, Inc. The Company loaned operating capital to Pathways during the course of the acquisition transaction. On February 15, 2001 the Company delivered notice to The Pathways Group, Inc. terminating the merger agreement between the two companies. The balance of funds loaned to Pathways by the Company in the amount of approximately $3.4 million is collateralized by a blanket assignment over the Pathways assets. The Company is in the process of filing a claim for the recovery of the amounts loaned to Pathways. However, as of June 30,2001, the Company set up an allowance to offset advances due from Pathways due to the potential that the funds advanced may not be recoverable.

On December 11, 2000 the Company entered into a letter of intent for the acquisition of a majority position in entertainment distribution technology developer Rockster, Inc. Under the terms of the agreement, Upgrade will acquire an ownership interest of 57 percent of Rockster from the Company. The Companies are working towards the development of a definitive agreement. To date the Company has non-secured advances aggregating $950,000 to Rockster. The Company believes the advances will be recovered through the acquisition.

NOTE F - COMMITMENTS

In the prior fiscal year, a subsidiary of the Company entered into an agreement with SciVac, Inc. to build a sputtering machine as a part of its research and development activities for an amount of $3,000,000. As of June 30, 2001, the subsidiary had paid $1,200,000 and recorded a liability for the amounts billed but unpaid as of June 30, 2001 equaling $1,800,000. The sputtering machine is expected to be sold within the next fiscal year to a contract manufacturer to facilitate the production of shims used in the UltraCard. The sputtering machine is reflected as a current asset on the balance sheet of the Company.

In the prior period the Company reported the lease of a new facility in Los Angeles. The Company has expended $125,000 during the recent quarter ended June 30, 2001, on leasehold improvements towards the completion of the facility. Currently Rockster Inc. is occupying the premises.

On October 10, 1997, Ultracard licensed the rights to two technology patents from Cardtech, Inc. (Cardtech). Ultracard's president is also the controlling stockholder of Cardtech. Ultracard is required to pay Cardtech a minimum royalty fee of $650,000. Royalty fees are due on January 1 of each calender year. As of March 31, 2001, $1,300,000 for both the calendar year 2000 and 2001 royalty fees remained unpaid, causing Ultracard to be past due on the agreement. Cardtech has deferred the required 2000 and 2001 payments to September 30, 2001. In consideration for the deferral, Ultracard has granted a patent mortgage to Cardtech on all its intellectual properties.

ITEM 2. MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Certain statements contained in this Quarterly Report on Form 10-QSB, including, without limitation, statements containing the words "believes, " anticipates," "estimates," "expects," and words of similar import, constitute "forward looking statements." You should not place undue reliance on these forward- looking statements. Our actual results could differ materially from those anticipated in these forward- looking statements for many reasons, including the risks faced by us described in this Quarterly Report and in other documents we file with the Securities and Exchange Commission.

Net losses aggregated $22.2 million in the first nine months of the current fiscal year ending June 30, 2001 compared with an $11.8 million net loss for the corresponding period of the prior fiscal year. This increase in net loss reflects a continued and growing level of investment into the Companies technology, production processes and the development of commercialization of the Companies core technology. Research and development expenditures more than doubled in the current fiscal year compared to the prior year, comprising a large part of the increased expenditures as the Company nears the completion of a production ready product.

In the preceding quarter the Company announced that it had terminated the merger agreement with Pathways. Advances of $3.4 million dollars have been made to Pathways by the Company as of June 30, 2001. The Company has collateralized the amounts due from Pathways by way of a general security over the Pathways assets. The collectability of the amounts due from Pathways are potentially unrecoverable and accordingly the Company has provided an allowance for collection of the amount due in the quarter ended June 30, 2001. The Company plans to actively pursue collections.

The Company has been able to reduce its general and administrative costs by $2.85 million compared to the corresponding 3-month period in the prior fiscal year. This reduction is comprised of lower legal costs, and reduced compensation components related to key employee warrant issuances. The Company has experienced significantly higher interest expense as a result of debt financing entered into during the current and past quarter. UltraCard Inc. has again increased its research and development expenditures by $0.8 million over the corresponding prior period in a concentrated effort to complete a commercialized version of its high memory capacity UltraCard and read write device. These increasing expenditures reflect the Company's focused efforts upon completing its research and development initiatives, while at the same time, establishing production processes and specifications to facilitate the Company to engage others to produce the UltraCard and its read write device. The other significant operating subsidiary cQue (formerly Centurion) contributed only 6% of the total loss reflecting the focus of the consolidated groups efforts to complete the UltraCard technology. For the near future research and development expenditures are expected to increase to meet the Company's numerous potential market opportunities. All of the Company's research and development costs have been expensed as incurred.

In an effort to accelerate the Company's market penetration with the UltraCard and related products, and in order to augment internally developed research and development initiatives, the Company will license technology from other businesses, engage others to develop components and/or acquire other businesses as an alternative to internal research and development and marketing efforts. The marketplace is beginning to recognize the UltraCard as a leader and superior product in the smart card industry and management are focused upon accelerating the Companies access to this multi-billion dollar marketplace.

Sales and marketing expenditures have increased by approximately $161,000 as compared to the nine month period ended June 30, 2000, as the Company nears completion of UltraCard's products. Sales and marketing expenditures are

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associated with the Company's attendance at trade shows and industry awareness programs as the Company builds market awareness to establish and develop new markets and prepare for effective product launches for products which are nearing the first phase of completion.

LIQUIDITY AND CAPITAL RESOURCES

Cash and equivalents were approximately $108,000 at June 30, 2001. The Company is managing tight cash flows in providing funding for an aggressive research and development program at UltraCard while developing acquisitions in the software development area of business. Cash flows from financing activities of $ 11.4 million in the current period represents a 34 % increase in the capital raised in the corresponding period of the preceding year. In light of the more restrictive financial conditions at the current time this fact speaks well for the Companies ability to manage and continue to grow through economic downturns. The proceeds were used as to operations $8.4 million, with the balance of $ 3.2 million allocated to investing activities for acquisitions in process of Rockster Inc. and the development of the UltraCard, Upgrade and Rockster facilities.

The Company has experienced a significant increase in its current liabilities, increasing from $6.5 million in September 2000 to $11.5 million as at June 30, 2001. The Company has relied upon trade creditors to extend payment terms, while it aggressively pursues equity and debt capital from sources internationally. At the date of this report, negotiations for the sale of additional debt and equity securities in amounts in excess of $50 Million dollars are underway.

In order for the Company to meet the funding requirements from its investee Companies and to meet ongoing operating requirements, it will have to raise additional financing. The Company expects that its existing and planned capital resources will be adequate to satisfy the requirements of the current and planned operations until the end of the current fiscal year. However the rate at which the Company expends its resources is variable, may be accelerated, and will depend on many factors. The Company will need to raise substantial additional capital to fund its operations and may seek such additional funding through public or private equity or debt financing, or through the licensing of its technology. There can be no assurance that such additional funding will be available on acceptable terms, if at all. The Company's continued existence as a going concern is ultimately dependent upon its ability to secure additional funding for completing and marketing its technology and the success of its future operations.

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PART II Other Information

Item 1. Legal Proceedings

Upgrade, its president, Daniel S. Bland, and Chief Operating & Financial Officer, Howard Jaffe, are defendants in The Pathways Group, Inc. v. Upgrade International Corporation et al., Superior Court of the State of California in for the County of Sonoma. The complaint, filed August 3, 2001, alleges breach of merger and collateral agreements between Upgrade and plaintiff, breach of oral argument, fraud, and negligent material misrepresentation, and seeks specific performance of the agreements, an injunction against exercising provisions pursuant to the merger agreement whereby Upgrade could obtain control of Pathways. Specifically, the complaint alleges that Upgrade failed to provide interim financing to Pathways pending consummation of the proposed merger transaction, and prevented Pathways from obtaining alternate sources of financing. Upgrade believes that the plaintiff's allegations are without legal or factual basis and intends to vigorously defend the lawsuit. Upgrade also intends to file a counterclaim against Pathways, its Board of Directors and all Executive Officers, for moneys due and owing from funds advanced, fraud in the inducement as well as other misrepresentations made by Pathways to Upgrade. As a result, upgrade recorded a provision for the advances made to Pathways in the event those amounts prove to be uncollectible.

Item 2. Changes in Securities and Use of Proceeds

During the three months ended June 30, 2001, the Company sold unregistered securities as follows:

In April, 2001, Upgrade completed a private placement offering of 175,000 shares of its common stock at a price of $4.00 per share for total proceeds of $700,000. The offer and sale of securities was made pursuant to an exemption from registration under Regulation S of the Securities Act of 1933 (the "Act"), due to the foreign nationality of the investor.

In April, 2001, Upgrade completed a private placement offering of 390,000 shares of its common stock at a price of $2.00 per share for total proceeds of $780,000. The offer and sale of securities was made pursuant to an exemption from registration under Regulation S of the Securities Act of 1933 (the "Act"), due to the foreign nationality of the investors.

In April, 2001, Upgrade completed a private placement offering of 25,000 shares of its common stock at a price of $6.00 per share for total proceeds of $150,000. The offer and sale of securities was made pursuant to an exemption from registration under Regulation S of the Act, due to the foreign nationality of the investor.

In April, 2001, Upgrade completed a private placement offering of 183,334 shares of its common stock at a price of $2.00 per share for total proceeds of $366,668. The offer and sale of securities was made pursuant to an exemption from registration under Regulation S of the Act, due to the foreign nationality of the investor.

In April, 2001, Upgrade completed a private placement offering of 41,666 shares of its common stock at a price of $2.00 per share for total proceeds of $83,332. The offer and sale of securities was made pursuant to an exemption from registration under Regulation S of the Act, due to the foreign nationality of the investor.

In April, 2001, Upgrade completed a private placement offering of 80,000 shares of its common stock at a price of $2.00 per share for total proceeds of $160,000. The offer and sale of securities was made pursuant to an exemption from registration under Regulation S of the Act, due to the foreign nationality of the investor.

In April, 2001, Upgrade completed a private placement offering of 200,000 shares of its common stock at a price of $2.50 per share for total proceeds of $500,000. The offer and sale of securities was made pursuant to an exemption from registration under Regulation S of the Act, due to the foreign nationality of the investor.

In April, 2001, Upgrade completed a private placement offering of 616,721 shares of its common stock at a price of $2.00 per share for total proceeds of $1,233,442. The offer and sale of securities was made pursuant to an exemption from registration under Regulation S of the Act, due to the foreign nationality of the investor.

In April 2001, Upgrade issued a $825,500 convertible debenture that bears 8% simple interest and is due October 15, 2001. The debenture is convertible into shares of Upgrade's common stock at $1.25. The issuance was exempt under Rule 506 under and Section 4(2) of the Act.

In April, 2001, Upgrade completed a private placement offering of 80,000 shares of its common stock at a price of $2.50 per share for total proceeds of $200,000. The offer and sale was exempt under Rule 506 under and Section 4(2) of the Act.

In April, 2001, Upgrade completed a private placement offering of 205,000 shares of its common stock at a price of $2.00 per share for total proceeds of $410,000. The offer and sale was exempt under Rule 506 under and Section 4(2) of the Act.

In April, 2001, Upgrade completed a private placement offering of 375,000 shares of its common stock at a price of $2.00 per share for total proceeds of $750,000. The offer and sale was exempt under Rule 506 under and Section 4(2) of the Act.

In April, 2001, Upgrade issued 53,185 shares of its common stock for services performed. The issuance was exempt under Rule 506 under and Section 4(2) of the Act and Regulation S of the Act due to the foreign nationality of the investor.

In May, 2001, Upgrade issued 32,000 shares of its common stock at a price of $1.25 per share pursuant to the conversion of debentures. The issuance was exempt under Rule 506 under and Section 4(2) of the Act.

In May, 2001, Upgrade issued 40,000 shares of its common stock at a price of $1.25 per share pursuant to the conversion of debentures. The issuance was exempt under Rule 506 under and Section 4(2) of the Act.

In May, 2001, Upgrade issued 10,000 shares of its common stock at a price of $1.25 per share pursuant to the conversion of debentures. The issuance was exempt under Rule 506 under and Section 4(2) of the Act.

In May, 2001, Upgrade issued 29,433 shares of its common stock at a price of $1.00 per share pursuant to the conversion of debentures. As reported in the Company's Form 10-QSB for the period ended December 31, 2000, the issuance was exempt under Rule 506 under and Section 4(2) of the Act.

In June, 2001, Upgrade issued 115,606 shares of its common stock at a price of $1.74 per share pursuant to the conversion of debentures. As reported in the Company's Form 10-QSB for the period ended December 31, 2000, the issuance was exempt under Rule 506 under and Section 4(2) of the Act.

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In June 2001, Upgrade issued a $239,685 convertible debenture that bears 8% simple interest and is due October 15, 2001. The debenture is convertible into shares of Upgrade's common stock at $1.50. The issuance was exempt under Rule 506 under and Section 4(2) of the Act.

In June, 2001, Upgrade issued 50,000 shares of its common stock for loan fees. The issuance was exempt under Rule 506 under and Section 4(2) of the Act and Regulation S of the Act due to the foreign nationality of the investor.

In June, 2001, Upgrade completed a private placement offering of 15,000 shares of its common stock at a price of $2.00 per share for total proceeds of $30,000. The offer and sale of securities was made pursuant to an exemption from registration under Regulation S of the Act, due to the foreign nationality of the investor.

In June, 2001, Upgrade issued warrants to purchase 162,500 shares of its common stock at $2.00 per share. The warrants are exercisable immediately and expire five years from date of grant. The issuance was exempt under Regulation S of the Act due to the foreign nationality of the investor.

In June, 2001, Upgrade issued 50,000 shares of its common stock for at $2.70 a share for total proceeds of $135,000, in connection with the issuance of a debenture. The issuance was exempt under Rule 506 under and Section 4(2) of the Act and Regulation S of the Act due to the foreign nationality of the investor.

In June, 2001, Upgrade issued 47,490 shares of its common stock for total proceeds of $125,000 as part of a loan penalty fee. The issuance was exempt under Rule 506 under and Section 4(2) of the Act and Regulation S of the Act due to the foreign nationality of the investor.

In June, 2001, Upgrade issued 12,784 shares of its common stock at a price of $1.74 per share pursuant to the conversion of debentures, for total proceeds of $22,206. The issuance was exempt under Rule 506 under and Section 4(2) of the Act and Regulation S of the Act due to the foreign nationality of the investor.

Item 6. Exhibits

Exhibit No.	Description

Upgrade International Corporation

Date: August 19, 2001

/s/ Daniel Bland

Daniel Bland, President and Chief Executive Officer, and Secretary

Date: August 19, 2001

/s/ Howard A. Jaffe

Howard A. Jaffe, Chief Operating and Financial Officer